



**Impact of MiFID on the
Fund Management Industry**

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I. The new European regulatory landscape

The new European regulatory landscape

- **MiFID will modify the market structure**
 - Promote competition among trading venues, offer greater choices to investors and decrease costs for investors when trading
 - Improve the efficiency of the price-formation mechanism on a pan-European basis
 - Foster innovation and take stock of evolution in markets and technology
 - Complete the integration of the EU market for financial services
 - abolition of the so-called “concentration rule” in many European countries
 - competition between regulated markets and MTFs and systematic internalisation
 - recognition of the possibility for investment firms to internalise client orders

The new European regulatory landscape

- **MiFID will modify the legal and operational conditions under which ISPs provide services :**
- **Organizational rules: main changes due to the need to adapt to the specific details contained in the level 2 measures**
- **Rules of conduct: main innovations are :**
 - A new regime for best execution
 - The introduction of the eligible counterparty regime
 - The introduction of the execution-only service
- **The effect of the transposition of MiFID will be to encourage ISPs to assume more responsibility in how they comply with the General regulation**
- **Adapting to the new regulatory framework (client classification, new process for execution of orders) :**
- **The need to think also in terms of opportunities (internalisation, operating MTFs, etc)**
- **1st November 2007: deadline for entry into force and compliance by market participants**

Background to MIFID

- **How MiFID relates to collective investment schemes ?**

- Exclusion from the scope of MiFID of collective investment schemes, whether or not coordinated at EU level, their management companies, and depositaries (Recital 15 and Article 2(1)h of the MIFID Level 1)....
-but bringing some **UCITS management functions** under the scope of MiFID (Article 66 of the MiFID Level 1), and...
- ...**inclusion of UCITS** in MiFID financial instruments (in Section C of MiFID Annex)

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6

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II. Impact on organizational rules and rules of conduct

Contents

1. **Categorisation of clients**
2. **The introduction of the eligible counterparty regime**
3. **A new regime for best execution**

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8

1. Categorisation of clients

The key principles of MiFID

- **MiFID provides for different levels of protection according to the categories of clients**
- **Measures to protect investors** (particularly the provision by the distributor of adequate information on the nature of financial instruments, and on the risk associated with investing in them) **should be adapted to the particularities of each category of investors:**
 - retail
 - professional
 - eligible counterparties

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10

1. Categorisation of clients

To avoid the mismatches in the categorisation of clients that would stem from a too systematic approach, MiFID provides for a range of “opt-in” and “opt-out” possibilities :

- **A client which is deemed to be a professional under the MiFID provisions may request non-professional treatment in order to benefit from a higher level of protection (“opt out”)**
- **A retail clients may be treated as a professional on request (“opt in”) and on the condition he satisfies the procedure provided by Annex II to MiFID**

1. Categorisation of clients

Practical consequences :

- **Before 1 November 2007 :**
 - MiFID requires that investment firms implement written internal procedure in order to categorise clients. This shall also impact account opening procedures
 - Article 28 of the MiFID Level 2 requires that new and existing clients be notified their categorisation
 - Investment firms will also have to develop procedures and documentation to identify and provide clients with the required level of protection according to their category (to be continued)

2. The introduction of the eligible counterparty regime

The key principles :

- UCITs and their management companies, pension funds and their management companies are **automatically categorised as eligible counterparties** (Article 24(2) of the MiFID Level 1)....
- ... which means that they won't benefit automatically, when they enter into transactions with other ISP from the protective rules set out by the Directive as regards conduct of business obligations, best execution and order handling
- Eligible counterparty status **is limited to dealing** (and related ancillary services), so in relation to other activities/services, for example, investment advice or portfolio management, an "eligible counterparty" will be a professional client

2. The introduction of the eligible counterparty regime

Practical consequences :

- **Before 1 November 2007 asset managers will need to :**
 - determine whether or not, to be treated as professional or retail clients to obtain the protections ("opt in")
 - put arrangements in place either on a general basis or on a trade-by-trade basis to comply with these provisions
 - categorise, where appropriate, their own clients

