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MiFID II Pan-European overview

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MiFID II: It's the final countdown!

Europe will see the update to the Markets in Financial Instrument Directive (MiFID II) come into force on 3 January 2018. MiFID II will bring dramatic changes to financial markets in Europe and with little less than a year to go, the clock is ticking louder than ever to be ready on time. At this crucial stage, we have looked throughout Europe to assess what the priorities and challenges are for firms as they begin the final push.

Introduction

Our pan-European, cross-sector research comprises insight from 16 PwC network firms and focuses on practical and strategic issues raised by investment banks, retail banks, and wealth and asset managers. We hope this will give you valuable insight and help with your MiFID II planning.

Our research shows that the breadth of changes firms must make presents one of the most significant compliance challenges to date. Add to this the way in which MiFID II will change the dynamics of markets and force firms to reconsider strategies, and it's clear that this is an area that deserves a great deal of attention in the coming year.

January 2018 may sound like it's still a long way off, but given the nature and scale of changes most firms still need to make, it will come round very quickly.

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UK MiFID II Leader

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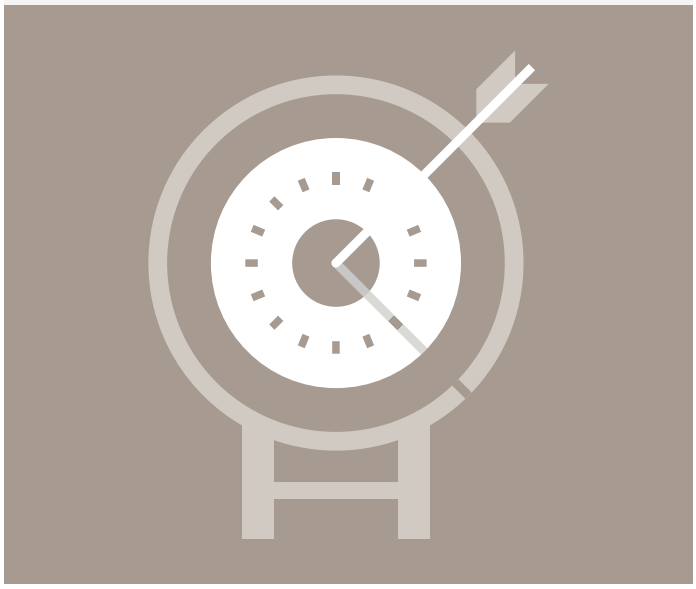

Asset managers

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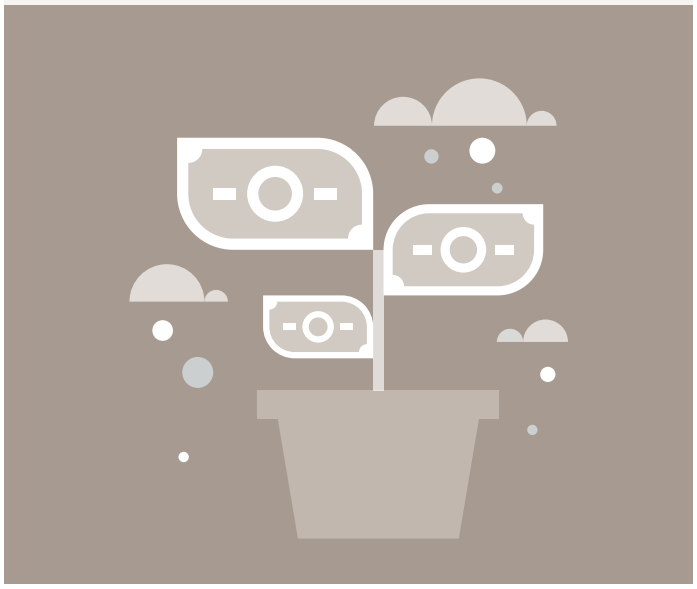


Pan-European research and insight

At a high level, our research found that all types of firms across Europe appear keenly focused on investor protection rules, with markets issues being of secondary interest in most cases. The exception is investment banks, which clearly see markets changes and strategic consequences as their main concern.

Retail banks identify inducements and the impact of changes on existing operating models as the main challenge. Wealth and asset managers, meanwhile, are prioritising product distribution and believe that their staff may not be adequately equipped to meet enhanced reporting requirements.

