MiFID II: what next for wealth and asset managers?
Introduction

ESMA’s MiFID II Level 2 documents issued in December 2014 comprised circa 1,600 pages and included:

1. Final Report of *ESMA’s Final Technical Advice Report* to the Commission on MiFID II and MiFIR. This was a follow-up to ESMA’s Consultation Paper, which was published on 22 May 2014

2. *Consultation Paper* on Regulatory Technical Standards (RTS) and Implementing Technical Standards (ITS). This is a follow-up to the Discussion Paper, which was published by ESMA on 22 May 2014. The Consultation Paper is supplemented by a separate document, Annex B, containing the detailed proposals. The consultation period ended on 2 March 2015. ESMA will issue a Final Report on the technical standards to the Commission in June 2015. It should be noted that a further Consultation Paper will be issued by ESMA in 2015 in relation to transparency of derivatives not covered by the current consultation.

ESMA’s Final Technical Advice Report addresses the following areas:

- Investor Protection
- Transparency
- Data publication
- Micro-structural issues
- Requirements applying to and on trading venues
- Commodity derivatives
- Portfolio compression

In addition to the above, the Consultation Paper also covers Market data reporting and post-trading issues for firms.
ESMA's Final Technical Advice Report sets out the final set of recommendations from ESMA to the European Commission taking into account industry feedback – in substance, the Final Report is largely unchanged from the May 2014 Consultation Paper and it remains to be seen whether a compromise will follow in specific areas during the EU Commission and Parliament approval stages.

Objective of the Consultation Paper was to set out the proposed technical standards and details of industry and trade associations' views on key MiFID II implications. In a number of areas, industry players have observed and commented on the practical difficulties of ESMA's proposals – for example, the definition of liquidity in relation to financial instruments. ESMA is under time pressure but fundamental issues must be addressed.

Much of the MiFID II package, including the ESMA December 2014 papers, relate to market infrastructure and transparency requirements of trading venues, and as such, these requirements largely impact the environment in which asset and wealth managers operate as opposed to being obligations on them directly. However, managers need to adapt their practices to operate in the post-MiFID II market environment and they must also address the numerous investor protection requirements and reporting requirements, which will have a direct impact of considerable significance on their businesses.

We are aware that a number of the leading wealth and asset managers in the UK have performed an initial impact analysis of MiFID II to:

- Identify changes required to their operating model based on regulatory impacts
- Identify strategic opportunities arising out of MiFID II

In order to be compliant with the coming requirements and to prepare for the broader business changes that MiFID II will bring all managers should perform a MiFID II gap analysis for their firms in the first half of 2015. Whilst there are uncertainties in some areas, many of the requirements are clear and firms need to act now in these areas in order to be able to cope with the remainder of the changes as they reach a state of clarity.

The following pages provide an overview of the key implications of MiFID II which should be mapped against the firms' current arrangements to identify gaps and opportunities:
MiFID II has set out specific requirements both in relation to product manufacturers and distributors.

Firms, who create, develop issue and/or design investment products should be considered as “manufacturers”. This includes investment firms advising corporate issuers on the launch of new securities.

“Distributor” refers to an investment firm that offers and/or recommends investment products and services to clients. In this context, “offers” has a wide application and should be read in a broad sense.

**MiFID scope manufacturers must:**

- Identify potential conflicts of interest in relation to the product
- Ensure Compliance function reviews and monitors requirements in relation to the product
- Identify target market at a sufficiently granular level
- Perform scenario analysis
- Consider the appropriateness of the charging structure
- Determine whether the product is complex
- Review the performance through the lifecycle of the product
- Provide the required relevant information to distributors
- Satisfy itself that the distributor is appropriate in relation to the end investors for whom the product was designed

