

A long-exposure photograph of a city skyline at night. The image shows several tall buildings with lit windows, palm trees in the foreground, and a highway with light trails from cars. A large yellow diagonal shape is overlaid on the right side of the image.

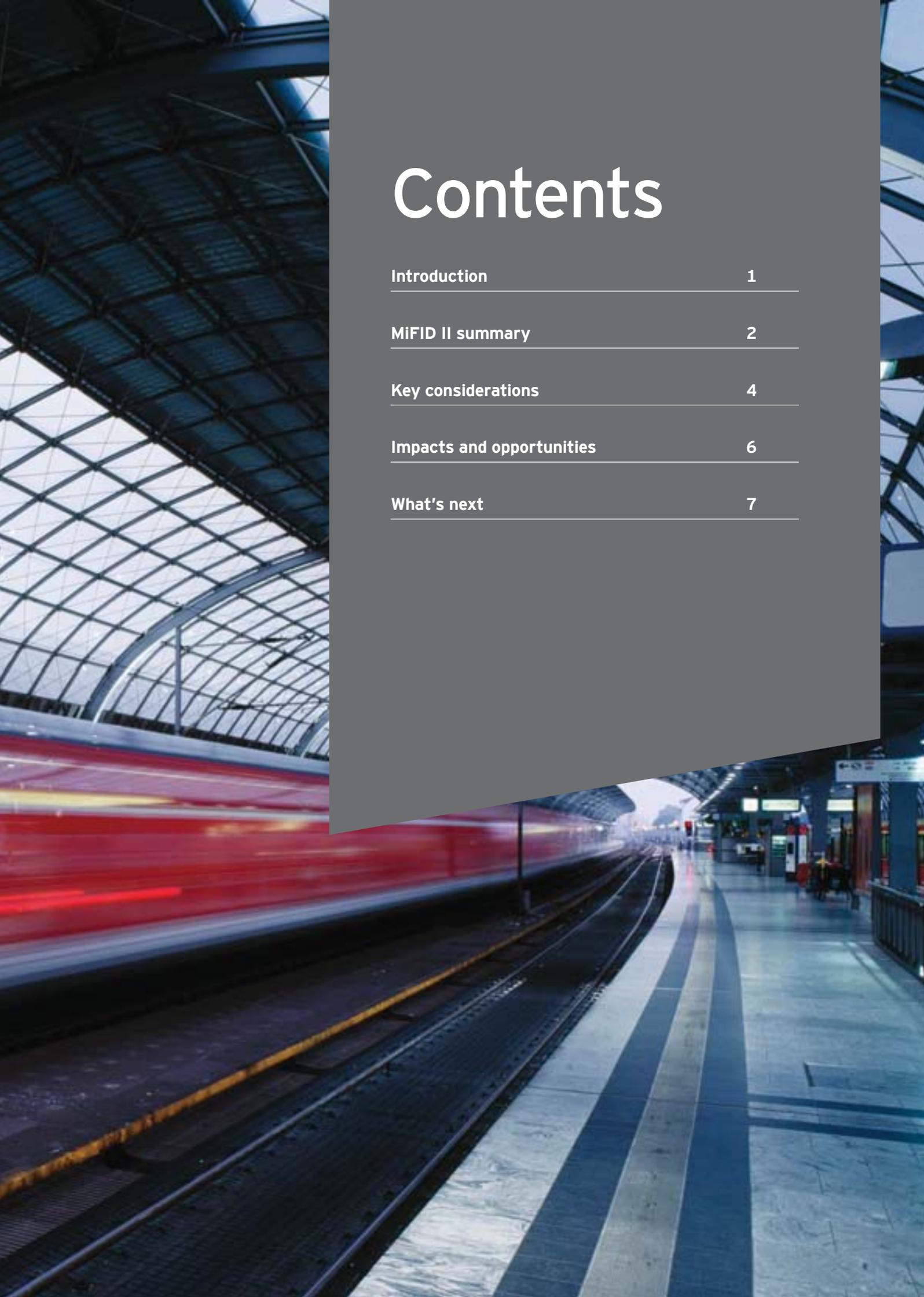
MiFID II: Time to take action Wealth & Asset Management

The EY logo, consisting of the letters 'EY' in a bold, white, sans-serif font.

