ECMI Commentary

No. 47 / 24 January 2018

EUROPEAN CAPITAL MARKETS INSTITUTE

MiFID II will profoundly affect the portfolio management business

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The first indications to emerge from the impact of MiFID II, following its implementation on 3 January 2018, suggest that … more time is needed. The breadth, complexity and detail of the issues covered in the revamped version of the Markets in Financial Instruments Directive meant that even the delay of one additional year in its implementation was not sufficient to adequately prepare supervisors and operators for the challenges. Judging by the last-minute Q&A updates and guidance issued by ESMA (European Markets and Securities Authority) immediately before the deadline, market participants still required clarification on many details. This process can be expected to continue for some time (see e.g. ESMA, 2017). Changes to the portfolio management business, apply right away and may also require further guidance.[1] But at least the process has started, and it is far-reaching.

With MiFID II, one of the last sets of post-crisis measures has come into force, tackling conflicts of interest in asset management and investment advice, improving transparency in the price formation process of securities and derivatives, and requiring extensive data reporting to markets and supervisors. But how is the new measure preparing operators to meet the new challenges in the market, e.g. digitalisation, robo-advice and blockchain, or how will these developments be impacted? The previous financial market measures had wide-ranging impact: the 1994 Investment Services Directive (ISD) allowed for remote access to exchanges in the EU,

[1] These matters were discussed at an ECMI seminar on Unbundling Investment Research under MiFID II: How to balance price, allocation and quality, 17 January 2018 at CEPS, Brussels.

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and thus interconnectedness between markets, and its successor, the 2004 MiFID, ended the monopoly of exchanges and forced equity markets to have ultra-fast and competitive matching systems, which lowered spreads.

The initial response, as reflected in new demands for additional delays in implementation for derivatives markets and the monitoring of dark trading in equity markets, highlight the complexity of the measure. Indeed, in terms of length, including the level-2 measures, MiFID II is now at least 25 times longer than the ISD, or 5 times longer than MIFID I (Lannoo, 2017). In terms of content, it now covers *in extenso* the conduct of business for all financial market operators and almost all products handled in these markets. In contrast, the 1994 ISD was restricted to equity markets and contained only some very basic conduct-of-business requirements for brokers and investment advisers. These were extended in MiFID I, but apparently required more detail to be enforceable.

With MiFID II, significant changes can be expected affecting the structure of the portfolio management industry, the products that can be offered to retail investors and the way in which they can be offered, the transparency of non-equity markets, and market behaviour in general. Moreover, it can be expected that the securities market structure will be further affected by the possibility to create new platforms, through organised trading facilities (OTFs) or discretionary trading platforms. The process for obtaining a waiver for off-market trading was made more difficult, but the choice of platforms was increased.

On the **portfolio management** side, the most widely debated and controversial change introduced by MiFID II is the requirement imposed on asset management entities to pay for research only from their own resources. They need to create a separate research payment account (RPA) to hold the payments made by their clients for funding research or absorb the cost themselves. Free research from banks or brokers can no longer be accepted, unless it is a general market commentary. This new requirement has far-reaching implications for independent asset management firms as well as for such units in large banks. A CFA survey (CFA, 2017) found that most asset management firms intend to absorb research costs rather than charge clients, which raises the questions of how this will be managed and whether it can be adequately supervised. Yet the survey findings also highlight a disparity between large and small firms, with large asset managers more likely (and more able) to absorb research costs internally than small asset managers, suggesting a competitive advantage for larger firms. Establishing and running a RPA is seen to be very complex. The intention of the new rule was to ensure independent advice, and to make progress towards an unbundling of execution services and research, thereby rendering the brokerage market more competitive. This follows on from the Myners Report (2001) and other initiatives in the UK to address conflicts of interests with institutional investors.

The unbundling raises many questions and will require a consistent interpretation, for example whether UCITS management companies fall within its scope, which is not clear at the present time. One impact of the new rules is that they will induce a more calibrated use of and payment for research. Some argue, in fact, there will be a decline in research spending, and less coverage of companies with small market capitalisation, with all that this implies for capital markets. It could also disadvantage EU firms internationally, for example as compared to US firms offering services in the EU.[2] The SEC issued a statement indicating that it would study the impact of MiFID II, but would not require unbundling within their territory, meaning that US firms can continue to fund research from commissions.

On the **retail investor** side, the conflict of interest provisions of MiFID I have been further clarified and reinforced, by requiring banks and portfolio managers to unbundle their investment advice. Investment firms need to inform clients whether their investment advice is provided on an independent basis, i.e. that it is paid for by the user.[3] Payments from third parties to sell certain financial products to clients, apart from certain "minor non-monetary benefits", are prohibited. Many investors received statements from their banks detailing these new provisions around the turn of the year. Will these new requirements accelerate the implementation of robo-advice in the EU? Many robo-advisors have entered the market, mostly based on passive investments/ETFs, but their AuM are still very small compared to traditional players (see Joint of Committee of ESAs, 2017). Existing and potential providers of robo-advice services fully comply with MiFID II, in particular the suitability assessment requirements.

On price **transparency**, MiFID extends the price transparency obligations that apply to equity markets to bonds and derivatives, but these will only come into force gradually. For bond markets, the rules will be implemented over a period of four years, depending on the results of annual liquidity testing. In practice, this means that they will apply to government bonds, which are mostly traded by professionals, but that a transparent market for corporate bonds, which are also in the hands of retail investors, still is a long ways off. On the derivatives side, several futures markets have requested an additional delay for the introduction of the rules.

Complexity has also increased in the **market structure**, with the addition of a new trading facility, the OTF. At the same time, however, the systemic internaliser (SI) regime and 'large in scale' (LIS) waiver for dark trading have been made stricter (ECMI, 2017a). In short, at one and the same time, more and less competition to the established exchanges, more new trading platforms but also more on exchange trading. In the final analysis, MiFID I brought only one real newcomer to the equity markets, namely – the trading facility BATS. It remains to seen what MiFID II can and will do, and what change OTFs will bring.

Many of these changes also require not only the private sector, but also supervisors at national and European level to introduce significant upgrades. Operational matters related to ESMA and its budget are being addressed in the ESA review, but it does not appear that these issues will

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[2] These concerns were extensively discussed at a seminar organised by ECMI on 26 September 2017 at CEPS (see ECMI, 2017c, for a report of the event).

[3] On top of that, the firm must also inform the client: i) 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 ii) whether it will provide a periodic assessment of the suitability of the financial products recommended.

be sorted out soon, despite the fact that its chairman raise them in almost every speech he delivers.

MiFID also mandates much more elaborate reporting to supervisors, but problems were also experienced here in meeting the deadline. ESMA indicated that the market data collected to date were insufficient to publish, and that the problem was due to the partial information provided by trading venues. ESMA should receive information about 30,000 instruments in the context of the double volume caps (DVC) calculation (for the transparency), but it has received complete data for approximately only 650 instruments so far, i.e. around 2% of the expected total. Over time, however, ESMA will have amassed a wealth of information, which should allow for a much better monitoring of markets.

Hence, a gradual revolution is unfolding, whose effects will be most consequential and immediate on the portfolio management side. Unbundling and the pressure this creates on costs will require further automation of investment advice, which might also facilitate compliance with many other MiFID conduct of business requirements. More broadly, the question can be raised whether MiFID II brings us closer to capital markets union (CMU). Rules have become more harmonised and investor-friendly, certainly on the conduct-of-business side, and markets will gradually become more transparent. But others will argue that the structural impact on portfolio managers will make sell-side institutions more constrained, and inhibit capital markets research.

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