3. Best execution

The key principles :

- MiFID best execution requirements apply to management companies that provide the service of reception and transmission of orders (RTO) and that provide the service of portfolio management... **when executing decisions to deal** on client of client portfolios (Article 21 of MiFID Level 1 and Articles 44 and 46 of MiFID Level 2)
- Asset management companies that transmit orders to other entities for execution and that provide the service of portfolio management, when **placing orders with other entities for execution** that result from decisions to deal in financial instruments on behalf of client, are subject only to a duty of a “**best selection**” (Article 45 of MiFID Level 2)

3. Best execution

Practical consequences :

- **Before 1 November 2007 asset managers will need to :**
 - put arrangements in place to comply with the new best execution/best selection framework
 - produce and implement a best execution/best selection policy consistent with the new framework
 - provide appropriate information on the best execution/best selection policy, to clients and where appropriate obtain their consent to their policy
 - undertake continuing monitoring of compliance with the policy, and updating and notification to clients of amendments to the policy



1. A new scope for the regulation of Investment advice

Investment advice becomes an investment service

- Investment advice is defined as :

“the provision of personal recommendations to a client, either upon its request **or at the initiative of the investment firm**, in respect of one or more transactions relating to financial instruments”

1. A new scope for the regulation of Investment advice

- The critical importance of advice in the distribution is widely recognized and the legislation of Member States already provides for a regulatory framework covering some aspects of advice
- The new European regime will help depart advised from non advised situations:

→ Under MiFID, there are three kinds of relationships with clients :

- 1/ The Provision of investment advice or portfolio management (article 19(4) of the MiFID Level 1)
- 2/ The provision of investment services other than investment advice and portfolio management (article 19(5))
- 3/ The provision of execution-only services (article 19(6))

1. A new scope for the regulation of investment advice

Departing “advised” situations...

1/ The provision of **investment advice or portfolio management**:
case where the client has not chosen himself a specific financial instrument - article 19(4) of the MiFID Level 1 :

“When **providing investment advice** or portfolio management the investment firm shall obtain the necessary information regarding the client’s or potential client’s knowledge and experience in the investment field relevant to the specific type of product or service, his financial situation and his investment objectives so as to enable the firm to recommend to the client or potential client the investment services and financial instruments that are suitable for him”

→ **Suitability and know your customer rules** are the cornerstone of conduct of business regulation in such a situation

1. A new scope for the regulation of Investment advice

Departing “advised” situations...

- The recommendation must be presented as “suitable for the client’s needs”
→ obviously general mailings will not be considered as falling under article 19 (4)
- Warning: MiFID should govern cases where the distribution of collective investment schemes and/or the provision of advice is undertaken by an investment firm. The recently published “White Paper” by the European Commission has clarified to some extent the applicability of MiFID’s provisions to the distribution of investment funds :

“MiFID should underpin the quality of client support that advisors, brokers and other intermediaries provide to clients contemplating investment in investment funds. It will increase the onus on investment firms that sell funds to ensure that the product is appropriate for the individual client, and that the client is fully apprised of any risk warnings related to particular products.”

1. A new scope for the regulation of investment advice

... from “non advised” situations

2/ The provision of investment services other than investment advice and portfolio management – basically execution or RTO = the client has decided to invest in a specific financial instrument and asks for execution =>articles 19 (5) and (6) of the MiFID Level 1 :

→ “appropriateness test”, less demanding than the “suitability test” required in advised situations : obligation only to check the knowledge and experience of the client, and not the suitability with regard to his financial situation and his investment objectives

This is consistent with the fact that the client is supposed to have chosen alone his investment

MiFID Level 2 : professional clients are provided with a lighter version of tests (no need to assess if a professional client is able to bear the risk, no need for appropriateness test)

1. A new scope for the regulation of investment advice

... from “non advised” situations :

3/ The provision of execution-only services (article 19 (6)) of the MiFID Level 1 :