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“Markets in Financial Instruments Directives (MiFID II) will bring about fundamental changes to distribution of wealth and asset management products and services in the EU. Relationships will change, and the winners will be those who adapt their strategies and have the operational capability to respond effectively to the new environment. “

Introduction

| Business implications for wealth and asset managers | |
|---|--|
| Profitability | <ul style="list-style-type: none"> ▶ Margins are likely to be put under pressure: the combination of the requirements will bring about change to products, how they are distributed, operating models across the business and pricing and cost structures. |
| Products | <ul style="list-style-type: none"> ▶ Fewer products are likely to be offered. ▶ There will be a greater focus on alignment of product and customer profiles. ▶ Model portfolios are expected to be a greater feature. |
| Distribution | <ul style="list-style-type: none"> ▶ More scrutiny is needed by providers as to how and by whom their products are distributed and how they communicate with distributors and end investors. ▶ The number of distributors is expected to fall. ▶ Platforms are likely to grow further. ▶ Independents may find distribution more challenging. ▶ Technology will open up new distribution and advice models. |
| Operating models | <ul style="list-style-type: none"> ▶ Market infrastructure changes will force operating model changes in the impacted business models. ▶ Inducement and distribution requirements, combined with technology changes, will require operational change and force new distribution models. |
| Pricing and costs | <ul style="list-style-type: none"> ▶ Greater awareness of cost base and product profitability will be required. ▶ The changes themselves will have implications for pricing and costs. |

Key issues

Those areas of particular interest to wealth and asset managers and service providers include:

Investor protection/distribution

- ▶ An EU-wide ban on independent financial advisers or discretionary portfolio managers accepting or retaining payments/inducements - effectively banning payment or retention of retrocessions or commissions to or by independent advisers or managers
- ▶ Regulatory powers to ban products – likely to lead regulators to increasingly focus on product development, oversight and targeting of products
- ▶ Enhanced provisions around suitability and appropriateness, particularly in relation to “complex” products
- ▶ Alignment of the Insurance Mediation Directive II with the investor protection provisions of MiFID II

Market structures and transparency

- ▶ Increasing requirements for formalization of internal matching and crossing systems across different financial instruments
- ▶ Limiting the volume of business that can be dealt on so-called “dark pools”

- ▶ Increased pre- and post-trade transparency around equity and non-equity markets, including the development of a consolidated tape for post-trade data
- ▶ Widening the application of the rules to a wider range of commodity derivatives and including position limits around such derivatives
- ▶ Stricter controls on algorithmic trading
- ▶ Open, non-discriminatory access to trading venues and central counterparties - vertically integrated trading venues and central counterparties (CCPs) to open up after a transition period

Governance

- ▶ Enhanced requirements around governing bodies of investment firms, including around diversity and compliance, as well as ensuring that members have sufficient time to undertake their duties

Access by third-country firms

- ▶ A harmonized regime for granting access to EU markets for firms operating from third countries, dealing with professional investors and eligible counterparties, based on equivalence assessment of third-country jurisdictions by the European Commission; where firms are dealing with retail customers, Member States may require a branch to be established in their jurisdiction

