Making the Most of MiFID II

How to Get Ready for the Requirements

Connor Sloman
Head of Client Solutions
EMEA

Financial services firms throughout Europe will see sweeping regulatory changes come into effect on 3 January 2018. That’s the compliance deadline for the revised Markets in Financial Instruments Directive, known as MiFID II. Developed in response to the global financial crisis in 2008, the regulation will affect any business involved in the manufacturing, distribution and trading of financial instruments in the European Union.

Individual countries will continue to introduce adaptations of the directive for their own regions. Countries have until 3 July 2017 to adjust their domestic laws and regulations to MiFID II. And Morningstar is actively talking to industry bodies and clients across the continent to weigh in on how these changes can be good for investors and good for the industry.

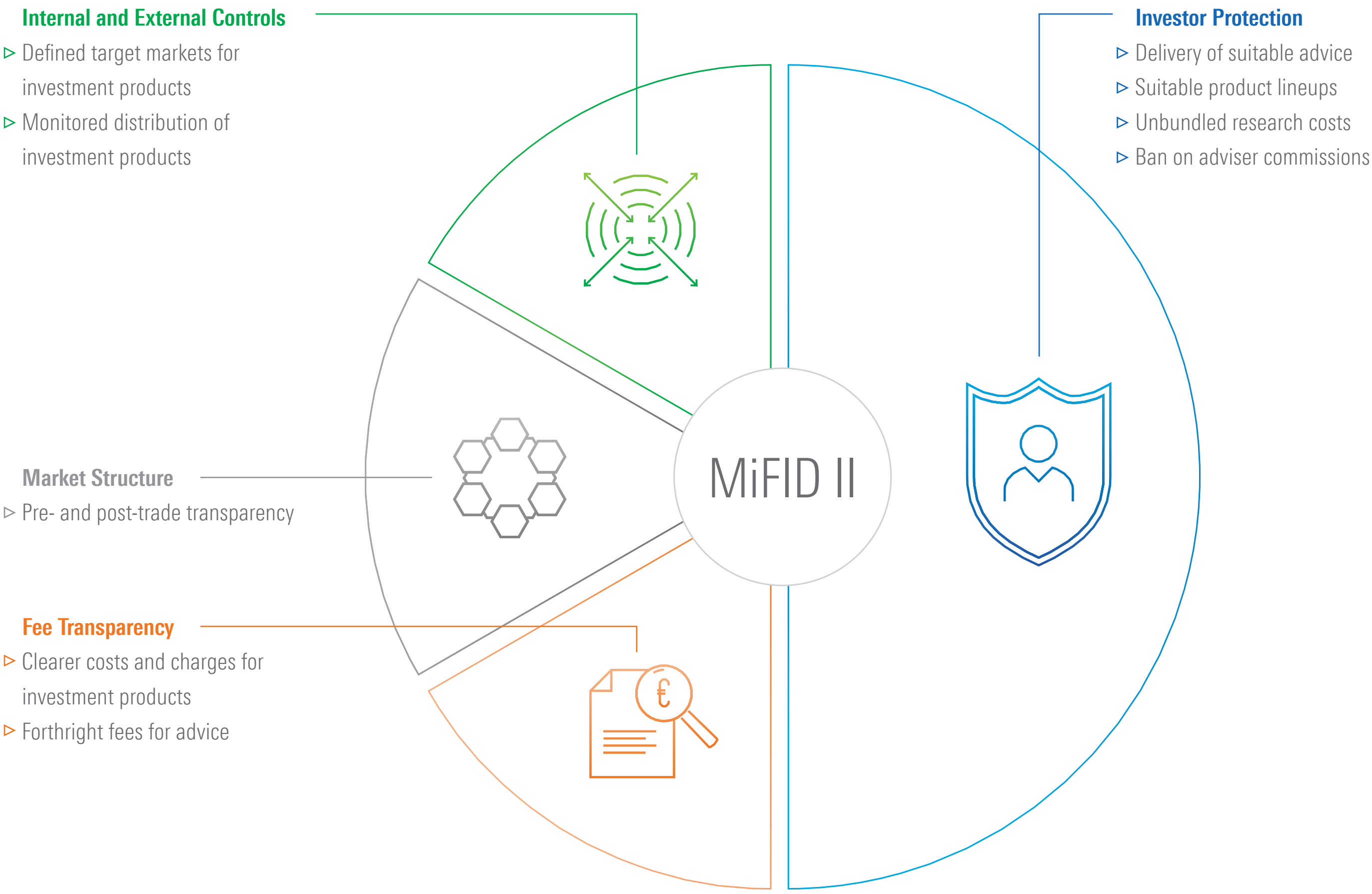
Deconstructing the Directive

The far-reaching directive can be broken down into four main areas: investor protection, fee transparency, internal and external controls, and market structure. Morningstar helps firms adapt their business models to comply with this regulation while also addressing investing trends driven by MiFID II and other regulations worldwide. Those trends include a preference for low-cost investing, outcome-oriented solutions and automated advice. Our expertise concentrates on the changes associated with investor protection, fee transparency and internal and external controls.

