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EXPERT ANALYSIS

MiFID II Expected to Have Significant Impact On Investment Managers

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When implemented, revisions to the EU's Markets in Financial Instruments Directive (MiFID II) will radically change the regulation of EU securities and derivatives markets, and significantly impact the investment management industry.

MiFID II is expected to come into effect in or around January 2018, a year later than originally planned.

The current MiFID framework (MiFID I) imposes direct obligations on discretionary portfolio managers who manage segregated accounts.

Many investment fund management entities such as UCITS (undertakings for the collective investment in transferable securities) management companies and alternative investment fund managers (AIFMs) fall outside the framework but are nevertheless indirectly impacted by MiFID I because they delegate portfolio management to MiFID-regulated firms and because some EU member states voluntarily "gold plate" national laws so as to impose MiFID requirements on non-MiFID firms. UCITS management companies and EU AIFMs also are governed by their own sets of directives.

The MiFID II framework will continue to apply directly to EU discretionary portfolio managers. It will be extended to apply to UCITS management companies and EU AIFMs who manage separate discretionary accounts, while UCITS companies and EU AIFMs acting as management companies will continue to be indirectly impacted. MiFID II also is expected to harmonize the EU's regulatory approach to non-EU investment managers.

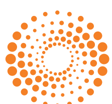
EU-BASED DISCRETIONARY PORTFOLIO MANAGERS

EU-based discretionary portfolio managers will need to plan for the following MiFID II regulatory challenges:

Investment research

MiFID II will allow EU lawmakers to distinguish between permissible and impermissible third-party benefits to discretionary portfolio managers.

There has been significant debate since the European Securities and Markets Authority (ESMA) proposed characterizing the investment research that brokers provide to discretionary portfolio managers as an impermissible nonmonetary benefit.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It is not clear whether ESMA's proposals, which are not yet final draft laws, will be adopted given that the United Kingdom, France and Germany have jointly challenged ESMA's view.

If ESMA's original proposals are adopted, discretionary portfolio managers may no longer be able to receive generic or (even) tailored investment research from brokers unless they pay for that research themselves, raise management charges to absorb the extra costs or, with client agreement, use research payment accounts that are funded in advance.

It is widely believed that adoption of ESMA's original proposals would put pressure on smaller managers who may not be able to afford the research themselves, would result in discretionary portfolio managers being more selective in the investment research for which they pay, and would call into question the business models of some investment banking research desks.

However, at the time of writing, it is expected that ESMA's original proposals will be watered down to a position slightly more palatable to the investment management industry.

Best execution

MiFID I already requires MiFID investment firms to seek best execution for customer and portfolio orders, but MiFID II will raise the bar.

Order execution policies will need to be amended to ensure that the factors used to choose trading venues are applied to more subcategories of financial instrument than the five used currently.

Managers will need to provide greater transparency by publishing annually the top five execution venues used for each subclass of financial instrument they trade for managed portfolios.

This will require disclosure of information that currently is regarded as confidential: commercial relationships with execution brokers, a breakdown between passive and aggressive orders, conflicts of interest and execution venue fee arrangements.

When combined with an expanded obligation to monitor execution quality, these new requirements will significantly increase compliance burdens.

Scope of transaction reporting rules

In order to enable EU regulators to monitor transactions for potential market abuse, MiFID investment firms are currently required to report transactions in financial instruments admitted to trading on EU-regulated markets and related tradable assets such as derivatives, which have an underlying reportable instrument.

MiFID I contains an exemption that was flexibly interpreted in the U.K. to allow managers to rely on sell-side EU MiFID firms to report on their behalf.

Other EU jurisdictions determined that only the market-facing counterparty had the reporting obligation. MiFID II will increase the scope of reportable transactions to include financial instruments traded, or admitted to trading, on all EU trading venues, not just EU-regulated markets.

Discretionary portfolio managers are potentially within this scope, because the reporting requirement will apply to both counterparties that are market-facing and those that are not.

However, there will be a carve-out for "transmitting firms," such as portfolio managers who send orders to a broker for execution.

That exemption, though, will apply only if the portfolio manager passes on specific transaction details and flags to the broker, and the broker also is an EU MiFID investment firm.

This means that portfolio managers passing on trades to non-EU brokers or executing trades directly with a counterparty will need to report transactions to the relevant EU regulator.

Transaction reporting itself will become more onerous because of an increase in the information that must be reported.

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Transaction recording requirements

Discretionary portfolio managers also will need to comply with new, more burdensome transaction-recording requirements.

This will be supplemented by a formal requirement that telephone conversations that lead to, or are likely to lead to, portfolio transactions be recorded.

Trade transparency

MiFID II extends pretrade transparency requirements to nonequities and restricts trading venues' use of waivers from those requirements, both of which will impact investment managers' trading strategies.

Although draft ESMA secondary legislation indicates that fewer bonds will be subject to pretrade transparency requirements than originally feared, credit fund managers nevertheless will need to identify how the requirements will affect the funds they manage.

Post-trade transparency for over-the-counter transactions raises similar types of issues given the extension of scope to nonequities.

The possibility remains that certain portfolio managers will themselves have new formal obligations to report trade details.

Although those obligations may be outsourced, they still represent a new type of compliance burden for managers.

Product governance

MiFID II will introduce a number of requirements that in broad terms will require fund distributors to identify target markets, ensure that funds are compatible with those markets and carry out regular reviews.

EU-BASED MANAGEMENT COMPANIES

MiFID II will apply directly to UCITS management companies and EU-based AIFMs when they manage separate discretionary portfolios.

In those circumstances, management companies will need to comply with most MiFID II conduct of business requirements.

MiFID II also will indirectly impact the investment funds managed by UCITS management companies and EU-based AIFMs when they delegate portfolio management to a MiFID discretionary portfolio manager who is obliged to comply with MiFID II requirements.

Management companies may benefit from MiFID II investor protection requirements (such as enhanced best execution and, if adopted, the unbundling of investment research from order execution).

However, other measures such as trade transparency (which may impact orders executed for client portfolios) and restrictions on the distribution of complex UCITS will place indirect burdens.

Some EU jurisdictions will "gold plate" their regulatory require-ments so that some MiFID-style requirements will be applied to management entities that fall outside MiFID scope.

The U.K., for example, has in the past extended MiFID investor protection requirements to non-MiFID firms where considered appropriate to secure policy goals but has recently indicated a softening of that approach in stating that more onerous MiFID II transaction reporting requirements will not be extended to EU management companies when not performing MiFID investment services.

Finally, EU lawmakers may in due course seek to amend the UCITS directive as well as the AIFM directive so as to extend certain MiFID-style requirements to EU management companies.

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NON-EU DISCRETIONARY PORTFOLIO MANAGERS

MiFID II will introduce new "third country" requirements for non-EU managers who wish to provide portfolio management investment services to EU investors.

Generally, non-EU portfolio managers wanting to access retail investors will need to set up an EU branch that will be regulated essentially in the same way as other MiFID investment firms.

In order to access professional clients, non-EU discretionary portfolio managers will have to register with ESMA (but are not required to set up a branch), assuming that regulatory equivalence and reciprocity determinations have been made by the European Commission.

In the absence of such determinations, EU national rules will prevail, meaning that discretionary portfolio managers will need to ensure that they provide cross-border services in a way that does not infringe local EU member state licensing requirements.

We expect that MiFID II will focus non-EU discretionary portfolio managers on how to access EU clients in a compliant manner, in a similar fashion to the way the Alternative Investment Fund Managers Directive focused non-EU management entities' minds on how to compliantly market funds to EU professional investors.

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