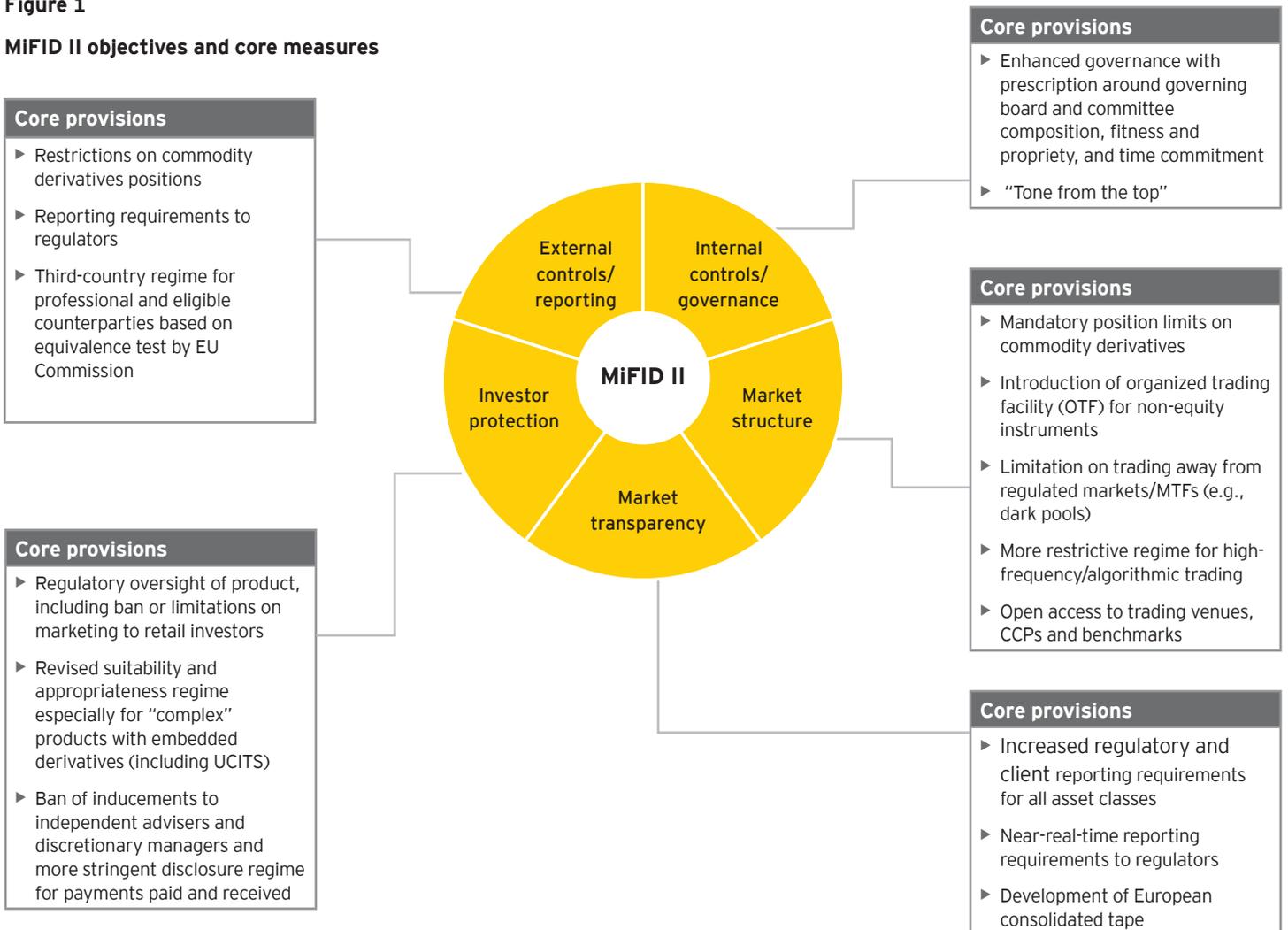
MiFID II summary

What is driving MiFID II?

Since its implementation in November 2007, MiFID has been the cornerstone of capital markets regulation in Europe. Since its inception, however, not all benefits have been fed down to the end investor as envisaged. MiFID II is aiming to address the shortcomings of the original MiFID release and respond to lessons learned during the financial crisis. The diagram below highlights the key areas of focus and core measures of MiFID II, of particular interest to wealth and asset managers.

Figure 1

MiFID II objectives and core measures



"The European regulatory reform program is fast becoming a reality that will transform the investment industry. Alongside EMIR, CRD IV, structural change and Solvency II, MiFID II is one of the key regulatory initiatives that will change the market structure and business models. Firms that manage the regulatory agenda as part of their strategic evolution and maintain flexibility will capture market opportunities that elude those that view implementation merely as a compliance task."

- John Liver, Partner, Head of Global Regulatory Reform, Ernst & Young LLP (UK)

What is the timetable for implementation?

Political agreement was reached on MiFID II in January 2014, and the European Parliament formally adopted the new rules on 15 April 2014. It was formally published in the Official Journal on 12 June 2014. Member States must introduce the necessary national rules by 3 June 2016, and these must apply from 3 January 2017.