"A lot of MiFID II is focused around transparency, protecting the investor and putting the investor's best interest first," said Connor Sloman, Morningstar's head of client solutions, EMEA. "Firms will need to remove conflicts of interest and demonstrate how they're helping the investor. And how they approach this will vary firm by firm."

These regulatory changes will give firms an opportunity to rethink and standardise how they deliver advice, with the goals of also increasing efficiency, limiting risk and enhancing the service experience they offer investors.

As the compliance deadline for MiFID II approaches, financial firms will need to adapt their advisory and asset management businesses to demonstrate their commitment to investor protection and maximum transparency.



Investor Protection

The directive requires that every portfolio is constructed with the client's objectives in mind and that those portfolios are monitored for suitability on an ongoing basis. It also bans inducements for independent advice and makes sure that anyone providing investment advice is putting each client's best interest first.

What It Will Take to Deliver Suitable Investment Advice

Under MiFID II, advisory firms will need to deliver suitable advice and recommend investments that are appropriate for each client's needs. UK and Dutch advisers have already made such changes because of the Retail Distribution Review (RDR), though other advisers across Europe must adapt their processes.

As a first step, Sloman said, internal investment research teams at advisory firms will help decide what investment products should be available to their clients. "We will see much more of a focus on the quality of the investment product being offered to the firm's clients."

Rethinking the Advice Process

Firms should review their entire advice process to make sure that the investments in their lineup and portfolios they offer are suitable to investors' needs.

"Suitability requires an assessment of investors' risk tolerance and also their ability to bear losses based on their financial situation," Sloman said. "That risk capacity will lead to a suitable asset allocation. Then, the investment solution needs to match that asset allocation."

Advisers will need to produce a report that shows investors why the investment solution or portfolio is suitable to their requirements. Then, advisers must continuously monitor the portfolio to make sure it remains aligned with the client's needs. As firms examine their advice process, many are considering how they can use technology to enhance it, Sloman said. Technology can help them offer more efficient, scalable and investor-centric services.

A New Breed of Investment Products

Asset managers will also need to review their product lineups to define their target markets so their products are distributed appropriately. "Are the investments of the right complexity? Are they oriented toward the objectives of clients who are looking for specific outcomes? MiFID II provides an opportunity to evaluate those lineups, to consolidate products and to become more efficient," Sloman said.

As they concentrate on investor needs, asset managers may want to differentiate their product lineups by adding outcome-oriented funds. These types of investments will serve advisers well as they build portfolios designed to help investors meet specific goals.

"Having distribution focused on the investor rather than being driven by product sales and commissions should improve investor outcomes and improve trust in the industry, which would then benefit asset managers as a result," Sloman said.

Unbundling of Research

How asset managers pay for equity research across Europe will change dramatically under MiFID II. By January 2018, they will be required to pay directly for the research they receive rather than combining those payments with the commissions for trading and execution. Such unbundling also will apply to advisory firms who pay for research bundled with their commission payments. Separating these costs is known as research and payment unbundling.

Financial firms will need to be transparent about what they are spending on research, and they'll have to decide how to cover that amount.

"We predict investors will gravitate to the best outcomes and experiences."

"Some are passing research costs on to the end investor," Sloman said. "Some will pay for it themselves. Through this process, irrespective of who's covering the cost of the research, there will be much more attention paid to the quality of the research and the actual value that the firm is receiving from that research."

Ban on Commissions

MiFID II prohibits independent advisers from receiving commissions and rebate payments, a restriction that's already in place in the UK and in the Netherlands. Under the directive, advisory firms elsewhere will need to decide first whether their advisers will be independent.

If advisers are independent, then they can no longer receive any commissions and will need to offer only fee-based services, Sloman said. Non-independent advisers can receive commissions, but they must be upfront about how investors benefit from the products they recommend and how those products will help them achieve their goals.

"The clarity of what an investor is paying for should lead to a more competitive landscape in terms of the products available and the quality of advice," Sloman said. "We predict investors will gravitate to the best outcomes and experiences."

Fee Transparency

The directive's emphasis on transparency, particularly around fees, is expected to make it much easier to see who's paying for what throughout the investment process.

Investors Will Know What They're Paying For

After January 2018, asset managers will be required to provide investors and advisers more transparency on the costs of their products. These costs will be broken down into four main components: the ongoing charge for the fund; one-off fees, such as entry and exit fees; incidental fees, such as performance fees paid by the fund; and the transaction fees related to the investment product.