**MiFID II scope distributors must:**

- Obtain all the above product information from the manufacturer irrespective of whether the manufacturer is UCITS, AIFMD or 3rd country governed
- Provide statements to the investor on suitability ahead of investment – requires greater knowledge of both the customer and the product
- Have suitable governance arrangements around which products to offer
- Provide manufacturers with sales information to enable the manufacturer to perform its lifecycle reviews

The requirements in this area may now be viewed with certainty and firms should prepare themselves accordingly. How much of a change this will require will depend on specific circumstances of firms and the geographic area of their operations, as to date some jurisdictions have applied different requirements in relation to products and their distribution.
For Wealth and Asset Managers in Europe, inducements are likely to be a significant area of impact as there are potentially implications for their distribution arrangements, costs, revenues and overall business model.

For asset managers the key impact considerations are:

- Effectively inducements may only be paid to non-independent financial advisors. Different EU jurisdictions are implementing these requirements differently, and some of the detailed local requirements will not emerge for some time
- Distribution models that will be viable in the MiFID II environment and related remuneration arrangements
- Incremental impact of MiFID II in the UK given that the RDR was applicable to future sales
- Consideration of independence of distribution firms

For wealth managers (firms offering financial planning services and personal investment management services to high net worth clients), the key impact considerations are:

- Assessment of independent or non-independent status
- Quality enhancement evidencing requirements in order to receive and retain inducements by non-independents
- Disclosure requirements
Both in Europe and globally, the practice that some portfolio trades have bundled commission rates that allowed broker commissions to be used to pay for research has been in place for many years. Under ESMA’s proposals in its Final Report, MiFID II will put an end to this practice.

The key proposed requirements are that wealth and asset managers:

► Will no longer be able to pay bundled broker commissions
► Will be able to charge portfolios directly with research costs providing a set of specific governance, process, control and client reporting requirements are met. The key requirements are:
  ► Must set a research budget
  ► Establish a framework for allocating research cost to each client
  ► Justify why those research costs are value adding to that client
  ► Provide pre and post spend research information to clients

For wealth and asset managers, the implications are:

► Governance, rigour, process and controls around research spend
► Clear expectation that brokers will price execution and research separately
► May be unable to pass some research costs to the client portfolios
► Differing rules may exist until portfolio management requirements for UCITS and AIFMD governed firms are aligned with MiFID II

Some uncertainty remains as to whether during the EU Commission and parliament approval process the ESMA proposals may be diluted. However, irrespective of that possibility, it is quite clear that as a minimum, the charging of research costs to clients is going to require considerably greater level of justification and process than has existed to date.
Although the Financial Conduct Authority (the “FCA”) currently has a strict client suitability regime in place in the UK, the MiFID II requirements have tightened the rules for firms around suitability reports, provision for periodic suitability assessments, appropriateness tests for complex products, and stricter conditions for being “independent” advisory firms. These conditions include taking account of a proportionate number of products (relevant to the product being sold) from a wide cross-section of firms who have no indirect or direct relationships with the distribution firm. Furthermore, independent firms should provide a clear rationale for recommending a certain product over others available in the market within the suitability report. This should now include product costs and charges comparisons.

The suitability and appropriateness requirements are incumbent upon distribution firms. Nevertheless, manufacturing firms will be required to provide more detailed and frequent product information to the distributors to enable distributors to carry out the necessary checks.

Execution-only businesses will be obliged to carry out the product governance obligations incumbent on distribution firms, whilst “complex products” can no longer be sold through the execution-only route. The distributing firm will need to carry out appropriateness checks on individual clients before selling them a complex product.
In line with the Packaged Retail and Insurance-based investment products (PRIIPs) Directive, MiFID II requires firms to disclose costs and charges to retail clients as a percentage and also as a monetary amount. The types of charges that should be disclosed are laid out in the Final Report. Our analysis shows that wealth and asset management firms have a fair way to go to capture, consolidate, and report to clients the detailed cost information required by MiFID II.

