Transcript

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Episode 50 – MiFID II

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Emily Larsen - And I'm Emily Larsen. In each episode, we'll explore topics relevant to today's trusted financial advisors, interviewing experts and investigating the world of wealth advising from every angle. We'll also provide you with actionable ideas designed to improve outcomes for advisors and their clients.

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Emily Larsen - Before we get started, one quick request. If you have enjoyed the show and found them of value, please take a moment to leave us a rating or review on iTunes. It would really mean a lot to us.

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Ben Jones - Today we're revisiting the topic of global regulation. Oh yes, very exciting. Now, you might remember that last year we covered the U.S. conflict of interest rules from the Department of Labor. And then we headed up North to discuss Canada's CRM2 rules. Today, we travel across the pond to the UK and Europe. And while these regulations that we're discussing are specific to EU financial markets this set of rules has had global implications. So, if you're in the U.S. and Canada, don't tune out just yet.

Emily Larsen - Today we're talking about MiFID II, the European regulation and directive that significantly changes how advisors do business in Europe and effects most markets around the world. We're going to get into the details on today's show and discuss how implementation is going, the implications for EU advisors, and the impact on North American advisors as well.

Ben Jones - Our guest today is the knowledgeable Ben Apfel. He's the Head of Legal for BMO GAM EMEA. That's Europe, Middle East, and Africa. And I had the pleasure of sitting down with Ben at BMO GAM's London offices to discuss this topic.

Ben Apfel - By name is Ben Apfel and I'm Head of Legal at BMO Global Asset Management for the EMEA region, which is obviously part of the Bank of Montreal.

Ben Jones - You know, when you're out with friends and family, out at dinner, and they said what do you do, how do you describe your role to them?

Ben Apfel - Well, I say I'm an in-house lawyer and I like to view myself as a trusted advisor to my business partners. So I'm not just there to provide effective challenge, I'm there to help them achieve what we call in the bank responsible growth.

Ben Jones - Fantastic, where are we today? Where are we recording?

Ben Apfel - We are recording in what is called the European room in Exchange House, the headquarters of BMO Global Asset Management in EMEA.

Ben Jones - We're in London England, on a beautiful, cloudy, rainy day, right?

Ben Apfel - That's exactly what you would expect.

Ben Jones - So, Ben, we're here to talk about something that's been quite impactful to I'm sure -- your life and the EMEA business and even just globally.

Ben Apfel - Yes.

Ben Jones - Over the last year or so in particular intensity but for quite some time. So, we're talking about MiFID II. So, before we kind of dive into some of the particulars of MiFID II, this is a big deal. It affects most markets around the globe and asset managers. So, we're all exporting regulation now.

Ben Apfel - Yes. That's a theme.

Ben Jones - And, we did an episode on the Department of Labor rule in the U.S., we did one on CRM2 in Canada, and so it's very appropriate that we cover MiFID II. So, what does MiFID II stand for?

Ben Apfel - So, first of all, MiFID stands for the Market in Financial Instruments Directive, pretty bland title. And the two stands for, well, simply because it's like mark II and there was a mark I. There was a mark I in 2007, since then, it's been the cornerstone of EU regulation of both investment business firms and also financial markets. So, what it's doing, this goes to the original MiFID and the MiFID II enhanced version is it's looking at how investment services provide firms in a range of areas from best execution to outsourcing to inducement, both on the sell and the buy side. And it's also looking at and regulating the operation of stock exchanges and trading venues.

Ben Jones - So MiFID, the original MiFID, comes out in 2007. Was it by design that there was a phase two, or did they just get to updating it and they decided we need to issue a second mark?

Ben Apfel - No, so it was by design, because I mean regulation is meant to be living and keep up with changes in the market place. And what the European commission, because this is a price of European regulation, that applies to members of the European Union, which Britain still is today. What they were looking at were two factors, huge factors of change that needed addressing in terms of title regulation. Firstly, the financial crisis from 2008 which exposed weaknesses in the functioning and transparency of markets and therefore investor protection. And secondly, also, products becoming increasingly more complex and houses offering an increasingly wide arrange, and bewildering range of products and investors becoming more active in their use of those products. So, I think the commission felt there was a need to also have greater regulation of how products are pushed out there and the governments around them. So, those are kind of the two big themes. This has been going for like maybe four years in terms of -- if not more -- in terms of development.

