ECMI-CEPS Seminar
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Investor Protection Under MiFID II: A step too far or a golden opportunity?

SUMMARY

By broadening the reach of the regulatory framework to the full product and service cycle, MiFID II emphasises the role of product governance (manufacturing and distribution) and the product intervention in preventing harmful products from reaching the market. The main conclusion drawn from participants at this CEPS-ECMI half-day seminar is that despite recent progress, such as the European MiFID Template (EMT, which is expected to standardise the information shared between product manufacturers and distributors) and ESMA's latest guidelines for the Target Market identification, further work and clarification are needed. The research reforms in MiFID II involve significant challenges for firms (particularly in relation to fixed income, commodity and currency research). Concerns were expressed by seminar participants about the ability to pay for research outside of the EU (e.g. in the US), and the danger of having a mechanism for research payment that will be overly prescriptive. The regulatory patchwork (PRIIPS, MiFID II, IDD and other national legislation) creates contradictions that may inhibit the enhancement of investor protection. There is thus an important coordinating role for ESMA (together with national competent authorities) in strengthening the monitoring of financial markets and the development of appropriate tools for doing so. Certainly, more regulatory convergence between member states, and regulatory initiatives within states, would contribute to a more uniform approach.

Keynote address: Danny Busch, Chair of Financial Law, University of Nijmegen

In recent years some of the financial products sold have not been in the interest of the client (e.g. massive miss-selling of interest rate swaps to SMEs in Germany, Italy, the Netherlands and the UK). Therefore, extensive consideration has been given under MiFID II to ways of preventing harmful products from reaching the market, in the form of a mandatory product approval process (product governance) and a power for national competent authorities (NCAs) and the European supervisors (ESMA and EBA) to remove harmful products from the market (product intervention). However, both product governance and product intervention must be interpreted broadly. For example, the manufacturing of products encompasses not only the creation, development, issuance and/or design of financial instruments, but also the advice of corporate issuers on the launch of new financial instruments. Similarly, the product governance rules for distributors apply irrespective of the type of service provided and of the requirements applicable at the point of sale.

The "Target Market" identification is crucial within the MiFID II product governance regime. After a strong demand from the industry for clarification on how the new requirement of the Target Market assessment should be interpreted and applied, ESMA responded in June with the issuance of a set of guidelines for manufacturers and distributors to define the Target Market of their products. An additional complication is that the manufacturer should propose the type of investment service through which the targeted clients should or could acquire the financial instrument (distribution strategy). If the product is deemed appropriate for a sale without advice, the firm should also specify the preferred acquisition channel (face-to-face, via telephone, online) and the design of the acquisition channel, if relevant. According to ESMA's guidelines, however, even though the client would not be within the targeted market for a given product, the advisor may under conditions recommend it for diversification purposes. Hence, it needs to be compliant with the MiFID suitability requirements and in particular the client's investment objectives.

It would be naïve to think that the product governance rules are watertight and guarantee that harmful products will avoid miss-selling in all conditions. Therefore, MiFID II introduces and enforces *ex-post* product intervention provisions in addition to the *ex-ante* product governance rules. As for the scope of the

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product governance and intervention rules, it should be noted that the rules apply to investment firms and banks, Undertakings for Collective Investment in Transferable Securities (UCITS) and Alternative Investment Fund (AIF) managers, as well as to ordinary banks that sell and advise on structured deposits. But further clarification is needed on whether or not UCITS management companies and AIFs managers, which do not provide investment services, are subject to product governance rules. ESMA has rightly stated that it would be preferable for the UCITS and AIFM Directives to be amended in such a way that these managers are subject to the product governance rules under MiFID II. ESMA recently raised similar concerns regarding the scope of the MiFIR product intervention rules. The adoption of the Commission proposal on the modernisation of the ESAs, which was published in September, includes a proposal that should close this gap in the scope of the MiFIR product intervention rules.

Both the product governance and product intervention rules are far-reaching in the protection offered to investors. The product governance rules are likely to entail higher compliance costs for the firms concerned. The internal procedures that must be put in place require a considerable exchange of information between the firm that manufactures a product and the firm that distributes it. However, these extra costs (which will undoubtedly be discounted in the cost price) are acceptable, in relation to the social costs caused by marketing harmful products. The new intrusive rules are not necessarily leading to less choice for investors, but should lead to less complex basic products. Finally, it should be noted that product governance and intervention rules do not function in isolation, since there are in most jurisdictions many other tools enhancing investor protection (e.g. financial literacy and education, private litigation, settling disputes, ban on advertising risky products, etc.)