The European Securities and Markets Authority (ESMA) is given responsibility for drafting a wide range of detailed rules (Level 2), which will be developed during the transitional period, and it will consult on these. It will then have responsibility for coordinating implementation across Member States, working with national regulatory authorities. The timing is set to coincide with the

revised Market Abuse Directive II (MAD II). It is also intended that investor protection requirements should be applied equally to insurance-based investments through the Insurance Mediation Directive (IMD II) and the Packaged Retail and Insurance based Investment Products Directive (PRIIPS).



“While much of the focus around MiFID II has been on the market structure and transparency changes, regulators at both domestic and pan-European levels are focusing on investor protection issues. It is important not to overlook the significant implications MiFID II will have in terms of how firms conduct themselves and behave towards their customers.”

- Sheila Nicoll, Senior Adviser, Ernst & Young LLP (UK)

Key considerations

The implications of the proposed changes are extensive, and questions remain around the practicality of some of the changes, which may have been subject to political compromise in order for agreement to be reached. Considerable further discussion and consideration of the impact on wealth and asset managers are likely to be required as ESMA draws up detailed requirements and as the market seeks practical ways of complying with the new requirements.

Some aspects of MiFID II will be in the form of a Regulation (MiFIR), which provides for maximum harmonization across the EU and which has a direct effect, with limited scope for national discretions, derogations or divergent interpretations. Other aspects will be in the form of a directive, which Member States implement in national law and where there may be more scope for different approaches.

Outlined below are some of the provisions that are particularly in the spotlight.

Investor protection/distribution

Member States across the EU are increasingly introducing initiatives to provide better protection to investors, particularly retail customers. There is increasing coordination, as ESMA and the other two European Supervisory Authorities (EIOPA, which covers insurance and occupational pensions, and EBA, which covers banking) work to fulfill their obligations to promote transparency, simplicity and fairness in the market for consumer financial products or services across the EU. MiFID II introduces a number of specific provisions, many of which extend rules that have been developed by different national regulatory authorities to a wider market. National differences are, however, likely to remain in a number of areas given the different structures of the retail markets in different Member States.

Below, we outline the most significant investor protection changes in MiFID II.

One area of controversy has been around the extent to which the MiFID conduct rules and investor protection provisions should apply to insurance-based investment products. There is a recognition that the investor protection measures should apply equally to such products, with a commitment to set out detailed requirements in the review of the Insurance Mediation Directive and that ESMA and EIOPA should work together to achieve as much consistency as possible.

Those giving investment advice will be required to detail how the advice will meet the client's objective, show whether they will provide an ongoing assessment of suitability, and indicate whether the advice is provided on the basis of a broad or restricted analysis of the market and range of financial products. If an adviser wishes to describe itself as “independent,” it will need to “assess a

sufficiently wide range of instruments” from a range of providers, not just the firm's own products. Equally, if an adviser offers products that have close links to the firm, these links will have to be disclosed at an early stage.

There has been confirmation that there will be a ban on independent advisers and discretionary portfolio managers receiving or retaining payments/inducements, effectively banning the payment of retrocessions or commissions to independent financial advisers, including non-monetary benefits.

Member States will be allowed to go beyond the requirements of the directive, which means that countries like the UK and the Netherlands, which have already applied a wider ban than is provided for in the directive, will be able to continue to do so.

Wealth and asset managers and advisers, including vertically integrated ones, will be affected by the increased disclosure requirements to clients: at least one a year, not just at the point of investment, clients must be told of the total aggregated costs and charges, including for “ancillary” services and the cost of the advice. While an itemized breakdown of those costs and charges does not have to be given to the client, it must be available on request.

The rules around suitability and appropriateness are being tightened up, with a narrowing down of the instruments that can be offered on an execution-only basis. There has been a particular focus on products “that make it difficult for clients to understand the risks involved,” and after some controversy UCITS with embedded derivatives will fall into the “complex” category and be capable of being offered only on an advised basis. A requirement for a suitability report is also being introduced.

Member States are given power to ban products where there are threats to investor protection, integrity of the market or financial stability. A formal banning power is likely to be used very sparingly, but regulators are likely to become more interventionist around product development, governance and oversight.