Ben Jones - It has been delayed one or twice?

Ben Apfel - And it was delayed once. Because of all of the technology implementation. So, originally, it was meant to come into force on the 3rd of January, 2017. And then it was delayed. And if you look at the sheer size of the thing, because I've got some stacks here that -.

Ben Jones - Yes, that'd be great.

Ben Apfel - I got together. So, MiFID II, which is the -- which consists in fact of two pieces of legislation. So there's a directive, and a regulation. And so those of you who are nerdy maybe about EU regulation, which is probably nobody listening. A regulation is a piece of legislation that comes into force automatically once it's passed the European Union level, so there's no need for local member state parliaments to actually bring the law into force. Whereas a directive is a piece of legislation that needs to be actually implemented into the member states local laws. So, there's two things. There's MiFIR which is the MiFID version of the regulation directly affected, which is more focused on markets. And then there's MiFID which is the directive, and it is more focused probably more on conduct of business. And in terms of stats, the entire thing - 1.7M paragraphs and 541,000 words - now, *War and Peace* is 580,000 words. So, you can see the sheer size of this piece of legislation. And that's before -- you've got to read all of this stuff. That's before you even get to doing the implementation.

Ben Jones - That sounds like a great way for me to fall asleep on the plane on the way home, is to try to read that entire regulation. But, I mean, that kind of explains why it's taking so long to get -- the full implementation done. Now, the rule was delayed -- it was -- the official start date was January of 2018 here. And so, is that the full implementation or is there still work being done on the timetable to get that in compliance?

Ben Apfel - So, from a European commission level, so the European Union level, that's it basically. The 3rd of January was when the regulation came into force. But, does that mean it's the end? Absolutely not, for a number of reasons. I mean, one is, as I said before, part of MiFID involves legislation that needs to be implemented locally. And some states -- some countries, are not as efficient as other countries in implementing legislation. So, you have this bizarre situation in, for example, Spain or Portugal, where half of MiFID, the regulation part, which takes effect directly, is in-force. And the other part, the directive, is not in-force, because their parliament has failed to pass it yet.

Ben Jones - Wow.

Ben Apfel - There's still parliaments that need to do it in some of the member states. The other thing is --.

Ben Jones - But does that put the parties that function in those markets in an awkward situation?

Ben Apfel - Well, yes, because they're kind of having to do a balancing act a bit. And the European commissions are not happy about it and they've done a bit of naming and shaming of some jurisdictions who've kind of not got their act together. But this is not an uncommon trend with European legislation. The other factor is, is that because of the complexity of implementation there's a betting in time, I mean naturally it's not like 3rd of January and that was it. Everything was up and running kind of smoothly. I mean, there was a lot up and running but there's a whole IT build and firms are still working through, and regulators, with the IT build. Working through the IT build needed in order to ensure full implementation.

Emily Larsen - Wow, 541,000 words. Let me try to recap with much fewer. After some delays, MiFID II, which stands for Market in Financial Instruments Directive Two, came into full effect on January 3, 2018, although some local parliaments have yet to pass the directive portion of the legislation. The regulation was partially in response to the 2008 financial crisis. The directive and regulation aims to provide greater transparency for end clients as well as regulate areas where potential conflicts of interest may occur. At this point you'll notice there's a team about conflicts of interest and transparency in regulation around the world.

Ben Jones - I asked Ben why advisors should care about MiFID II, and here's what he had to say.

Ben Apfel - So, from the perspective of financial advisors, actually who are regulated in the European Union, they should care about it because basically this has changed in significant ways the way they operate in practice. So, to run through a couple of things. First of all, they're enhanced competency requirements that they have to be able to demonstrate. So, knowledge of financial products, how they operate, and how to sell them appropriately to investors.