Product governance and product intervention

To prevent harmful products from reaching the market or from reaching unsuitable clients, MiFID II introduces mandatory ex-ante and ex-post product-approval processes. On the one hand, product-governance rules apply to investment firms, banks and UCITS and AIF managers that provide investment services and assign certain responsibilities to both manufacturers and distributors of products. On the other hand, product intervention empowers NCAs, ESMA and EBA to prohibit or restrict the marketing, distribution or sale of certain product(s).

- *What obligations must manufacturers and distributors meet? What is the likely impact on UCITS and AIF managers?*
- *What exactly are the target investors' "needs", and which criteria should be used to identify the underlying target market (e.g. for funds sold via multiple platforms or multiple distribution channels)?*
- *Which systems and checks should a firm implement in order to define the profile of a potential client?*

Andreas Stepnitzka: MiFID II's new Target Market requirements are a certain catalyst for many changes in the European distribution landscape. The wide-ranging new product governance requirements also indirectly capture asset managers, as they need to provide distributors with additional data on a product's Target Market. This is important to note as asset managers already are complying with their own product governance requirements through the UCITS or AIFM Directives. Nevertheless, as distributors will have many different types of products from many product providers "sitting on their shelf", the real challenge is to exchange this information in a way that is machine readable. Therefore, standardisation is key. Over the past few months, EFAMA has developed – together with other stakeholders in MiFID – such a standardised data template (the "European MiFID Template" - EMT) that is meant to provide all necessary information in such a common format. While other initiatives exist, this is the only truly pan-European initiative, which should help product manufacturers and distributors to sell their products on a cross-country basis. The aim is to provide distributors with all the information they need to continue selling funds and other investment products.

Michele Leoncelli: With MiFID II, producers of investment vehicles need to identify positive and negative Target Markets for each product and communicate them to distributors, who will then translate them into the known characteristics of their clientele, the effective Target Market, and subsequently use it to guide distribution. This product governance requirement is now being embedded into a variety of existing suitability and advisory approaches. Although the first draft taxonomies, such as the EMT are already provided to producers, the actual Target Market definitions have not been made available. This renders implementation difficult at this stage, as distributors are uncertain about the best strategy for translating potential Target Markets from producers into the effective Target Markets expressed in terms of their own specific client profiles. In the context of the portfolio approach, with diversification as a key consideration, it is the negative Target Market restriction that is of particular interest. Translations into effective Target Markets, along with their definition for products without MiFID producers, are likely to be an arduous task, and with just two months to go before the deadline and no data, distributors do not yet have a clear view about how time-consuming they will turn out to be.

Joris Lauwers: The EMT gives clear guidance to manufacturers and UCITS or AIF management companies on how to classify funds, and serves as a bridge between product manufacturers that are in general product-focused and distributors that are more client-focused. But for other types of products it remains hard to apply the same logic. For example, what exactly does capital preservation mean? How does it differ from capital protection? How can leverage be quantified and measured? Another topic that deserves attention is risk assessment. In Target Markets, ESMA requires for firms to either use the Packaged Retail and Insurance based Investment Products Summary Risk Indicator (PRIIPs SRI) or the UCITS Synthetic Risk and Reward Indicator (SSRI). While both score risk on a scale from 1 to 7, they do it in different ways leading to different results. Hence, a typical equity fund has a PRIIPS SIR of 4 and a UCITS SRRI of 5 or 6. An issue that has received scant attention to date is the question of home currency versus product currency. A product that offers capital protection in Czech corona is, for example, not useful for an investor in the eurozone. Lastly, the regulatory patchwork formed by European legislation such as PRIIPS, MiFID II and IDD (Insurance Distribution Directive) and national legislation creates contradictions that may inhibit the enhancement of investor protection, such as for example the different notions for calculating costs and for complex products. More regulatory convergence between member states and regulatory initiatives within states would contribute to a more uniform approach.