1. Investment banking

Investment banks across Europe are focusing on four areas in their MiFID II implementation efforts:

- Market structure and the revised systematic internaliser (SI) regime
- Product governance, particularly rules for product manufacturers
- Cost and charges disclosures, especially the impact on their business
- Transaction reporting.

Market structure, transparency and the SI regime

MiFID II's market structure changes are far-reaching. The prohibition of broker-crossing networks, tick size revisions and open access for Central Counterparties (CCP) have proven contentious, but the priority for most firms is the changes to the SI regime.

The existing MiFID I SI regime applies to shares alone but MiFID II will extend to equity-like and non-equity instruments, leading to a far greater number of firms being classified as SIs. Firms classed as SIs will be required to publish quotes for trades above certain thresholds. The obligation to publish quotes will require a technical reporting infrastructure which newly-classified SIs may struggle to implement, but more importantly will have important strategic consequences for firms.

Firms identified two particular points that concerned them:

- The calculation of SI thresholds. Firms have had difficulty in self-identifying as SIs because of a lack of holistic market information and problems sourcing quality internal data
- The treatment of back-to-back trades. Firms are unsure whether undertaking back-to-back trades should be included within the SI numerator – firms have heard differing views from regulators on this issue and would welcome clarity.

Product governance

MiFID II aims to strengthen investor protection by enhancing governance around product manufacturing and distribution by:

- Ensuring conflicts of interest are managed as opposed to simply being identified
- Tightening controls around product manufacturing processes
- Obliging firms to specifically consider target markets and investor risk during production
- Imposing requirements for a charging structure review for new products
- Requiring firms to provide appropriate information to distributors.

Investment banks raise concerns about product governance in almost every jurisdiction. Firms feel target market and product design definitions are particularly troublesome.

Beyond difficulties in scoping target market assessments, firms also see interactions between manufacturers and distributors as challenging. Under MiFID II, manufacturers must work closely with distributors to allow for refinement of product target markets. Distributors will be expected to share information on who is purchasing products and their experiences with those products.

Manufacturers worry about their ability to engage with distributors and the infrastructure needed to make this flow of information viable. Without proactive engagement between the sell and buy sides, meeting target market requirements may be difficult. Firms must consider the role they play in identifying, and refining, target markets – this isn't the sole responsibility of either a manufacturer or distributor; they must work together.

Cost and charges disclosures

MiFID II's new disclosure requirements mean investment firms must disclose ex-ante and ex-post information on:

- All costs and associated costs charged by the investment firm for the investment service or ancillary service provided
- All costs and charges associated with manufacturing and managing of financial instruments.

Investment banks are generally worried about the impact full disclosure will have on their business but also point to specific issues as well. They feel complexity of disclosures will be particularly challenging for them and seek clarity on the term 'actual costs'. Some firms also identify the scale of 'repapering' as a point of concern while others feel co-ordinating MiFID II, UCITS and PRIIPS disclosures represents the biggest disclosure challenge.

ESMA guidance on product governance requirements

The European Securities and Markets Authority (ESMA) is actively seeking to address industry concerns on product governance and published its Consultation Paper on Draft Guidelines on MiFID II product governance requirements on 5 October 2016. ESMA[1] outlines greater detail for manufacturers to consider when undertaking target market assessment. For manufacturers, ESMA asks they consider a minimum of six elements when identifying a potential target market for their products:

- Type of client
- Knowledge and experience of client
- Financial situation of their client and ability to bear losses
- Risk tolerance of client and risk/reward profile of products
- Client objectives
- Needs of clients.

Manufacturers are also advised to make sure that potential target market assessments are more detailed for complex products – ESMA's proposed guidance says manufacturers should build on these six elements when proposing potential target markets.

ESMA also gives guidance on how firms should deal with products manufactured prior to MiFID II application, how to identify negative target markets and application of assessments in wholesale markets. Firms manufacturing or distributing financial products should review the guidelines to determine potential impact. The consultation closes on 5 January 2017 and manufacturers should consider responding with their concerns.