Ben Jones - And are those tests that they have to -- CE tests or things that they have to do on an ongoing basis.

Ben Apfel - No, I think it's up to the firms to determine that people who are client facing have the necessary knowledge and competency. Although, clearly, there are qualifications that financial advisors can do. And, in some jurisdictions such as the UK, in order to be a financial advisor you do have to have a qualification. Secondly, there are restrictions on payment of trail fees which is a huge deal. So, just to clarify, trail fee is also known as a rebate. Is something that a product manufacturer, fund manufacturer, will pay to a distributor of their fund from their own bottom line, from their annual management fee that they receive on the fund, in consideration of the distributor promoting the fund to their underlying investors. And the issue with that, from a regulatory perspective, is that it creates a conflict of interest because, potentially, the distributor is not looking at the product that is most suitable for the client and meets the target market that they're selling to. They potentially are looking for the product that will pay them the most rebate. And so, that has been a long standing concern and we've seen in the UK, for example, in 2012, that the financial conduct authority introduced the retail distribution review, which banned payment of rebates to any type of financial advisor. Not just independent financial advisors. This is like the kind of follow on, and it probably arises in large part due to British influence before the Brexit referendum. So, what you're seeing now is that if you're a portfolio manager, and you're dealing with retail customers, or you're an independent financial advisor, and you're dealing with retail customers, you're no longer allowed to receive any trail fee.

Ben Jones - And so, has this increased the utilization of fee-based type advice?

Ben Apfel - Well, it's too early to say, but, obviously the only model you can utilize if you're an independent financial advisor is being paid directly by the end investor. And that leads to the challenge that some investors may say I'm not willing to pay for an advice service. I'm just going to go track down whatever investors I think are appropriate. And then you end up with a potentially advice gap. That's one of the trends that has come out of RDR. However, let's remember, the ban on rebates or trail fees under MiFID II -- so, outside of the UK which is gold-plated, or the Netherlands, applies to independent financial advisors. If you're a restricted financial advisor, so in other words you're not looking at the whole range of market products, you're looking at, say, a platform of products that you've decided, you've selected, or you've wrapped because you're a large private bank, then you can still receive rebates. But the test for receiving those rebates to make sure that there isn't a conflict with the end investor, and it's appropriate for the financial advisor to receive the rebate, is much higher. They have to be able to show that the receipt of the rebate will enhance the quality of services they provide to the end investor. For example, it will enable them to host a greater data set on a particular fund manufacturers products on their website. So that's -- that's on that. The other thing that is huge is product governance. So, product governance, which was already a big deal from an FCA perspective in the UK, those rule have been adopted as part of MiFID II and pushed out across the whole of the European Union and this is all -- a whole set of rules around how you launch and then operate and distribute a product in the best interest of investors. And, two, an appropriate set of investors. So, products are not going to the wrong target market. And the rules apply to both fund manufacturers, so the people who create and launch funds and also, distributors, so the people offering the funds to end investors. If you're a financial advisor, now, you have a formal regulatory requirement under MiFID II to make sure that you understand the characteristics of the fund that you're selling. So, BMO Funds, for example, you look at the target market that we have identified for that fund. So, maybe we say, only advised retail investors. And, you are able, therefore, to sell the product appropriately to the end investor.

Ben Jones - So, I want to make sure I understand that. That particular thing means that as a manufacturer or fund manager investment firm, like us, we would have to define who the product is appropriate for and then the advisor would also have to make sure they were only selling it, or promoting it, to that type of client?

Ben Apfel - Yes, that's exactly right, Ben. And to facilitate them doing that, there's been an industry wide data template of that called the European MiFID template. Very --

Ben Jones - Very clever, huh?

Ben Apfel - Which lists out the appropriate distribution channels, fund characteristics--.

Emily Larsen - So, now, let's look at why advisors who don't practice in Europe should care about MiFID II.

