

Letter

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MiFID II: Impacts, Challenges & Opportunities

MiFID II is proving to be a significant game-changer for the European Financial Sector. Significant, because of the wide-ranging implications for different types of financial firms and for a broad scope of activities. A game-changer, as it prompts financial market actors to fundamentally reassess the client-segments they want to cover and further to re-design their offer to service these segments in a compliant and effective manner. It is important to note that, while it is clear that MiFID II will require resources for its implementation, firms should also reflect on the opportunities opened by this new regulatory framework. In our analysis, we will focus on the impacts on Luxembourg Fund Managers, and their Service Providers, notably Depositary Banks.

> MiFID II, a regulation with significant impacts

In 2014, the EU Markets in Financial Instruments II Directive (MiFID II 2014/65/EU) and the Markets in Financial Instruments Regulation (MiFIR 600/2014) were adopted.

While the new regime is scheduled to go live in January 2017, in an uncommon move, the European Securities and Markets Agency (ESMA) stated in it's European Parliament hearing in November 2015, that it considers this "calendar ... unfeasible" and expects significant delays. This ESMA statement points towards the complexity in applying MiFID II as well as the far-reaching impacts of the directive. A fact also reflected by the over 100 implementing measures, encompassing thousands of pages, drafted by EU regulators. And there is more expected in 2016...

The evolution towards MiFID II reflects the paradigm shift in financial regulation post the 2008 Financial Crisis and endeavors to tackle shortcomings of the original directive. MiFID II clearly broadens the regulatory scope and will transform Business as well as Operating Models because it takes a transversal approach, covers many more functions within a given organization and encompasses more activities along the value chain.

Another layer of complexity is added by the need to align MiFID II with other financial regulations in order to ensure a congruent and efficient implementation.

With total EU-wide estimated implementation costs ranging from EUR 500 to EUR 700 million plus ongoing annual costs between EUR 300 and EUR 500 million, the Luxembourg Financial Sector that is tilted towards Service Providers, is bound to feel the change.

MiFID II is applicable, to various extends, to Investment Firms, Market Operators and Data Reporting Service Providers.

Even though ManCos are mainly regulated under the UCITS and AIFM Directives, ManCos with extended scope as well as entities holding delegated functions or are appointed by ManCos are covered. And, increasingly, ManCos remain responsible for delegated and appointed activities.

Fund Service Providers, like for example the Depositaries and Fund Administrators, are definitively touched by this new directive since they must ensure that their activities are compliant and further that the services they offer enhance the compliance of their clients.

> Editorial

The importance of MiFID II for the European Financial Sector is the reason why Akeance Consulting organized the event "MiFID II: Impacts, Threats & Opportunities" around this topic at the prestigious House 17 in Luxembourg city. The panel featured two prominent industry experts: Olivier RENAULT of Société Générale Securities Services, representing the service provider view and Alastair WOODWARD of Aberdeen Asset Management, embodying the Asset Manager perspective. Both were interviewed on key MiFID II topics by Frank ROESSIG, the Country Manager of Akeance Consulting Luxembourg.

The event was attended by over 90 representatives of the Luxembourg Financial Community coming from various types of Asset Managers, Depositary Banks, Private Banks, Wealth Managers, Family Offices, Corporate Treasuries, Fund Service Providers, Insurances, Industry Groups and Supervisory Bodies. The panel was followed by a networking cocktail during which participants could further discuss MiFID II issues with experts from Akeance Consulting.



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› Reframing Corporate Governance

MiFID II imposes a strengthened regime concerning the eligibility, the commitment and the responsibilities of Board Members.

Further, the Compliance function is enhanced, as all activities are now subject to risk monitoring in view to identify and prioritize compliance tasks. This implies that Compliance Officers should track assessment gaps with Senior Management and, if applicable, the remedial actions.

Regarding employees, firms should ensure that no incentives exist that conflict with the obligation to act in clients' best interests. And where conflicts could arise, proper arrangements should be effected to avoid these. These items could mainly be addressed through organizational changes plus adequate policies and should therefore be managed by focusing on efficiencies.

› Re-shaping the Distribution

Discretionary Portfolio Managers (DPMs) and Independent Financial Advisors (IFAs) will not be permitted to receive or retain inducements from Product Manufacturers for distributing their products. Inducements are only allowed, in very limited circumstances, when they are disclosed and enhance service quality.