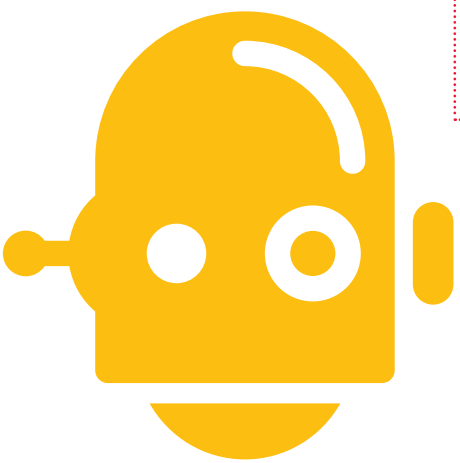
1 Consultation Paper on Draft Guidelines on MiFID II product governance requirements https://www.esma.europa.eu/sites/default/files/library/2016-1436_cp_guidelines_on_product_governance.pdf

Transaction reporting requirements

The European Commission's changes to MiFID transaction reporting requirements will increase the burden of transaction reporting significantly. Transaction reporting under MiFID applied only to financial instruments admitted to trading on a regulated market. MiFID II will extend transaction reporting by:

- Extending reporting to transactions completed on multilateral trading facilities (MTFs) and organised trading facilities (OTFs)
- Increasing the scope of reportable transactions to instruments where the underlying is traded on venue and instruments where the underlying is an index or a basket which is traded on venue
- Incorporating a wider range of transaction types
- Requiring greater volumes of information from transaction reports.

Increasing scope is cited as the biggest challenge investment banking firms face. Firms recognise the significant technical challenge facing them and are taking steps to prioritise this work.



Our research reveals firms exploring radical changes over how they service clients to respond to inducement changes. Some firms are exploring lower-touch approaches to servicing clients, such as increasing reliance on robo-advice.

ESMA guidelines on the transaction reporting regime

ESMA is actively seeking to guide firms in their transaction reporting preparations and throughout 2016 has published transaction reporting guidelines and instructions. It issued final guidelines on the implementation of the transaction reporting regime under MiFID II on 10 October 2016.[2] The guidelines provide clarity on how to complete transaction reports and comply with record keeping and clock synchronisation requirements, and clarify MiFID II provisions on trading capacity, execution of transactions on a trading venue and the mechanics for reporting. The guidelines also outline the rules on how to identify the buyer and seller in a transaction and provide trading scenarios to help firms understand reporting obligations. ESMA advises firms that if their situation doesn't exactly match the scenarios outlined, they should identify the most relevant scenario and map it to their own circumstances.

ESMA also gives additional guidance on validation of Legal Entity Identifiers (LEIs) and explains how ESMA defines a reportable event. Finally, it provides more granular analysis of time-stamping provisions and rules on compliance with the maximum divergence requirements. Firms should review the guidelines to determine whether their existing processes are calibrated to meet MiFID II requirements.

2. Retail banking

There are a number of areas where the MiFID II implementation priorities of investment and retail banks overlap – particularly in co-operation between manufacturers and distributors on target markets and the impact of full cost disclosure.

Retail banks have four clear areas of interest:

1. Product governance – target market and interaction with distributors
2. Inducements, mainly the impact on existing fee models
3. Conflicts of interest, especially around captive products
4. Independent vs. non-independent advice – the scale of identification and separation.

Target market

In common with investment banks, retail banks flag target market requirements as their main product governance issue. Co-ordination of feedback between product manufacturers and distributors is a great worry; manufacturers must make sure that distributors understand the products they are selling, work with them to assess whether end clients fit their target market and to revise distribution processes if there's a material change in potential risk or return. Across Europe, firms are wondering how such a feedback loop could function, with some raising the idea of technical infrastructure to capture distributor data.

Inducements

Revisions to inducement rules are one of the more controversial elements of MiFID II. The new rules around independent advice and portfolio management services will ban receipt and retention of fees, commission or any monetary or non-monetary benefits from third parties if it relates to provision of services to its own clients.

2 Final guidelines on the implementation of the transaction reporting regime under MiFID II https://www.esma.europa.eu/file/20011/download?token=cHI6iMY4

European retail banks feel this ban could have a significant impact on existing cost structures and fee models. Our research reveals that firms are exploring radical changes in how they service clients as a direct result of these inducement changes. Some firms are exploring lower-touch approaches to servicing clients, such as an increasing reliance on robo-advice. Such a radical shift in strategy highlights the significance of proposed inducement bans. Firms should consider the operational impacts of such a shift in strategy closely.