Ben Apfel - If you're a financial advisor in another jurisdiction, why should you care about the impact of MiFID II? I would say, there's two points. First of all, practically speaking, if you're buying a product from a European product manufacturer, then they are going to seek to get additional information from you as a distributor. In particular they will request whether you have sold the fund in line with it's identified target market, or whether you've had sales outside. And they will also want to receive details of investor complaints.

Ben Jones - And so, on this point, if you're an advisor sitting in Miami and you do a fair bit of offshore business UCITS the manufacturer of that particular UCIT might ask you for some more details than they have in the past.

Ben Apfel - Yes, that's exactly what I'm saying. The other reason why you should care is because often a huge regulation such as this is an indication of trends generally, in global regulation. So I think this is the kind of writing on the wall in terms of transparency of cost and charges for investors. And also, financial advisors acting in the best interest of their end clients rather than their own pockets. And so, what we're seeing -- we've seen in other jurisdictions like Australia or the Netherlands, complete ban on rebates. In Canada, we've had CRM2 which has resulted in enhanced disclosure of costs and charges. And in the U.S., as you mentioned, we've had the Department of Labor fiduciary rule and which requires financial advisors -- they have a specific duty to undertake certain activities to show they're acting in the best interest of end investors. And obviously that's generating a whole controversy. That controversy in a way mirrors almost the controversy that you see around regulations in the UK, like the retail distribution review, which is - are we over-regulating financial advisors so much that either you see a drop off in the number of people who prepare to be financial advisors, or you see a drop in investors willing to seek advice because they find the process so cumbersome.

Emily Larsen - We're all exporting regulation in today's globalized society, so it may be educational to listen to our episodes on the CRM2 regulation in Canada, and the U.S. Department of Labor's fiduciary rule. Those episodes are 32 and 24 respectively, and we'll have links to them at bmogam.com/betterconversations.

Ben Jones - As with the regulations in the U.S. and Canada, the chief concern among many in the financial industry is that regulations such at MiFID II have gone too far, creating big barriers to entry, and increasing the cost burden on smaller firms, causing them either close or merge into larger ones. So let's explore the specific critiques and some of the unintended consequences of MiFID II with respect to what you've seen so far, it's early times where we're recording this. The law's kind of been officially in place for a little over a month. Are you seeing any unintended consequences for financial advisors in the EU?

Ben Apfel - I think it's too early to say, except that what you are seeing is that fund platforms, if they haven't received this European MiFID template with all of the necessary data, then they are basically stopping the funds from being on a platform. So you have all of the asset management houses trying to make sure that the templates all develop, but that the IT build works to make sure that the data flows to the platforms or distributors so that they can then fulfill their own regulatory obligations.

Ben Jones - I've read some of the critics of MiFID II and certainly in the U.S., the DOL rule. Some of the critics say that it increases the barriers to entry to the point where new firms don't start up, there's not new advisor recruitment. And that also the big firms, because they have scale, are able to comply really easily and a lot of these small firms have an unwieldy burden that's placed upon them and maybe it limits competition. Where do you come out on this?

Ben Apfel - So, on the IFA side, yes. I mean, you saw this with RDR in the UK. You saw lot of smaller advisors saying it's all too difficult. I'm not going to basically continue acting as a financial advisor anymore. I suspect what you might see, and I don't have a crystal ball, but you might see the same trend with independent financial advisors in Europe, and therefore greater drift towards a restricted advisor model in Europe. So investors being able to go to private banks who offer a more limited range of products that they selected rather than whole of market.

Emily Larsen - One of the topics within MiFID II that has received the most attention and press outside of Europe is how MiFID II impacts research. Ben Apfel explains the new options.

