MiFID 2: TAMING THE BEAST

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After years of extensive debate and delays, the Markets in Financial Instruments Directive 2 (MiFID 2) is finally set to go live in January 2018. MiFID 2 is designed to make the trading of financial instruments in Europe more efficient and transparent to ultimately increase investor protection. It is easily the most complex piece of regulation global asset managers will face this year.

With less than a year before implementation, asset managers must focus on three key areas to ensure they are prepared: transaction reporting, fee transparency, and product governance.

**TRANSACTION REPORTING**
The biggest operational shift in MiFID 2 is that the responsibility of transaction reporting will be transferred from brokers to asset managers. This new responsibility adds to asset managers’ ever-expanding reporting burden, which now includes requirements for European Market Infrastructure Regulation, Securities Financing Transactions Regulation, and Dodd Frank. With an estimated 15 million financial instruments falling under MiFID 2 and over 81 required data fields that will need to be reported on a single trade, transaction reporting requirements will demand significant systems development. Asset managers have three options when deciding how to approach their new reporting responsibilities:

1. **Build** an in-house solution
2. **Buy** a third-party solution
3. **Outsource** the responsibility to an Approved Reporting Mechanism

Ultimately, the asset manager’s decision will come down to organizational capacity and systems strategy. If a firm chooses to outsource, they are responsible for the accuracy of the reporting and will need to ensure the appropriate oversight. If they have not done so already, asset managers will need to make their final decision soon to allow enough time to test in advance of the January 2018 deadline.

**UNBUNDLING OF FEES**
MiFID 2 contains a number of enhancements to fee disclosures. Among them, MiFID 2 explicitly prohibits the payment of commissions and rebates to independent advisors. Asset managers who use external advisors and distributors for their funds need to review, and where required, revise existing commercial arrangements to adhere to the new rules. To accommodate the new fee arrangements, asset managers may consider establishing new fund share classes.

Currently, the costs of trade execution and investment research are usually bundled into a single fee. Under MiFID 2, these costs need to be unbundled and disclosed separately. Unbundling requires asset managers to decide how they want to account for research fees. One option is to establish Research Payment Accounts where the accrued research fees are aggregated and then paid by the fund to research providers. The alternative is to pay the research fees directly.

To prepare for unbundling, asset managers should review their research inventory to determine if they wish to keep receiving it. Once this decision is made, firms must choose a method for accounting and paying for such research.

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MiFID 2 imposes stricter product governance requirements for both product manufacturers and their distributors. Asset managers must define the target market for each fund, which frames the suitability requirements for the end investor.

A deeper level of engagement between asset managers and their distributors will be required under MiFID 2. Beyond defining the target market, asset managers and distributors will also be required to perform ongoing surveillance to ensure the fund is being sold exclusively to investors in the intended market, and matches the risk profile and investment needs of investors.

For asset managers with more complex products, ensuring that their current investor base will continue to fall within the parameters of their MiFID 2 target market is of particular concern. The requirement to monitor the types of funds sold, as well as the method of sales and distribution, calls for asset managers to develop robust oversight models of their distribution networks.

**MOVING FROM PREPARATION TO IMPLEMENTATION**
MiFID 2 has been a long time coming, but a substantial body of work still remains. As the final rules and market practices emerge, the clock is ticking as the January 2018 deadline approaches. So while many firms have been preparing for MiFID 2 for a few years, the focus needs to swiftly shift from preparation to implementation. An important year of execution lies ahead as the industry looks to tame the MiFID 2 beast.

**CHECKLIST FOR ASSET MANAGERS**

To prepare for January 2018 firms should:

- ✓ Enact systems changes and testing
- ✓ Evaluate existing fee structures
- ✓ Review data and reporting solutions
- ✓ Refresh policies and procedures
- ✓ Assess product sets and distribution channels

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