Salvatore Gnoni: MiFIR introduced product intervention requirements at the EU level. MiFID II responds to the shortcoming emerged in the application of MiFID I by broadening the reach of the regulatory framework to the full product and service cycle, emphasising the role of product governance and by providing supervisors with new intervention powers. For the first time NCAs and ESAs have the power to prohibit or restrict products (or intervene on a precautionary basis) based on: i) the marketing, distribution or sale of certain financial instruments and structured deposits or financial instruments with certain features or ii) certain financial activities or practices. Moreover, the picture has been completed by the PRIIPs Regulation, which has given similar power to EIOPA for insurance-based investment products. A number of conditions have to be complied in order to exercise these powers, including the identification of a significant investors protection concern to be addressed, the lack of EU regulatory requirements, as well as the lack of action by NCAs to adequately address a threat. Having said that, the most notable difference between NCAs' powers and ESMA's powers concerns the length of the effect of the intervention. While ESMA intervention cannot exceed three months (with the possibility to renew the measures), NCAs' intervention measures can either be permanent or temporary. Furthermore, there is an important coordination role for ESMA vis-à-vis national measures. ESMA has to assess whether action taken by NCAs is justified and proportionate and that, where appropriate, a consistent approach is taken by NCAs. ESMA will continue strengthening the monitoring of financial markets and the development of appropriate tools for doing so.

Disclosure of inducements, independent advice and obligations for buy- and sell-side firms

Under MiFID I, an investment firm must act honestly, fairly, and professionally in accordance with the best interests of its clients. Under MiFID II, the rules have been further restricted and it is now important to determine which type of investment service is being provided when analysing the inducement requirements (e.g. investment advice on an independent basis and portfolio management, other investment services or ancillary services). In addition, buy- and sell-side firms need to make explicit payments for investment research to demonstrate that they are not being induced to trade. This will require firms to put systems in place for managing unbundled payments for execution and advisory services, developing a taxonomy of services that are categorised as research and pricing models for these services.

- *What are the risks and benefits associated with the different types of financial advice (independent and non-independent, face-to-face and automated), and what internal processes must a firm put in place when providing investment advice on an independent basis?*
- *Who will pay for the research – the firm or the investor? How will the unbundling of research/trading costs impact the business model of buy- and sell-side firms?*
- *Can a single research payment account (RPA) be used to manage separate research budgets or should RPAs be treated as client money accounts? What will be the impact on execution rates as full-service rates are unbundled?*

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Danny Busch: Unlike MiFID I, MiFID II draws a distinction between independent and non-independent advice. Firms providing investment advice on an independent basis must define and implement a selection process to assess and compare a sufficient range of financial products available on the market. Moreover, when providing advice, the firm must give the client the following information: i) whether the advice is provided on an independent or non-independent basis, as well as the type and nature of the restrictions that apply, such as the prohibition to receive and retain inducements; ii) whether the advice is based on a broad or more restricted analysis of financial products, in particular whether the range is limited to financial products issued or provided by entities having close links with the firm; and iii) whether it will provide a periodic assessment of the suitability of the financial products recommended.

The idea behind rules on inducements is to prevent conflicts of interest where an investment firm allows itself to be swayed by interests other than the client's interests (e.g. its own interests). While MiFID I already contains such rules specifying acceptable ways in which investment firms pay or are paid for their services, these have been tightened under MiFID II – especially in relation to independent investment advice and portfolio management. It is expected that the new rules will change the most common business models in the financial services industry. For example, a distribution fee (a payment that a portfolio manager receives from the manager of a collective investment scheme for making available its 'distribution channel'), may mean that shares or units in collective investment schemes are included by the portfolio manager in investment portfolios of clients only if the manager receives an attractive distribution fee. Such investments are not necessarily the best choice for the client. Under MiFID I, the fees of this kind do not appear to be prohibited outright, whereas under MiFID II distribution fees paid to an independent investment adviser or portfolio manager are prohibited when the advisor or manager concerned does not remit the payment to the client.