Ben Apfel - With respect to research, what you're seeing is enhanced rules on inducements generally in respect to rebates. And as an extension of that, what we have seen is a move to what people call unbundling research from execution costs. So, in the pre-MiFID II days, when you did a trade, you potentially were paying partly for an execution cost and partly through what people called soft dollar or a commission sharing arrangement for research that you would get from the sell side house that you're doing the trade with. Regulators have increasingly thought that creates conflict of interest because effectively you're using investors' money to just pay for research that you may not even look at from a quality perspective, and just consume willie nilly, and again, that's not fair. It's not providing value for money for investors. It's only serving to benefit the asset manager, and also potentially the sell side in terms of their execution costs being linked to research. What we have seen under MiFID II is a ban on what were commission sharing arrangements. So a ban on doing a completely aggregated trade. There are only two routes not to paying for research from the sell side. One is paying from your own bottom line, so the asset manager funding the cost of research and entering into separate research provider agreements with the sell side in a standalone contract and then executing on an execution only basis in terms of equities. On the fixed income side, this is not really directly relevant because you have spreads where the cost of trading is made up of a number of factors and research may be one of them. But on the equity side, what you're seeing is trading on an execution only basis, and paying for research separately. The other method is what's call the research payment account, which is where you pass the cost to the end client. So what you have there is a separate standalone account set up with a third party provider. And when you do a trade, for example, you can say I want this portion of the trade, Goldman Sachs, to go into the research payment account. Then you direct the -- at the end of each quarter, you direct how the monies in the research payment account should be paid to different third party research providers. The rules are very prescriptive in terms of how you do that, the disclosure you provide to clients getting their consent. What you have seen overwhelmingly in the European marketplace is that asset managers have gone for paying for research from their own bottom line.

Ben Jones - Yeah, so you've got option one, pay for it out of your own bottom line. Option two, create this fairly complex accounting system to disclose this appropriately.

Ben Apfel - Yeah. And also pay the third party research providers, and then agree an annual research budget with your end client. I think people -- the industry felt times up on this generally, and so you've just seen a complete move to paying hard for research from asset managers' bottom line.

Ben Jones - And so, given that London's a huge financial hub -- I mean, we're sitting right here in the middle of the financial district, there are a lot of firms that operate globally that are located here in London, across Europe, in the Americas, and even in Asia Pacific. Are firms taking kind of a global approach to this or a regional approach? Do you see any commonalities in how they're trying to adapt to MiFID II as a rule?

Ben Apfel - Well, if you're a global firm, you are invariably going to have European clients, and they may contract with a European legal entity. But if it's U.S. equities, it will then get delegated back to a portfolio manager in the U.S. If you're faced with the scenario and you're a global firm, then the European legal entity will have to ensure that equivalent protections are in place in the U.S. So that's not saying you can't have soft dollar in the U.S., but some of the features from the European research payment account regime would need to be implemented. For example, greater use of commission sharing arrangements, which mean that you have more transparency as to the separation between execution and research costs. Having a research budget for investment strategies and moving to execution only trading when you reached that budget's upper limit. Assessing the quality of research, making sure that how research providers are chosen and the assessment of the quality of research is completely separately from the dealing desk. So you can do it that way, right? What we've actually seen in practice is a range of approaches. So, some firms have gone execution only across the entire globe. So they have gone, even for my U.S. clients, I'm not going to use soft dollar anymore. I may start with Europe paying for my bottom line, but I'm going to phase in paying for research, even for non-European clients, and it's now possible as a result of changes in SEC regulations, so no action letters for the sell side to accept hard dollars from asset managers. Some firms have gone for execution only for European mandates that are delegated then to the U.S. if they're U.S. equities. Some firms have gone for execution only in Europe. But then, when you delegate to the U.S., they still allow the firms to use soft dollar, as long as the equivalent protections that I described before are in place.

Ben Jones - Wonderful. And over time, do you think that there is one approach that gets settled on, or do you think that it'll always be kind of one of these two, three, four different types of approaches.