The three European Supervisory Authorities have separately published a “Joint Position on Manufacturers' Oversight & Governance Processes,”¹ which gives a clear indication of thinking across all financial services products. Regulators are increasingly focusing not just on transparency of products (complexity, charging) but also on governance of product development, on whether products have value or utility, whether they have been stress tested in different market conditions, and whether they reach the target market.

¹ “EIOPA opinion on the use of a common application package for internal models,” EIOPA, <https://eiopa.europa.eu/home-news/news-details/news/eba-eiopa-and-esma-publish-joint-position-on-product-oversight-and-governance-processes/index.html>, 31 March 2014.

“The uncertainties of any proposed inducement ban will be important – whether it is introduced through MiFID II or by local regulators. For practical reasons, firms will need to decide on an entity-by-entity basis how to justify their provision of dependent or independent advice.”

- Dr. Anthony Kirby, Executive Director
Regulatory Reform and Risk Management, Ernst & Young LLP (UK)

| The questions wealth and asset managers should be asking themselves | | | |
|---|--|---|---|
| Distribution | Inducements | Third-country access | Disclosure |
| <ul style="list-style-type: none"> ▶ What are the benefits and downsides of independent advice? ▶ What is the impact on the product shelf and open architecture? ▶ How to retain distribution power? ▶ Sustainability of alternative distribution models? ▶ What should be the pricing structure for products? | <ul style="list-style-type: none"> ▶ What fees are potentially at risk, and what is the impact? ▶ Is the current distribution model fit for MiFID II? ▶ How will independent advice and the ban on inducements impact the product landscape? ▶ What is the most appropriate fee structure post MiFID II? | <ul style="list-style-type: none"> ▶ What is the impact on intercompany cross-border SLAs (including non-EU)? ▶ What is the impact on tax agreements (transfer pricing/income tax)? ▶ How is the cross-border business affected? | <ul style="list-style-type: none"> ▶ What are the implications of the more granular disclosure requirements at product level? ▶ How to comply with the detailed disclosure requirements where inducements are paid? ▶ What will be the impact on block trades? ▶ How to take advantage of enhanced transparency requirements? |

Market structure and transparency

The provisions increase equity market transparency and, for the first time in EU legislation, establish a principle of transparency for non-equity instruments, such as bonds and derivatives, broadening the pre- and post-trade transparency regimes, albeit with waivers for large orders, requests for quote and voice trading, and with some allowance for deferred publication and volume masking.

Wealth and asset managers should have more data available about market prices because trading venues will be required to make pre- and post-trade data available on a reasonable commercial basis, and a consolidated tape mechanism is to be established for post-trade data. The challenge for managers and other interested parties will be to establish and maintain systems for analysis and effective use of the ever-increasing data volumes.

The concept of an organized trading facility (OTF) has been introduced for non-equity instruments to trade on organized, multilateral trading platforms. There are limitations by the OTF operator on use of its own capital, and matched principal trading investment firms with direct access to a trading venue will be allowed to help complete orders only in illiquid sovereign debt and corporate bonds. OTF operators will have discretion over order execution. Transparency requirements will apply where the market is determined (by ESMA) to be sufficiently liquid. The detailed implications of this remain to be seen, but the overall effect will be to formalize trading in non-equity instruments. It would appear to bring greater complexity for wealth and asset managers.

Fewer trades will be capable of being passed through “dark pools” since a volume cap is introduced on the use of reference price waivers and negotiated price waivers (4% per venue and 8% EU-wide), together with a requirement for price improvement at the midpoint for the former. This resulted from a political compromise, and there are very significant questions around how it will work in practice, how thresholds will be monitored and what happens if trading is approaching to the threshold.

MiFID II aims to open up the market and introduce more competition and choice for users by establishing a harmonized EU regime for nondiscriminatory access to trading venues. After

a transition period, trading venues and central counterparties will have to allow their users to process their trades through a clearinghouse of their own choice, effectively abolishing the vertically integrated market model that exists in a number of EU Member States, notably Germany and Italy.

There are controls on high-frequency traders undertaking algorithmic trading activity, including circuit breakers and investment firms with direct electronic access to a trading venue. They will be required to have in place systems and risk controls to prevent trading that may contribute to a disorderly market or involve market abuse.