We therefore observe a fundamental re-think in the structure and the remuneration of distribution networks, the client segmentation as well as the product mix. This could on one hand motivate the extension of in-house distribution

channels, sometimes even by integrating external actors, and on the other hand trigger enhanced value propositions by IFAs to generate more fees paid by investors.

In turn, this will motivate IFAs to focus on client segments that are ready to pay for advice while other client groups will have a tendency to be targeted for directly marketed products.

The inducement ban will also shift product shelves, as it becomes more challenging for Product Manufacturers to market other firm's products. Meanwhile, IFAs must validate their independence by offering a diverse and representative product range. As a consequence, Product Manufacturers may have to produce two product compartments for the same underlying Financial Instrument, one with fees channeled via the in-house distribution and one without fees, for the marketing through independent distributors.

Another notable aspect is linked to the classification of financial products as non-complex products that can be sold on an Execution-Only basis while complex products are subject to an Appropriateness Test. Therefore, firms must classify their products accordingly and as a consequence, possibly decide to reduce the scope of financial products as well as the advice available for retail investors.

› Investor-Driven Product Development

Under MiFID II Product Manufacturers and Distributors have to demonstrate that a given product has been designed

for and is compatible with a given market.

This implies the set-up of a product approval process that comprises the precise identification of an investor segment, an ongoing assessment of the relevant risks as well as the validation of the distribution strategy.

It is important to note that all the actors in the distribution chain must comply and should do so during the whole product life cycle, independently of the origin of a financial product.

Therefore both Fund Managers and Transfer Agents must create an appropriate product validation process. The challenge here resides in the fact that if one link in the distribution chain fails to comply, the information flow breaks down and no real control over compliance is possible beyond that point.

› Ensure Suitability and Appropriateness

A Suitability test covering the following client items must be applied to all financial products subject to Investment Advice and Portfolio Management: financial knowledge, investment objectives, risk tolerance and financial situation.

The Appropriateness test focuses on client knowledge and is applicable to complex financial instruments.

It is important to note that Suitability and Appropriateness must be re-assessed on a regular basis.

> Example of a MiFID II impact project

Akeance Consulting professionals know how to support Asset Managers and their Service Providers with the planning and the implementation of MIFID II. The objective is to ensure that organizations are compliant, remain efficient and provide their clients with a satisfactory customer-experience. In this context, one of the European leaders in the asset management industry entrusted Akeance Consulting with the assessment of strategic MIFID impacts.

First, we achieved a comprehensive scan of MIFID / MIFIR and ESMA texts (Technical Advice, RTS, ITS, Q&As,...) that are relevant to particular business areas.

In parallel, we highlighted the application scope:

- potential exemptions for given Asset Management activities;
- geographical scope;
- investment services and financial products covered by MIFID.

The regulatory impact assessment was then compared to existing processes and systems to identify to which extend they were compliant, and where there were gaps.

From this gap analysis, a high level roadmap was defined, detailing the main actions to conduct, the project organization as well as a quantification of required IT modifications.

Also, there is a significant extension of the range of products for which a firm must conduct an Appropriateness Test when it sells to a retail client on a non-advised basis.

In particular, the test will apply to structured UCITS and to investments in a non-UCITS investment fund. In concrete terms this means that a Portfolio Manager should be able to justify investment decisions, especially regarding complex products or high-cost structures as well as switches.

This could lead to the reassessment of distribution strategies and in some cases the product scope for non-sophisticated investors could be curtailed.

The other practical issue is the manner in which the application of proper procedures to ensure Appropriateness and Suitability can be proven to supervisors. Ideally every exchange with a client should be documented in the form of a written, sound or even video record. This creates challenges in terms of quantitative but even more so qualitative data management.

› *Appropriate Information must be made available to investors*

The investor reporting requirements have been increased under MiFID II and are now applicable equally to all market counterparties. Firstly, in terms of content as reports will now have to include a broader review of the fund management activities (value of holdings, order execution, losses and suitability) as well as performance details. Secondly, regarding the delivery since the frequency has now to be quarterly, while access should be possible through audited online systems.

Further, clients should be given comprehensive information on the service

provided, the risks of a financial instrument and on all costs and charges linked to their investment product that clearly depicts the impact on the investment return.