Conflicts of interest

MiFID II demands firms to pay more attention to conflict management and discourages them from overreliance on conflict disclosure. It sets specific procedures and measures for firms to implement in managing conflicts, requiring firms to:

- Control information exchange between relevant persons if that exchange could harm clients
- Implement separate supervision of staff where they may be open to a conflict of interest
- Remove direct links between remuneration of relevant persons in different functions if their remuneration targets create client conflicts
- Prevent any person from exercising undue influence over any client's investments
- Stop any person from being involved in sequential transactions if conflicts arise as a result of their repeated involvement.

Our research shows firms are uncertain about how to satisfy these requirements, particularly when they're dealing with captive products.

Firms need to rethink their approach to conflicts of interest under MiFID II, placing much greater focus on conflict management and the policies and procedures surrounding it.

Independent vs. non-independent advice

MiFID II obliges firms giving advice to clients to increase transparency over the nature of that advice. Firms are required to provide detail on:

- Whether advice is independent or not
- The range of products which advice is being provided and the nature of the advisors' relationship with product manufacturers
- Any periodic assessment of suitability the advisor plans to undertake.

For advice to be classified as independent, providers must assess a sufficiently diverse range of products. Advice cannot be limited to products produced by themselves, firms with close links to them or firms with which they have a relationship that may create conflicts of interest. Firms cannot describe their businesses as 'independent' if they offer a blend of advice types. Firms are also required to separate independent and non-independent advisors and services. Our research reveals firms find identifying the type of advice on a product by product basis as challenging and separation of functions as costly.

ESMA's Q&A on investor protection

Firms may wish to review ESMA's Q&A on MiFID II investor protection topics to better understand expectations on independent advice, suitability and appropriateness. ESMA uses its Q&A to send a warning to firms offering independent advice while simultaneously offering their own products to clients. ESMA is likely to take an unfavourable view of product comparisons that routinely result in the firm recommending their own products as most suitable for the client; this could be an indicator that comparisons are creating a bias towards the firm's own products. This creates a conflict which requires careful management by the firm.

ESMA sets out clarifications on suitability and appropriateness requirements which firms should take note of. It reiterates firms must deliver suitability reports even if transactions do not take place and even when advice is not a buy or sell recommendation. ESMA also warns firms about circumventing suitability requirements by altering a client's risk profile. It also provides more guidance on how firms should respond if their client insists on purchasing an unsuitable product. ESMA's scenario analysis may help firms in identifying higher risk situations.

3. Wealth managers

Wealth managers agree with banks that market structure changes will be troublesome, as well as being concerned about the impact of full cost disclosure, bans on inducements and conflicts management for captive products. Where they differ on inducements is their response to the ban; retail banks are moving towards low-touch advice whereas wealth managers raise the idea of revising fee models. Wealth managers indicate they may move from transaction-by-transaction fees to all-in fee models.

Staff capabilities

Our research highlights one unique area of focus for wealth managers. It appears they worry more about the ability of their staff to deal with the volume of change created by MiFID II – something that was not raised by investment banks, retail banks, or asset managers.

Wealth managers are concerned about:

- The ability of staff to deal with MiFID II reporting requirements (in terms of reporting to their own clients, reporting to product manufacturers and transaction reporting), and/or
- The ability of staff to implement successful MiFID II change programmes.

These issues were not specific to any particular jurisdiction, with a number of jurisdictions reporting this same concern.

4. Asset managers

Asset managers echo many of the concerns raised by investment and retail banks. Inducement bans, the impact of cost disclosure, transaction reporting and market structure all featured in feedback from across our European network. The one area where we saw asset managers focus in much greater detail was product governance for distributors.