The directive requires the introduction of position limits on commodity derivatives designed to target excess speculation, with some exemptions for positions held by non-financial entities, and the scope of the directive is extended to physically settled derivative contracts (except wholesale energy products). There is also a transition period for contracts on oil and coal. ESMA is required to draw up the methodology for calculating such limits within parameters included within the directive.

Internal controls/governance

On corporate governance, a considerably strengthened regime encompasses rules on the diversity of management bodies of investment firms as well as the time commitments for members of such bodies. A “fit and proper” test is also being introduced for such members, requiring them to have knowledge, skill and experience to understand the risks of the business. ESMA is likely to be involved in drawing up more detailed requirements. Firms will also be required to have a remuneration policy that encourages responsible business conduct and fair treatment of clients and avoids conflicts of interest. ESMA is already doing work around remuneration of staff who recommend products and services to clients.

A record will need to be kept of where senior management deviates from the compliance officer’s assessment and recommendations.

Third-country access

As with all EU regulations and directives, there has been considerable discussion around the extent to which firms from countries outside the EU can access EU markets. Agreement has been reached that provides for a harmonized regime for granting such access, based on an equivalence assessment of third-country jurisdictions by the European Commission, which would include requirements around exchange of information between regulators. The regime would enable third-country firms to provide investment services and activities to professional and eligible counterparties across the EU without a place of business in the EU, subject to notification to ESMA. National regimes would continue to apply for a three-year transitional period until the European Commission has made a decision regarding equivalence. Member States would be allowed to require third-country firms dealing with retail investors to establish a branch, with MiFID II containing requirements around such a branch, including initial capital requirements, exchange of tax information and membership of an investor compensation scheme.

It is understood that there has been agreement that the equivalence test should not be based on a line-by-line assessment, but important questions have been raised about the practicality of multiple agreements across different jurisdictions. ESMA has, however, had some experience in this area as a result of its responsibilities under AIFMD.

The concept of reverse solicitation remains, whereby the EU regime would not apply when investment services are provided entirely at the initiative of EU clients.

Given that MiFID now seems to have established some principles around third-country access when dealing with professional and eligible counterparties, it seems entirely feasible that these would be read across to AIFMD in due course.

Impacts and opportunities

Many valuable lessons have been taken from MiFID I. These are likely to mean that the cost of MiFID II will not reach the levels of MiFID I. Much will depend on the detail of both the Level 1 text and the Level 2 requirements to be drawn up by ESMA. The cost is still likely to be substantial, given the scope, impact on business models and the need to align with other parallel regulatory developments. These cost demands, coupled with increased capital and liquidity requirements on the sell side, may drive some firms out of the market, and banks and brokers may wish to recover those costs through the pricing of products that may have an impact on wealth and asset managers and/or the performance of the portfolios they manage.

Some uncertainty on impact will remain until the detailed provisions emerge in 2015 through the publication of Level 2 text and ESMA guidance. New issues are constantly arising as the negotiations continue. For example, MiFID II now includes an amendment to AIFMD, which will enable the passporting of MiFID activities by alternative investment fund managers who are carrying out permissible MiFID activities. Equally, there may be some late changes or additions as national authorities seek to use MiFID II final negotiations as the mechanism through which to achieve Europe-wide requirements in relation to specific areas.

Business model

As a part of the drive towards greater investor protection, the market structure and transparency requirements are designed to increase competition and reduce spreads, with the long-term direction toward a transparent, higher-volume, lower-margin, more-commoditized capital market. As was seen in the equity market with MiFID I, fragmentation of liquidity across multiple venues could, however, lead to mixed results in the short term, with increased cost to access quality liquidity for the buy side. The consolidated tape provisions are generally being welcomed by wealth and asset managers in that they should help overcome some of the difficulties arising from fragmentation; however, a drive toward greater transparency may deter some investment banks from making quotes, driving liquidity away from the market and concentrating the business on a smaller number of price makers. It is not clear how the limitations on dark pools will work in practice, but they may limit the ability of wealth and asset managers to transact large trades without suffering large market impact costs. It is not clear how internal crossing networks will be affected.

“The third-country access rules arising out of MiFID II may represent an opportunity for wealth and asset managers from a non-EEA country who deal with eligible counterparties, but it remains to be seen how these requirements will work in practice.”

