MIFID II – CHALLENGES AHEAD

Guest Author
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THE SECOND 'MARKETS IN FINANCIAL INSTRUMENTS DIRECTIVE II (2014/65/EU)', ("MIFID II"), WILL BRING FUNDAMENTAL CHANGES WHICH WILL IMPACT A BROAD RANGE OF FINANCIAL SERVICES BUSINESSES. IN ADDITION TO DISCLOSURE AND REPORTING REQUIREMENTS TOWARDS CLIENTS, RULES ON APPROPRIATENESS AND SUITABILITY AS WELL AS ON PRODUCT GOVERNANCE, MIFID II WILL INTRODUCE A NEW INDUCEMENT REGIME. IT IS FOR SURE THAT IT WILL IMPACT THE BUSINESS MODEL AS WELL AS THE DAILY WORK OF FINANCIAL ADVISORS.

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A NEW REGIME

Under the MiFID I regime fees, commissions and non-monetary benefits paid to or received from third parties are currently allowed in limited circumstances. With regards to inducements, the new MiFID II framework distinguishes between independent and non-independent advisors.

INDEPENDENT ADVISORS: BAN OF INDUCEMENTS

From January 2018 onwards, independent advisors and portfolio managers will be banned from accepting and retaining fees, commissions and/or any other monetary and/or non-monetary benefits from third parties. They can be accepted only if the advisor transfers them in full to the client. That means that the traditional commission-based income model of the independent advisor is becoming a phase-out model. The independent advisor will need to adapt to the new MiFID II environment in order to ensure a comfortable income. Reasonable solutions would be, for example, fee-based financial service models which already exist in the market since years.

DEFINING INDEPENDENT ADVICE

Any financial advisor who declares to be independent must comply with the following requirement: He/she must consider a sufficiently large and diverse range of products from a range of different providers before making any recommendation to a client. This includes that he/she shall not limit the financial instruments offered to those issued or provided by firms with whom he/she has close links or economic relationships. This also means that independent financial advisors have to set up an appropriate product selection process which considers aspects like risks, costs and complexity of the product as well as the characteristics of their clients. Neither the selection of instruments nor the recommendations that are made to clients should be biased.

NON-INDEPENDENT ADVICE

The European Securities and Markets Authority ("ESMA") that has been empowered to develop technical standards regarding MiFID II does not provide a definition of non-independent advice. This means that if the advisor is not able to comply with the above mentioned requirement for independent advice and cannot assess a sufficiently diversified range of available financial instruments, he shall be deemed non-independent. Financial advisors providing advice on a non-independent basis shall also be prohibited from accepting and retaining fees, commissions and/or any other monetary or non-monetary benefits unless all the following conditions are being cumulatively met at all times:

- the inducement is designed to enhance the quality of the relevant service to the client;
- the inducement does not impair compliance with the firm's duty to act honestly, fairly and professionally in the best interests of its clients; and
- the existence, nature and amount of the payment or benefit (or, where the amount cannot be ascertained, the method of calculating the amount) must be clearly disclosed to the client before the service is provided.

Concerning the first condition, the Commission Delegated Directive provides some non-exhaustive examples of quality enhancements. As a general rule, the inducement must be justified by the provision of an additional or higher level of service. These additional services might include for example the assessment of the continuing suitability of the client's investments on an annual basis or advice about the suggested optimal allocation of the client's assets. Another example would be the provision of added-value tools that help clients to take investment decisions or enable them to monitor the range of financial instruments in which they are invested.

Generally speaking the on-going inducements must be justified by the provision of an on-going benefit to the client. Also the service provision to the client shall not be biased or distorted as a result of the inducement.

It is important to note that under MiFID II, both non-independent and independent advisors need to disclose fully all costs to the client.

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DETAILS STILL TO BE CONFIRMED

It has to be noted that the Delegated Regulation as well as the Delegated Directive still need to be adopted by the European Parliament. In addition, ESMA confirmed in early August 2016 that they are doing preparatory work on additional regulatory measures further specifying the rules on inducements.

OUTLOOK

Since 2013 the Retail Distribution Review ("RDR") in the UK has already banned sales commission payments from product providers to advisors. It appears that the number of financial advisors in the UK decreased by 15%. Some of them were simply not willing to meet the higher qualification requirements of the RDR and left the industry.

Besides this, most clients have never knowingly paid for investment advice. In the UK they were reluctant to pay for it after the introduction of the RDR. As clients became more aware of the cost of financial advice, financial advisors were shifting their focus towards higher wealth, higher margin clients according to a survey conducted by the Association of Professional Financial Advisors in the UK. The importance of justifying charges for financial advice has grown and it seems that so far, not all clients have been convinced to pay for advice at true costs. A growing advisory gap is the consequence. If he is to continue to serve those clients, the financial advisor will need to improve his proposition to justify better the advice fees, or needs to look for alternative services targeting this client type.

MiFID II will have a deep impact on the marketplace by imposing new rules but, as with every innovation, it also opens up new business opportunities for the advisor who is well prepared.

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