The provision of investment services that only relate to the **execution and/or the reception and transmission of client orders (...)** is possible without obtaining the information or making the determination provided for in paragraph 19 (5) where specific conditions are met (and in particular) :

→ the above services relate to shares admitted to trading on a regulated market (...), **UCITS and other non-complex** financial instruments

→ the client is informed that he does not benefit from the appropriateness test

1. A new scope for the regulation of investment advice

Practical impacts: a new framework for the supervision of the compliance of advice with the suitability requirement

Financial instruments covered by MIFID are listed in Section C of Annex I to MIFID, which again includes investment funds

- Record-keeping and control: necessity to establish and maintain (5 years) some records that keep track of the service provided (advised or non advised situations).

In case of advised situations this means:

- record-keeping of the advice given to the client;
 - to take into account CESR's Recommendations (Ref:CESR/06-552c) dated February 2007
- A framework for the supervision by regulators of advised sales of financial instruments, including investment funds
- Will make it easier for regulators to control the quality of the advice given, which is a key point of regulation on the retail market

1. A new scope for the regulation of investment advice

Pending questions

Necessity to clarify which provisions of the UCITS and MIFID Directives will apply when a management company provides investment advice in respect of its "own" units or units of parent companies :

- Vade-mecum of the European Commission on the implementation of MIFID relevant provisions to collective investments schemes/UCITS. Expected timing : summer 2007.

2. Consequences regarding the payment on funds' distribution

- Remuneration may influence advice when funds' distributors are paid through manufacturers' commissions, which is frequently the case in the business model of investment funds' distribution
- Extract from White Paper :
"Considerations, such as the level of commissions paid by fund promoters to distributors, should not bias the selection of funds. At present, fund managers will pay on average 50% of their management fee to a third party distributor. It needs to be examined whether such commissions constitute payment for services rendered such as pre/after-sales service to clients. Conflicts of interest and inducements must be properly managed or disclosed : intermediaries must diligently undertake duties of care to the retail client. MiFID provides the tools to manage these concerns. Its implementing measures stipulate that inducements must be disclosed and can only be provided where they are in the interests of the client."

2. Consequences regarding the payment on funds' distribution

The "inducements" framework

- **Article 26 of MIFID Level 2, provides for requirements in relation to the receipt or payment by an investment firm of a fee, commission or non monetary benefit ("Inducements")**
- **There are two general circumstances in which article 26 does not prohibit a firm from paying or receiving fees, commissions or non monetary benefits :**
 - ➔ **in Article 26(a):** if the payment is provided by or paid to the client or a person acting on behalf of the client;
 - ➔ **in Article 26 (c):** if the payment is a "proper fee" that enables or is necessary for the provision of investment services; (restrictive examples)

2. Consequences regarding the payment on funds' distribution

The “inducements” framework

- **Article 26 b) recognises some cases where receipts or payments are permitted as long as they comply with two conditions :**
 - There is a clear and prior **disclosure** to the firm's client
 - They are **designed to enhance the quality of the relevant service** to the client and not impair compliance with the firm's duty to act in the best interests of the client. Recital 39 of the MIFID Level 2 recognizes that providing advice enhances the quality of the service
- ⇒ In the case of UCITS, how will distribution fees paid by the fund manager (out of the management fee) to the distributor be considered under Article 26 ?
- ⇒ On the basis of CESR's Recommendations (Ref:CESR/07-228b) on inducements dated May 2007, they will fall under Article 26 b)

2. Consequences regarding the payment on funds' distribution

Consequences :

- need for a regime of disclosure of distribution fees to the client. Article 26 authorizes disclosure of “essential conditions of remuneration”, and of detailed information only on request
- need for a regime ascertaining that the existence of a retrocession does not “impair the ability of an investment firm to act to the best interests of its client”
- the European Commission also points out that the distribution fee should be justified by a service provided to the client. The European Commission raises, in an implicit manner, the question of the identical amount of the distribution fee, perceived either in advised or in non-advised situation
- ⇒ *Disclosure of distribution fees is not only a matter of addressing potential bias on advice, but also a matter of ensuring “true prices” and making the client aware of what he pays for what service*
- ⇒ *Debate open on possible “unbundling” of distribution fees*