- Christian Soguel, Partner, Financial Services, Ernst & Young LLP (Switzerland)

“There are unknowns, but forward-looking and cost-conscious wealth and asset management firms and asset servicers should be taking an integrated approach to shaping their strategies and projects to comply with MiFID II and other proposed regulations to prevent inconsistencies, costs and duplication.”

- Uner Nabi,
Executive Director, Wealth & Asset Management Risk, Ernst & Young LLP (UK)

The ban on inducements and the increased cost disclosure requirements will require managers to consider their distribution strategies, made more complicated by the fact that national differences are likely to remain, potentially increasing the number of share classes required. It remains to be seen whether the “independence” label proves to be an attractive one. The need to be able to itemize the different elements of the total cost of business means that vertically integrated firms will need to make more of a separation between the production of the product, advice and distribution.

Depending on how the process works in practice, the third-country access provisions may allow business models to develop that involve more activity from third countries, at least when dealing with professional and eligible counterparties. The new rules do, however, seek to harmonize the organizational and conduct-of-business rules relating to branches. There is unlikely to be a standard pattern for retail clients given that Member States have discretion as to whether they will require a branch or not.

Systems, processes and controls

Many Member States are already intervening around product, but the directive will enhance the focus on this, requiring firms to have enhanced oversight over product, not just at the development stage, but also on an ongoing basis. There is likely to be further debate around the respective responsibilities of the product provider and the distributor/adviser, particularly in relation to whether a product reaches its target market and around ongoing responsibilities to ensure that the product remains suitable. Systems and processes will need to be adjusted to allow for this.

The buy side is likely to have to make significant adjustments in response to sell-side obligations in relation to the market structure changes, not only those arising from MiFID II but also from the Market Abuse Directive II (MAD II) and EMIR.

The market structure changes are likely to introduce greater complexity for managers in terms of data points and feeds.

Data and reporting

MiFID II, along with MAD II, will require adjustments and major changes in both operational arrangements, including trade and transaction reporting as well as audit trail/reference data - unique trade identifiers, counterparty and legal entity identifiers, and product identifiers. Those firms that have already invested in enhancing their data architecture across multiple asset classes will be best placed, while others will need to investigate this infrastructure as an immediate priority.

As far as record keeping and documentation is concerned, most firms have already implemented their transaction reporting capabilities to comply with MiFID I, resulting in robust record-

keeping requirements. There have, however, been several high-profile cases recently where firms were fined for misdemeanors, in certain jurisdictions, so audit trails need to be robust. MiFID II will also strengthen the treatment of client assets and money, which will necessitate further investments in data management.

What's next?