Turning to research rules, MiFID II poses real challenges to the industry. Research has value to investment firms, but it is in general regarded as an inducement if provided free of charge or at a discount under MiFID II, with two exceptions. In the first instance, the research is paid by the investment firm out of own resources. In the second case, the research is paid by the investment firm using money from the client, but it must follow strict rules, including: i) using a separate research account, ii) a specific research charge to the client, iii) regular assessments of the quality of the research, iv) setting of research budgets, v) provision of overviews to regulators, vi) drawing up a policy and vii) several requirements safeguarding the transparency towards clients. Overall, this is the opposite of what the industry is looking for, a mechanism that is overly prescriptive in payments for research.

In addition, the new rules on research have also an impact on sell-side firms. First, they must show that their research has true added value for the buy side, and second, they must provide the buy side unbundled costs of trading (i.e. separately identifying and charging for execution, research and other advisory services). Furthermore, and besides the exceptions under which research does not qualify as an inducement, research can also qualify as a minor non-monetary benefit (e.g. short-term market commentary, company results and information on upcoming events). However, substantive analysis, or substantiated opinions or any other research to which valuable resources are allocated, should not be considered as minor non-monetary benefits.

In conclusion, only time will tell whether the package of measures under MiFID II will have the desired effect and allow the right balance to be struck between costs and benefits. Properly regulating the financial services industry is no easy matter. Regulation should be neither unduly strict nor unduly lenient. Nor should it be unduly vague at the expense of legal certainty or excessively detailed at the expense of flexibility. Nevertheless, the question arises of whether compliance with the flood of new regulatory provisions is even possible. The regulatory compliance burden is starting to become a problem for the financial services industry.

Stephen Hanks: Whilst the details of the new conduct rules in MiFID II are important, the starting point for investment firms in dealing with clients must always be the principle of acting honestly, fairly and professionally in the best interests of the client. The UK experience of distinguishing between 'independent' investment advice and what is called 'restricted' advice has been positive. It provides clients with a broad way of distinguishing between the different types of service offered. The UK has also gone beyond the requirements in MiFID II by prohibiting inducements for restricted and independent advisers. However, these investment advice labels are no substitute for being thorough in collecting information from clients about their knowledge, circumstances and investment objectives; correctly assessing a client's attitude to risk and selecting products that meet his/her needs at a low cost. This requires judgement on the part of firms and supervisors.

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The research reforms in MiFID II involve significant change for firms, particularly in relation to fixed income, commodity and currency research. Many large asset management firms in the UK are opting to pay for research themselves rather than charge clients, but there will probably be a significant number of firms who do charge clients. The process of price discovery is still ongoing with signs that prices have now fallen from the initially proposed levels. The ability to pay for research outside of the EU, particularly in the US, remains a concern for firms. But based on public statements, the Securities and Exchange Commission (SEC) and the European Commission are working towards a resolution that would work from the perspective of both the US and the EU. Importantly, the introduction of the rules on 3 January 2018 will not be the end point for the impact of these changes. Asset managers and providers of research are likely to continue to revise their approach as more information becomes available about how others have implemented the rules.

Michele Leoncelli: Presently, there are few strong incentives for non-independent firms to diversify their service model to an independent one. One of the main benefits of this transition is the ability to build reputation as the firm will be able to approach a client as an independent advisor. Firms that provide non-independent advice will add a small end-up score disclaimer within the contract and the recommendation report, whereas independent advisor firms must assume additional organisational burdens and develop different organisational structures to support their business model. What is often observed in Italy, is that advisory firms with various models of service (both independent and non-independent) decide to state to clients that they are non-independent (even if these advisors do not get an inducement from the manufacturer). This is in order to avoid certain organizational requirements of independent models. Another important issue is the quality of the service that non-independent firms must provide in order to receive inducements from manufacturers. The precise standard of quality is not clear and would most likely be the topic of future discussion. It should be noted, however, that MiFID II presents a golden opportunity for Fintech and service providers. One can expect that the quality of services offered to final investors will be enhanced over the coming years and that new segments and new advisory models will emerge.

This is was the third and final event organised by ECMI on the topic of "Getting ready for the implementation of MiFID II/MiFIR". All three events look at the readiness of market players and the supervisory community to comply with the provisions set out in the new legislative framework. The first seminar focused on "Unravelling Ariadne's MiFID II Thread: Pre- and post-trade transparency for non-equity markets" (6th April); the second on "Drowning in MiFID II Data: publication arrangements, consolidation and reporting" (28th June).

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