This also means that products should be unbundled so that the cost and risk of every component become transparent. Hence, reporting under MiFID II will require the evolution of processes and systems and will have to be tailored to the quality expectation of various user groups.

› *Applying and evidencing Best Execution of Transactions*

A Portfolio Manager's execution and order placing policy will need to be more detailed and specific, both in connection with the venues and brokers used for particular classes of instrument and regarding the factors used in the selection. The summaries of execution and order placing policies that must be given to retail clients should focus on the total known costs associated with trading in particular ways.

Portfolio Managers will also need to publish annually the top five execution venues for client orders in the preceding year for each class of financial instrument. Trading Venues and Systematic Internalisers will be required to publish annual data relating to the quality of execution as well as periodic reports on the trading depths and further, provide clients with free information on order processing.

Some of the information required is likely to be burdensome or overly detailed and it is clear that system upgrades will be required to sample the data but even more importantly to process and work with the data. In this context, the ergonomics of the data access could become a differentiating factor.



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"MiFID II represents an important challenge for Service Providers to the Asset Management sector. On one side, it is certain that the compliance with new rules will generate additional costs but on the other side, Service Providers will be able to innovate and offer enhanced service solutions to their clients."

From a Conducting & Chief
Risk Officer of a ManCo

"The MiFID II framework cannot be looked at in isolation and needs to be analyzed and implemented in conjunction with other regulations such as PRIIPS and the upcoming new AML Directive.... It represents a major change and an implementation challenge but also offers potential opportunities for differentiation in the investments funds' value chain."

Summary

Overall, we gathered that MiFID II has significant impacts in terms of time and investments required to be compliant. Strategically, a review of the orientations will have to be conducted in order to either validate or to fundamentally transform existing Business Models, including the organizational set-up and the marketing mix. Operationally, processes, systems and controls but also data and reporting tools will have to be modified.

The opportunities linked to the compliance with MiFID II reside in operational efficiencies related to the costs and the quality of services, but also in the ability to tailor the product and information delivery to the needs of various clients segments.

Remarkably, while the consensus is that changes are meaningful, the expectation is not of a revolution but rather of an evolution towards MiFID II.

Akeance Consulting advises in Strategy, Organization and Management based on two ideas:

- **Transparency.** One of the key success factors of the services provided by Akeance Consulting is based on a simple operating mode: «I say what I do and I do what I say.» This principle is systematically applied.
- **Efficiency.** We act swiftly to allow our clients to reach objectives and generate gains quickly and simply.

Our firm was founded around a shared desire: to offer consulting services that translate a company's strategy into an operational success. Our commitment is also to deliver excellent advisory services, independently from audit networks and IT editors.

Akeance Consulting is currently a team of over seventy professional consultants with complementary skills & competencies:

➤ Financial Sector

Financial Sector consulting accounts for many areas of expertise: customer profitability, interest rate risk, liquidity risk, general ALM, risk and regulatory management, distribution, etc. Our capabilities cover sectors such as investment funds, asset managers, banks as well as insurances.

➤ Industry & Services

Our expertise is highly concentrated around the industrial and service sectors such as the automotive, equipment manufacturing, transportation & logistics, retail, and, in general, the processing industry.

➤ Real Estate

Our clients are landholders, social landlords, property developers, asset / property / facility managers or the real estate managements of large groups. The properties concerned encompass housing, office, shopping center and logistics platform.

We support our clients on many topics, including:

- Impact analysis of new regulations tailored towards respective business models.
- Securing effective compliance management that facilitates revenue and profit objectives.
- Implementation and operational integration of regulatory framework (AML, Basel 2 and 3, KYC, MiFID, Regulatory Reporting, FATCA,...).
- Diagnosis and benchmark of Management Controls and ALM.
- Optimization of financial management.
- Evolution of funding structure.
- Implementation of steering and reporting tools.
- Mapping, diagnosis, improvement, optimization of risk management.
- Optimization, implementation and merging of business processes.
- Definition of a strategy to support the international development.
- Projects audit and implementation support.
- Support IT solution selection and evolutions.

The realization of many projects for diverse clients, based on our strong expertise and in accordance with high quality standards, enables Akeance Consulting to achieve a strong visibility in strategy, organizational and management consulting.

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