Aligning MiFID II with other regulations

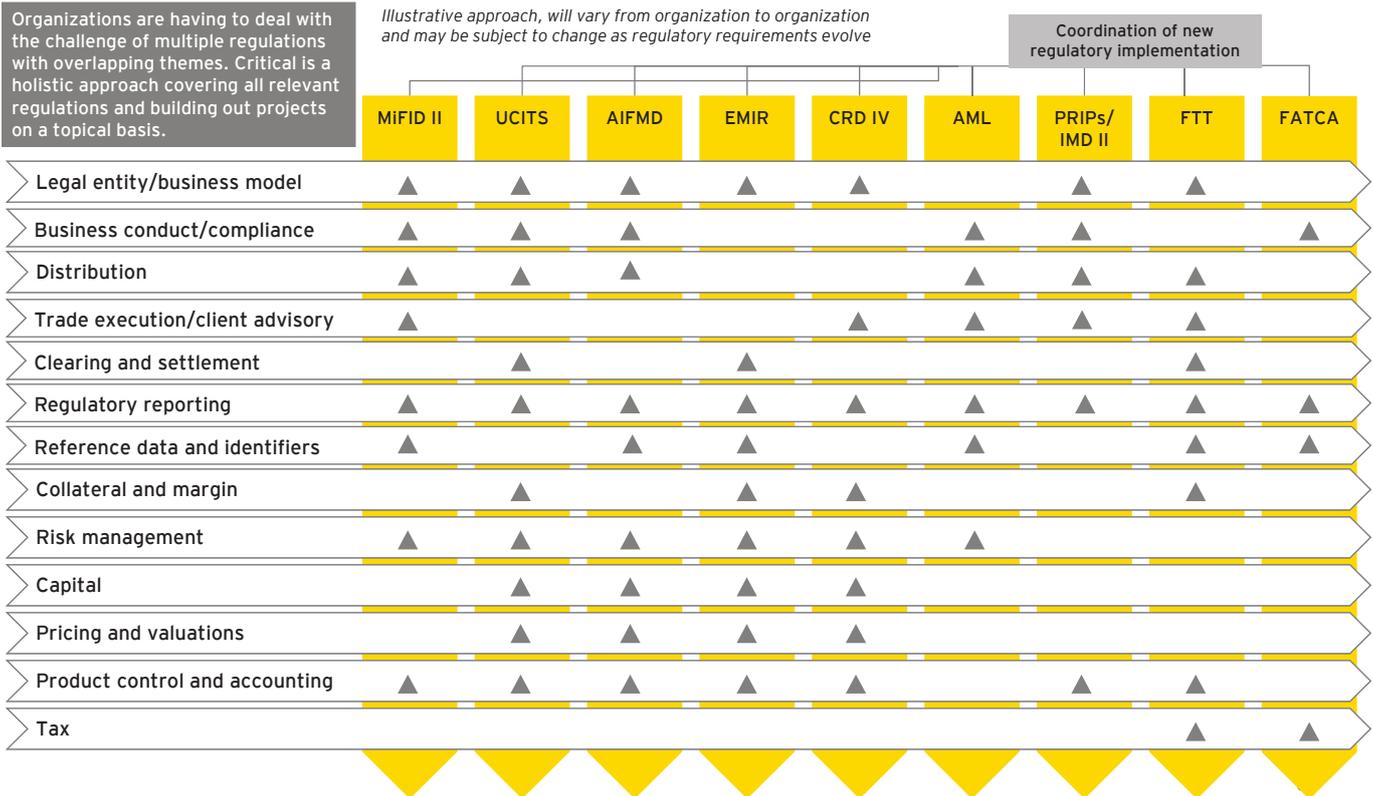
Managers are faced with an array of regulatory measures that need to be considered in conjunction with MiFID II. These include not just provisions primarily focused on investment management, such as UCITS and AIFMD, but also provisions with wider scope, such as PRIIPS and the Insurance Mediation Directive. Wider international initiatives also need to be considered, including possible implications of a Financial Transaction Tax and measures coming from other jurisdictions, such as Volcker and FATCA.

Earlier changes in national regulations will potentially interact with MiFID II. In Belgium, for instance, agreements have been reached between the regulator and banks around the limitation of the marketing of complex products, and in the UK, the Retail Distribution Review (RDR) is implementing many of the original MiFID II requirements on the ban on inducements. The Netherlands has also introduced such a ban.

With the sheer number of ongoing regulatory initiatives that overlap in key areas, it is inefficient to look at their implications independently. It is preferable to identify all relevant regulations and determine commonalities and overlapping themes. This will ensure a more cost-effective implementation of the requirements, as it reduces the duplication of work in overlapping areas.

Figure 2

Cross-regulation impact assessment



Overall priority actions

- ▶ Conduct initial impact assessment to determine significant impacts of MiFID II for your business
- ▶ Establish cross-regulatory reform agenda and ensure that MiFID II analysis is joined with other regulatory projects
- ▶ Conduct overall market impact analysis to identify suitable opportunities
- ▶ Assess MiFID II impact on revenue structure and on costs – for example, through increased controls and reporting requirements
- ▶ Confirm or amend strategy and operating models in light of the new regulatory environment
- ▶ Conduct detailed impact assessments and agree projects
- ▶ Establish a process to assess likely impact of Level 2 requirements and guidance as these emerge and to amend projects in the light of new facts as these become known
- ▶ Agree project time lines and budgets

How EY can help

EY has extensive experience in helping organizations navigate through regulatory initiatives. Our global regulatory team is a dedicated cross-functional team with extensive experience of regulatory change and deep understanding of wealth and asset management business environments and practices. Through our global knowledge in each of these areas we are able to help organizations understand the implications from strategic and operational perspectives as well as provide multidisciplinary teams at all stages of implementation projects to become compliant.

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EYG No. EH0185

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