Link to Article

MiFID II challenges for Wealth Managers

WHY IS IT RELEVANT TO ME?

Simply put, MiFID II applies to any "third-country firms providing investment services or performing investment activities through the establishment of a branch in the Union".

FIRMS WITHOUT EUROPEAN UNION (EU) BASED branches are affected. The provision of investment services and/or the performance of investment activities as a regular occupation or business on a professional basis within the EU is subject to a requirement for prior authorisation by a National Competent Authority within the EU.

Even if this doesn't apply to you, when dealing with EU investment firms or considering EU investment products, the firms you will be dealing with will be subject to these requirements and will have all of the obligations in terms of data capture, retention and disclosure discussed below and will require you to cooperate to help them meet their obligations.

What is the purpose of the legislation?

While the legislation is broad and complex the major themes underpinning what the EU is trying to achieve are:

- Investor Protection
- Market Structure
- Transparency and Regulation

The scope of the legislation and the areas where it impacts can be daunting but there is one fundamental underlying consequence for firms that might simplify the approach firms take to meeting their obligations. That approach focuses on the need for more accurate and detailed record keeping across the range of areas covered by MiFID II.

A brief overview of the legislative framework

MiFID II is a complex set of legislation which has two levels at the European level. In addition, local legislation may also be created in addition to implementing legislation; for example, countries can "gold-plate" the legislation in certain areas to make it more onerous should they choose.

MiFID II contains two linked pieces of legislation (referred to as the "Level 1" legislation):

- MiFID, which has been heavily revised; and
- the Markets in Financial Instruments Regulation (MiFIR).

Level 1 legislation will be supplemented in many areas by various implementing measures (known as 'Level 2' legislation). This takes two forms:

- 'delegated acts', drafted by the European Commission (EC) based on advice from the European Securities and Markets Authority (ESMA)
- 'technical standards', drafted by ESMA and approved by the EC.

ESMA has now completed the drafting of technical standards and has advised on the proposed delegated acts. The EC is currently in the process of endorsing the technical standards and has recently adopted the delegated acts, which are now subject to scrutiny by the European Parliament and Council before coming into force.

WHAT ARE THE KEY ISSUES FOR WEALTH MANAGERS?

Independence

The requirements firms must meet to be able to say they are independent advisers are stricter. Firms wishing to advertise themselves as providing independent advice, must be able to demonstrate that they consider a 'sufficient range of products' to be able to meet a client's needs within their chosen market. This will impact on the level and detail of record keeping and documentation firms are required to maintain to be able meet this requirement, and some firms may elect not to remain as independent advisers because of the costs associated with doing so.

Costs and charges

MiFID II requires fuller disclosure of the cost of services provided and the costs of the product recommended. This requires a breakdown which includes distribution and management fees, payments to and from third parties, including broker commissions and platform fees. The costs of research, which presents wider issues, must also be addressed in this area. The drive for transparency that underpins these changes has consequences on record keeping within firms. The additional work required to separate and verify the costs involved and ensure they are accurately and consistently reported, is matched by the level of documentation required to support this activity and will test the effectiveness of systems within firms to ensure that required information can demonstratively be shown to have been provided to clients at the required time.

Once defined, clients should be provided with these fees in an aggregated form to show the customer the cumulative cost of an investment both in cash and percentage terms.

This may result in advisers and their clients paying greater attention to where assets are invested and is likely to lead to pressure from clients to drive asset flows towards more competitively priced options.

Ensuring that all relevant costs and charges are captured, correctly apportioned and capable of being reported in a timely manner will present a significant challenge for firms.

Suitability

The UK is typically further ahead than most European markets, so firms with a UK presence will be familiar with the need to meet this requirement, which focusses on a generic assessment of the suitability of the product being offered to the market or some section of it. Under MiFID II, ESMA has addressed the issue of

DISCLOSURE

Under MiFID II, the level of information to be provided to clients will be significantly greater. Articles 24 and 25 of MiFID II provide the backdrop to the requirements which are extensive and too broad to be covered here.

In short, firms are required to *"act honestly, fairly and professionally in accordance with the best interests of its clients"*.