2. Consequences regarding the payment on funds' distribution

Next steps / practical impact

- The topic might ultimately be addressed by the “vade-mecum” announced by the European Commission
- **At this stage and until clarification is given by the Commission, it has been incorporated into French law Article 26 in its entirety, and to further assess the possible interpretations and consequences**
- **Remember that the wording of Article 26 is wider than funds' commissions and applies to all investment services**

2. Consequences regarding the payment on funds' distribution

The influence of MiFID on the changing distribution landscape

- MiFID is designed to enhance competition at the various levels of the value chain of investment services, including distribution of funds
- In the case of inducements on funds, the MiFID approach is clearly inspired by open architecture. The White paper clearly relates the «inducements» issue to the development of open architecture « *The move from foreclosed distribution systems towards open or guided architecture - where intermediaries offer a range of third party products - is gathering pace. This change can be to the great advantage of the investor if third party funds are selected on the basis of objective considerations such as cost or expected performance. Considerations, such as the level of commissions paid by fund promoters to distributors, should not bias the selection of funds* ».
- **This raises the question of the implementation of « inducements » on the distribution of in-house funds**
- **MiFID changes some of the game rules, but the impact on the architecture of distribution is hard to predict. It is not deemed to foster open architecture but to go along with its development.**

3. New rules applicable the marketing of financial instruments

- MiFID Level 2 (Article 27) defines detailed conditions to be complied with for an information to be “fair, clear and not misleading” (basic principle set in MiFID)
 - the provisions are applicable :
 - to the marketing of collective investment schemes as other financial instruments
 - to all documents, including marketing documents
- A topic in France with the report of Mr. Jacques Delmas-Marsalet relating to the distribution of financial products
- This report published in November 2005, claims for a more precise framework for the marketing documents on financial instruments

3. New rules applicable the marketing of financial instruments

MIFID provisions:

- To provide investor with a better protection, a mix of general provisions...
 - Information shall be accurate and in particular shall not emphasise any potential benefits of an investment service or financial instrument without also giving a fair and prominent indication of any relevant risks
 - Information shall be sufficient for, and presented in a way, that is likely to be understood by the average member of the group to whom it is directed, or by whom it is likely to be received
 - It shall not disguise, diminish or obscure important items, statements or warnings

3. New rules applicable the marketing of financial instruments

MiFID provisions :

... and of detailed provisions applicable to retail clients only :

- mainly concerning the comparison of investment, ancillary services or financial instruments (Article 27(3)) of MiFID Level 2)
- concerning the communication on past performances, simulated past performances and future performances (Article 27(4) of MiFID Level 2)

3. New rules applicable the marketing of financial instruments

Practical impact

- Marketing departments and management companies will have to take into account the new precise provisions introduced by the MiFID Level 2, in particular :
 - presentation of past/simulated/future performance
 - past performance not prominent feature
- Regulators may have to issue some guidance in coordination with the stakeholders to illustrate the more general provisions

Conclusion

- It would be a misconception, to think that the impact of MiFID on the fund management industry will be relatively limited
- A changing landscape for the fund management industry
- Due to a new framework which requires adaptation and commitment from now on, on the part of investment firms and regulators:
 - categorisation of clients
 - identifying advised and non-advised situations
 - new requirements for marketing documents
 - Possible impact on remuneration of distribution
- Some issues are still pending as regards the articulation with the UCITS Directive: applicability of MiFID for distribution of in-house collective investment schemes by management companies etc.
- Global approach is to foster competition in the distribution of financial products and ensure benefit for investors of a more integrated market :

« Distribution systems which match investor demand with fund supply must work efficiently. They must deliver products that meet the needs of individual investors on competitive terms. » (White Paper)