And with more advisers expected to move to a fee-based model because of the regulation, this will amplify the focus on the costs of both the recommended investments and of the advice service. Asset managers should review their distribution strategies and consider what they are charging for investment products.

"Post-MiFID II, advisers will pay more attention to the fees investors are paying for financial products," Sloman said. "By removing any influence that commission rates might have, advisers will become more focused on the quality of the provider and will look for lower-cost vehicles."

Investors Will Weigh the Value of Advice

Advisory firms need to adapt their offerings to include fee-based financial-planning services as they prove their value to clients.

> "Fee transparency will help investors know what they are actually paying for in terms of the quality of product that they're receiving and the quality of advice that they're receiving."

More explicit fees also will help bring increased attention to the financial objectives of the client and whether advisers are meeting those objectives, Sloman said. "We'll see more outcome-oriented solutions—such as multi-asset funds and risk-targeted funds—because of a renewed emphasis on financial planning."

Because there will be greater clarity around costs, clients are likely to be more interested in how their investments are performing in relation to their goals. They will want a portfolio that helps get them there.

"Fee transparency will help investors know what they are actually paying for in terms of the quality of product that they're receiving and the quality of advice that they're receiving," Sloman said.

Internal and External Controls

MiFID II will ramp up the need for firms to have internal oversight of audits, compliance and risk. They also must be prepared to pivot quickly to comply with any additional actions European regulators take at the country level.

These regulatory changes will give firms an opportunity to revamp their business processes to make long-desired enhancements. "Quite often, firms can find the budget to comply with new regulations, and they can include technology updates to support the advice process as well as other operational improvements," Sloman said.

Right on Target

Under the regulation, asset managers must define the target markets for their investment products and make sure that information is communicated to those who distribute them. Then, on an ongoing basis, firms must monitor the distribution of their investment products to make sure they are delivered to the appropriate clients.

"Some folks look at this as an opportunity to evolve and become more efficient by putting in place modern, scalable processes which will not only improve their businesses for the future but also offer investors better experiences."

These MiFID II changes give firms a chance to make sure they have the flexibility to add new data requirements when new regulations arise. Firms may also want to reassess their reporting process to reduce the hassle and complexity of gathering data and delivering any necessary regulatory documents.

"Some folks look at this as an opportunity to evolve and become more efficient by putting in place modern, scalable processes which will not only improve their businesses for the future but also offer investors better experiences," Sloman said.

After January 2018

Although some of the implementations of the directive are still being finalised, Morningstar is ready to help address the directive's main principles. Over the long term, we believe these changes will lead to a greater focus on investors and their goals, which will give firms an opportunity to position themselves as more investor-friendly.

"Post-January 2018, firms will still need to adapt to the competitive landscape and evolving investor trends," Sloman said.

Morningstar plays a vital role within the industry, as we work with investors, advisers, professional organisations and asset managers. "We're very much a part of the evolving conversations as the industry works out how to respond to this directive," Sloman said.

The New Rules of Engagement

Advisers should understand what they are selling and be experts in the service they provide. And they should understand the risks associated with different investment products.

"As we see a trend more towards outcome-oriented products, training advisers to be much more clear on what the product is intended to achieve and who the target market is for that product will become more important," Sloman said.

Asset managers will need to distinguish their products and keep their clients' objectives in mind. They will need to help advisers transition to client conversations that are less about the performance of individual investments and more about how they fit within an investor's overall portfolio and goals.

"MiFID II is clearly much more than just a compliance exercise," Sloman said. "There are certain elements that firms need to have in place prior to January 2018 to be compliant. But companies are also using the regulation to innovate, become more competitive and enhance the experience of investors ahead of changes we will undoubtedly see following MiFID II."

About Morningstar's MiFID II Solutions

The key principles of MiFID II—investor protection, fee transparency, and governance—align perfectly with Morningstar's mission. Our mission is to create great products that help investors reach their financial goals. We're a leading provider of independent investment research in North America, Europe, Australia and Asia. For more than 30 years, we have worked directly with investors and the professionals who serve them.

Morningstar has both the experience and vision to lead firms through the MiFID II compliance process with solutions to these business needs:

Product Governance: Target market data and manager and exchange-traded fund research to help firms manage their lineups.

Research Unbundling: Independent equity research by 100 analysts covering more than 1,500 companies globally.

Suitability and Advice Process: Portfolio risk scoring and advice workflow tools to help advisers build, propose and manage suitable portfolios.

Fee Transparency: Comprehensive investment product fee data and a calculation engine to determine the cost of investing and the impact of product and service fees on returns.

Contact Us Today

Email **MiFIDII@morningstar.com**
Visit **www.morningstar.com/company/mifid-ii-regulation-trends**