Product governance – distribution requirements

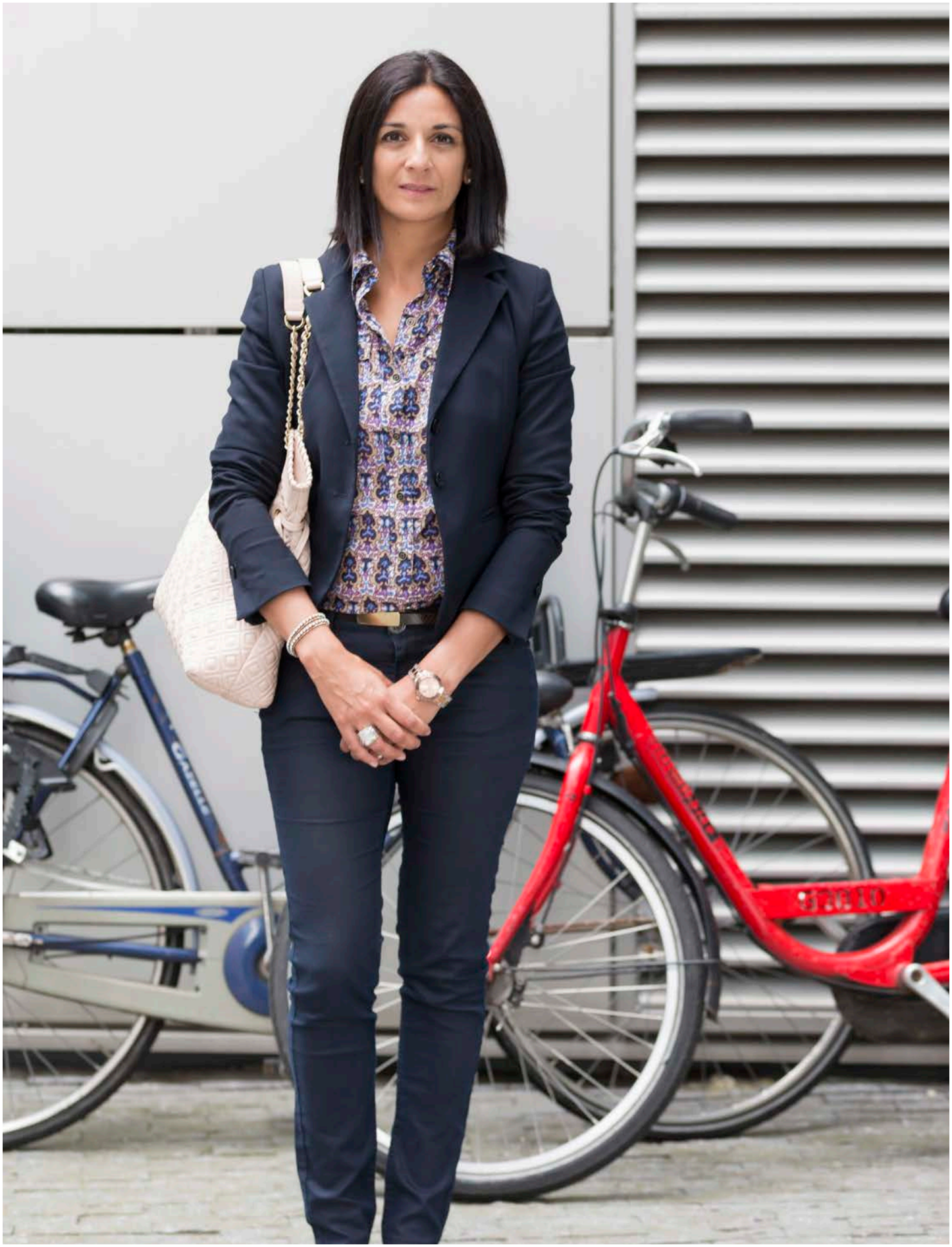
We found asset managers are keenly focused on product governance issues but unlike their investment banking peers, they focus more on distribution than manufacturing issues. Perhaps understandably, they give greater consideration to how they can help their counterparts with stricter distribution rules.

The main issues for distributors are MIFiD II requirements to:

- Obtain sufficient product information from manufacturers
- Set their own target markets if manufacturers have failed to do so
- Ensure products are a good fit for clients and to ensure this continues to be the case through periodic assessments
- Undertake periodic reviews of their product governance arrangements
- Provide sales data to product manufacturers.

Asset managers are exploring how they can restructure their existing product offering to better meet the changing needs of their distribution partners. This involves reviewing fund ranges and share class structure to make sure they fit distribution needs. Our research also found asset managers are unsure how distributors can effectively share product sales data with manufacturers – this was also raised by investment and retail banking clients and is a major concern across the industry.

At a higher level, asset managers are reconsidering existing distribution strategies, with some firms considering B2B models and direct sales. Beyond physical distribution, firms are keenly focused on the impact of inducement bans on existing fee models. Firms specifically identified trailer fee models as an area they may need to revisit in light of inducement bans for distributors.



Regulatory implementation map

The FCA offers limited additional guidance as to types of document which may meet MiFID II's definition of research. This is in contrast to the AMF who open their discussion on research by observing several document types where the research label could be debated.