Article 24 outlines the areas where information must be provided. There is detail within the article but also areas of ambiguity to be supplemented by ESMA. The fundamentals include:

1. Information on the *"firm and its services, the financial instruments and proposed investment strategies, execution venues and all costs and related charges."*
2. Information *"shall be provided in a comprehensible form in such a manner that clients or potential clients are reasonably able to understand the nature and risks of the investment service and of the specific type of financial instrument that is being offered and, consequently, to take investment decisions on an informed basis."*

These new requirements will have implications for both front and back office client management processes. This is likely to require upgrades to systems and processes to enable such reporting to be provided *"in good time"*.

RECORDING OF TELEPHONE CONVERSATIONS

In addition to a general requirement to keep sufficient records for MiFID II regulated businesses there is a requirement that firms record telephone conversations to ensure that there is evidence to prove:

- *"the terms of any orders given by clients and its correspondence with transactions executed by the investment firms,*
- *to detect any behaviour that may have relevance in terms of market abuse."*

The requirement represents a serious challenge to firms in that it requires that all calls and electronic communications that relate to a transaction, even those not directly involved in the transaction, must be recorded whether it is

> *"made with, sent from or received by equipment provided by the investment firm to an employee or contractor or the use of which by an employee or contractor has been accepted or permitted by the investment firm."*

This will clearly have various potential implications for firms:

- Is telephone recording permitted where we operate? If so, is two party consent required?
- What about Data Privacy issues?
- Who should be recorded?
- What should be recorded? All calls or only those that relate to MiFID II business? How do I establish which is which?
- What equipment is covered? What about personal mobile devices?
- Where should I store these recordings?
- How accessible do the stored records have to be?

The requirement is to keep recorded calls for a minimum of 5 years (and up to 7 years if requested by a relevant National Competent Authority.

Given the requirement to record all equipment provided, accepted and permitted by firms, many firms consider that banning the use of non-company equipment avoids the need to record calls made by personal equipment. This is not as straightforward as it might seem. Having a policy banning such use will only be effective if there is effective supporting effort to ensure that, despite the ban, the actual use of personal equipment does not become "accepted" by custom and practice within the firm.

Recognising that this is a significant additional obligation for firms MiFID II makes specific the need for firms to employ appropriate and proportionate resources, systems and procedures to ensure delivery of their obligations.

SOURCE MiFIID ARTICLES 24 & 25

suitability by requiring firms to:

- prescribe the content of suitability reports namely:
  - i. to outline the advice
  - ii. to set out how the recommendation is suitable for the retail client
  - iii. disadvantages and risks relating to acting on the advice
- ensure all recommendations are personalised
- bring to a retail client's attention should a periodic review be needed. Subsequent reports need only address changes (either in the client's circumstances or the financial instruments) since the previous report

Appropriateness, complex products and execution only

Product providers who offer investment products that are regarded as "complex" are required to carry out an assessment of the 'appropriateness' of a product to determine whether a customer can make an informed decision about the advantages and risks when deciding whether to purchase the product.

Clearly, the definition of "complex" is critical. This is made more complicated because certain products will contain both complex and non-complex components which firms will need to assess on a case by case basis to determine whether an appropriateness test is required. It is likely that the range of "non-complex" products will be limited. Once again, the consequence, of this change is the need for documentation to support the processes firms go through to determine "appropriateness" and the disclosures to clients regarding the affected products.

Inducements

There will be a ban on commission for independent financial advisers and discretionary investment managers wishing to remain independent. Such firms must adopt transparent fee structures. It is worth noting that some countries are pushing ESMA to ban commission for all financial advisers to secure a level playing field. As has been mentioned previously the drive for transparency merely adds to the administrative burden and will force firms into considering how they identify, assess and disclose all forms of income to clients and regulators, especially when regulators will see across sectors and be able to identify discrepancies in approach.

Summary

The challenges for firms are significant for a variety of reasons, not least is the breadth and depth of the changes being imposed. Anecdotally, firms have still to fully appreciate the additional administrative burden that will fall upon them in meeting these obligations and the likely need for enhanced systems within the firm to help capture, manage and report against those obligations.

Those firms who embrace the changes to adopt a more transparent approach can benefit from the opportunity to develop better client relationships through improved customer service.

Some firms in Europe are already changing their operating systems to take advantage of these changes, seeking to benefit both from being an early adopter and also to create momentum for change in customer behaviours. Firms that are slow to respond will find it hard playing catch up and the climate is expected to move quickly. ■