Ben Apfel - I think that there's a fundamental challenge at least between the U.S. and Europe, which you may have heard about, and ended up in these SEC no action letters. Which is, traditionally, investment banks have been prohibited under regulation in the U.S. from accepting hard dollars for research and they've had to be paid through soft dollar. And so you have this potential dilemma between the regulation in the U.S. saying no hard dollar payment and the regulation in Europe going it's basically you've got to pay research providers hard and either from your bottom line or a research payment account. So that challenge has been resolved through SEC no action letters and brokers in the U.S. can now start to receive hard dollar payments. With that resolved, I think you're going to see potentially a move, not immediately, but over the next few years potentially to research cost being born from asset managers' bottom line. The other thing is, on the sell side, what you're potentially seeing is that smaller independent research providers face a greater challenge in being paid, and that'll have a knock on effect potentially on smaller company research coverage, which could then have an impact on liquidity. And so we're seeing initiatives, for example, by some of the actual exchanges to partner with smaller companies and offer to issue research on their behalf free of charge.

Ben Jones - So the sell side and buy side relationships are undergoing a transformation in the way that they buy and consume research. And, as you can see, one theme during this episode has been how these kind of regulations have a ripple effect through the industry across the entire globe.

Emily Larsen - For those of you who are curious, we did ask Ben about how Brexit would play into this scenario, and he thinks that MiFID II will survive in some form post Brexit for a number of reasons. One reason is that any larger UK firm will have a continental European base and clients that do business in Europe. And another is that there probably won't be an appetite for divergent regulation after Brexit. So the UK likely will keep a similar regulation in place, depending on the UK's final trade relationship with the EU.

Ben Jones - Whatever side of the English Channel you're on, or whatever part of the globe that you're in, MiFID II is already making itself felt in our industry. So we hope today you've come away with a better understanding of the rule and the ways in which they will impact the various market participants around the globe. Looking ahead, I asked Ben what he sees into the future for advisors. What is a post MiFID II world feel like from an advisors' perspective?

Ben Apfel - So, I would say they're much more in the spotlight in terms of the services they provide to the end investor, and acting in their best interest. Secondly, if they're an independent financial advisor, their worrying obviously as to whether charging for independent advice is going to lead to a drop in clientele. They're also grappling with those enhanced competency requirements. They also have to give all of this disclosure to their end investors, the advisors, and they may get lots of still bewildered questions as to how does this disclosure helped me. But I think ultimately what this will do is force everybody from the manufacturer to the distributor to focus on keeping fund costs down and ensuring that sales are made in an appropriate way in client best interest.

Ben Jones - And if you were going to kind of summarize our entire conversation today in two sentences or less, what would you say?

Here we have, in the form of MiFID II, a laudable piece of regulation that is designed to tackle the evolution of financial markets and investors sophistication themselves. But, the problem, as always with laudable intentions, is the implementation. And the implementation is hugely prescriptive and, in some areas, not fully sought through, and so you end up with various material unintended consequences. For example, the impact from smaller company liquidity, because of the ban on research. In addition, any implementation of regulation of this size has a huge cost for financial services firms as well.

Ben Jones - Anything else that you'd like to share before we depart today?

Ben Apfel - Only thank you very much for listening. I know regulation isn't always scintillating but it has a huge impact, and ultimately the intention is designed to benefit each and every one of us as end consumers of financial services.

Ben Jones - Well thanks for joining the show.

Ben Apfel - Thank you.

Ben Jones - Thanks for listening to Better conversations. Better outcomes. This podcast is presented by BMO Global Asset Management. To learn more about what BMO can do for you, visit us at www.bmogam.com/betterconversations.

Emily Larsen - We value listener feedback and would love to hear what you have thought about today's episode. Or, if you're willing to share your own experiences or insights related to today's topic, please e-mail us at betterconversations@bmo.com. Of course, the greatest compliment of all is if you tell your friends and coworkers to subscribe to the show. You can subscribe to our show on iTunes, Google Play, the Stitcher app, or your favorite podcast platform. Until next time, I'm Emily Larsen.

Ben Jones - And I'm Ben Jones. From all of us at BMO Global Asset Management, hoping you have a productive and wonderful week.

Emily Larsen - This show and resources are supported by a talented team of dedicated professionals at BMO, including Pat Bordak, Gayle Gipson, Matt Perry, and Derek Devereaux. This show is edited and produced by Jonah Geil-Neufeld and Annie Fassler of Puddle Creative.