Given that MiFID II changes are contained in both a directive and a regulation it feels natural that we may see some divergence in national approaches to implementation. Interestingly, we are already beginning to see evidence of this in some early implementation efforts.

The UK's Financial Conduct Authority (FCA) and France's Autorité des Marchés Financiers (AMF) have been very proactive in their approaches to MiFID II implementation. Both have published consultations to help the industry prepare for MiFID II. This is in addition to work from BaFin which has seen them publish a draft transposition.

The FCA published its third MiFID II consultation on 29 September 2016, which covered conduct of business issues such as payments for research and inducement rules. This followed the AMF's consultation on payments for research published on 12 September 2016. The proposals show areas of potential divergence in approach and interpretation, in two areas in particular:

- The definition of research
- Their views on commission-sharing agreements.

1. Research definition

The FCA puts the onus on receivers of research to determine what constitutes research and what constitutes a minor non-monetary benefit. It asks recipients to closely assess everything they receive to make their own conclusions. The FCA offers limited additional guidance as to types of document which may meet MiFID II's definition of research. This is in contrast to the AMF, which opens its discussion on research by observing several document types where the research label could be debated.

The AMF gives firms additional guidance on several document types and sets criteria under which these documents may not meet the research definition. In doing so, it gives the impression that its definition of the term research may not be as prescriptive as the FCA's. The types of document covered include:

- General information
- Macroeconomic analysis (the AMF appears to create a carve-out for macroeconomic analysis which is widely disseminated to clients)
- Commercial services (the AMF suggests briefs passed to clients from sales teams may not constitute research)
- Corporate access (the AMF creates a distinction between simple meetings and intellectual meetings).

2. Commission sharing agreements

The AMF's language around commission-sharing agreements (CSAs) is also softer than the FCA's. The AMF focuses on conditions under which CSAs would still be authorised under MiFID II. It notes that CSAs aren't necessarily incompatible with the text of the delegated directive but may need some operational changes to make them work. The FCA also states that operational changes will need to be made to CSAs to ensure adequate control and oversight by the investment firm. However, the FCA is firmer in its language on CSAs, saying that it expects to see a step change in the approach to CSAs which it has seen during its supervisory work. The differences in strength of language appear to indicate a potential difference in approach to CSAs.

The full extent of national interpretations is yet to be seen as the implementation efforts of regulators are still relatively embryonic. It's also important to note both the examples above are taken from consultations and final rules and thinking may differ significantly. Nonetheless, early signs of divergence are evident.

How can we help?

We can support clients in revising their business model to deal with the strategic impact of MiFID II. We can also help in revising existing operating models to deal with the operational impact of new requirements. The operating model changes will impact front to back processes, controls, infrastructure and data. Training and client communication will also be key areas of focus.

We have a vast amount of experience supporting firms across the sector with MiFID II gap analysis, impact assessment, programme management and strategic implementation. We have deep expertise in all areas of MiFID II, from investor protection and governance, through to transparency and market structure. We can also help you understand the strategic opportunities MiFID II brings, and help you establish the cumulative impact of the broader regulatory change agenda, across the EU and beyond. If you would like to discuss any of the issues described above in more detail, please contact us.

As implementation at the national level is going to be a key dimension, especially for investor protection issues, PwC has set up a fully integrated cross-border European team, which thanks to its transversal approach and close proximity with both European and national regulators, can assist you in monitoring the possible differences between countries in this implementation and coping with these differences.

Country	Have industry workshops/ roundtables been run?	Have implementation consultations been published	Has a draft law been published yet?	Has MiFID been transposed into national laws?
Austria	No	No	No	No
Belgium	No	No	No	No
Cyprus	No	No	Yes	No
Czech Republic	Yes	Yes	Yes	No
France	Yes	Yes	Yes	Partially
Germany	Yes	Yes	Yes	Partially
Greece	Yes	No	No	No
Ireland	No	Yes	No	No
Italy	Yes	Yes	No	No
Luxembourg	No	No	No	No
Norway	No	Yes	No	No
Poland	No	No	No	No
Portugal	No	No	No	No
Spain	Yes	No	No	No
Switzerland*	No	No	Yes	No
UK	Yes	Yes	Yes	No
Overview				
Yes	7	7	6	2
No	9	9	10	14

*Switzerland sits outside the EU but adopts EU MiFID policy.

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