The items for disclosure related to financial instruments include:
- One-off charges such as distribution fees
- Ongoing charges such as management fees charged to investors
- Transaction-related costs such as broker commissions charged to funds
- Incidental costs such as performance fees

Firms should aggregate their own costs plus costs of any firms they direct clients to when providing the overall cost figure to clients for investment plus ancillary services. Third-party payments made to the investment firm should also be shown on the cost and charges statement.

Full ex-ante point of sale disclosure is required where the firm:
- Recommends or markets financial instruments to clients
- Is required to provide clients with a Key Investor Document (KID) under PRIIPs/Key Investor Information Document (KIID) under UCTIS, in relation to relevant financial instruments

Ex-ante assumptions should be reviewed on the ex-post experience and adjusted accordingly. Post-sale disclosure is applicable for all services that are in scope for ex-ante disclosure.
The ESMA Final Report has set out clear and detailed remuneration requirements for investment firms:

- Variable remuneration basis should include criteria such as quality of client service and fair treatment of clients
- Remuneration policies should be reviewed by Compliance functions
- Policies should be approved by the firm's management bodies
- Remuneration structures should be aligned to client interests to take a holistic view in terms of incentives provided to staff and consider if any incentives create a conflict of interest

CRD IV, UCITS and AIFMD have already set the tone on remuneration considerations. However, MiFID II broadens the scope of the remuneration requirements – the considerations set out above apply to all relevant persons who can have a material impact, directly or indirectly, on investment and ancillary services provided by the investment firm or on its corporate behavior. Requirements apply to staff serving both retail and professional clients.
Wealth and asset management firms can review the business impact in this area within the following themes:

- Assessing their systems capability to trade fixed income, FX, and derivatives through Regulated Markets (RMs), Multi-lateral Trading Facilities (MTFs), or Organized Trading Facilities (OTFs). OTFs are a new type of trading venue created under MiFID II.
- Assessing how they will meet the best execution regime now mandated under MiFID II across all asset classes.
- Policies and procedures changes required.

Firms that trade through dark pools and are caught under the algorithmic trading requirements will need to analyze how they monitor and record trade data and transactions, as there are a number of new threshold limits and reporting requirements introduced under MiFID II in relation to dark pools and algorithmic trading.

It is worthwhile for firms to perform a detailed analysis of their trading data stored to assess if their trading operations qualify under the revised definition of “algorithmic trading” under MiFID II.
Whilst much of the transparency requirements place reporting obligations on trading venues and Systematic Internalisers, the December Consultation Paper from ESMA provides considerable detail on the proposed transaction reporting requirements which also apply to wealth and asset managers.

The number of data fields required under the ESMA Level 2 transaction reporting requirements expands the requirement from 23 fields (currently reported) to 81 fields per executed trade. In order to meet these requirements, firms will typically need to electronically capture some new data and as a minimum consolidate information from different systems into one database for reporting on to the local regulators. As such, firms will face significant system and data implications in this area. It is crucial to recognize is that firms need to assess the gap between their existing capability and the MiFID II requirements now, if they want to be ready for the January 2017 implementation date.

Whilst firms should start preparing for the new transaction reporting requirements they should also maintain a watch over trade reporting requirements. Whilst we already know that the trade report will require asset managers to provide “flags” for individual trades, the trade reporting fields will become clear in the next six months.
MiFID II is changing the landscape of the financial services industry. Whilst it comes with the trials and tribulations of implementation, there are also new opportunities and threats to the businesses of wealth and asset management firms. An approach that includes a process for identifying and capturing the business implications, in its broadest sense, is essential to both survive and succeed in the post-MiFID II environment. In terms of preparing for regulatory compliance, it is clear that whilst uncertainties will remain in some critical areas for many months and based on the AIFMD experience, maybe years, sufficient certainty already exists in numerous areas particularly in relation to many aspects of consumer protection. Firms should work on the areas of certainty now in order to ensure that they are able to meet the tight timelines.
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