



# Clever

**MIFID II EXPLAINED:**  
Our Interpretation of  
MiFID II and the impact  
it will have on IFAs

## Clever guides you may find useful

**Developing and managing a centralised investment proposition  
PROD Guide**

**7 proven ways to grow your advisory business**

**Explore all our guides at:**  
[cleveradviser.com/clever-insights/](https://cleveradviser.com/clever-insights/)

## Contents

Introduction	<b>4</b>
The Goals Of MiFID II	<b>5</b>
The Impact of MiFID II on IFAs	<b>7</b>
Key Challenges	<b>13</b>
MiFID II and Technology	<b>16</b>
To The Future and Beyond	<b>18</b>



Developing and managing a centralised investment proposition



PROD Guide



7 proven ways to grow your advisory business



# Introduction.

MiFID, or Markets In Financial Instruments Directive, has been a crucial part of financial legislation for over a decade. The overall title for both the directive and its associated ruling (known as MIFIR), MiFID was designed to replace the Investment Services Directive that had been the industry standard since 1993. Covering the European Economic Area (all 28-member states, along with Norway, Iceland and Lichtenstein) MiFID's core objectives were to deliver legislative parity, increase competition and to increase consumer protection, and it set out to achieve these by bringing in a series of standard rulings that levelled the playing field for EU-wide investors. But the timing of its rollout? It was unfortunate; launched in November 2007, it was swiftly met by the financial crisis, which unseated the integrity of the directive by rendering many of its rulings obsolete, as well as sharply changing priorities.

With an estimated cost of £7 trillion, the world watched in horror as the downturn took its first victims, with banks and institutions falling like dominoes. In a time of frightening firsts, the FTSE broke its own record for its worst loss in a century when £484bn was wiped away overnight, while consumer confidence showed huge drops in spending, further fuelling the panic. But even as the after-shocks of the crash began to subside, leaving the need for undeniable change in its wake, advances in technology also challenged the framework of MIFID as it stood. Work that began in 2010 to fully revise the directive was published in 2014, and after a lengthy consultation period, MiFID II finally came into effect on January 3rd, 2018.

**“MiFID II is applicable to anyone whose business is involved in the trading and distribution of financial instruments.”**

## Who does it apply to?

Whilst there are some exceptions to MiFID II – insurers, for example - the broad brushstrokes of the legislation tighten up considerably on the exemptions that applied under the original directive, which also permitted those who traded in commodity derivatives to go beneath the radar. In short, MiFID II is applicable to anyone whose business is involved in the trading and distribution of financial instruments.

## The Goals Of MiFID II.

With over half a million words, 1,068 pages and an estimated reading time of five full days, it would be a gross understatement to say that MiFID II is a heavy read. But while the depth of the document is an intimidating prospect, it's mercifully easy to describe the new requirements and their intricacies in far fewer words.

**“MiFID II's aims are logical, effective and well-researched making things cheaper, clearer and safer for the investor.”**

Despite its density of detail, MiFID II's aims are logical, effective and well-researched, and build firmly on the shoulders of its predecessor. Customer focussed, the emphasis is on making things cheaper, clearer and safer for the investor, and cover everything from conflicts of interests to artificial intelligence. Increased investor protection takes the form of heavily revised communication legislation, while EU-wide regulation alignment levels the playing field. Increases in competition and supervisory regulation weight the balance even further in favour of investors, meaning that while global moods are unpredictable, the financial markets are effectively weighted down by these stabilising measures. These four points are broken down by the legislation into a series of high-end goals that develop and broaden these initial themes.

## More Explicit Costs of Trading and Investing.

Coming hot on the heels of the FCA's report this June into the UK's asset management sector, this aim will certainly bring relief to investors who, the report ruled, have been paying too much for too long.

### “Changes in the way charges and costs are reported.”

Asset managers, the FCA found, have been in receipt of 'persistently high' levels of profit<sup>1</sup>, and by changing the ways in which costs and charges are reported, it will give advisers an opportunity to be able to compare and contrast different funds, thus providing more detailed interpretations and advice. It will also introduce the need to detail 'slippage costs,' in with other transactions costs, a move that has never been done before and will incur a greater workload to execute properly. Disclosure on fees will now include those incurred across all bases; management, advisory, custodian, fund entry and exit levies, and must also be presented in both an ex-ante (forecast) and ex-post (actual) basis.

## Orderly Trading Behaviour Within the Markets.

To keep a watchful eye on trading markets, MiFID II is pushing trading away from phones and onto electronic venues, which offer better opportunity for both audit and surveillance trails. The science behind the semantics states that this generated data will be measured in 'petabytes,' (with one petabyte equal to a staggering quadrillion bytes), and institutions will have to report data on all time-stamped trades within a clocked minute via automated reporting platforms.

## A shift in Trading Towards More Structured Marketplaces.

Legislation is not always equated with innovation, but MiFID II does introduce a new trading venue – OTF (Organised Trading Facilities), a multilateral system that is neither a regulated market nor a multilateral trading facility. This will help drive an increased transparency of markets across all asset classes, from equities to fixed income by reducing the prevalence of both opaque market models and processes.

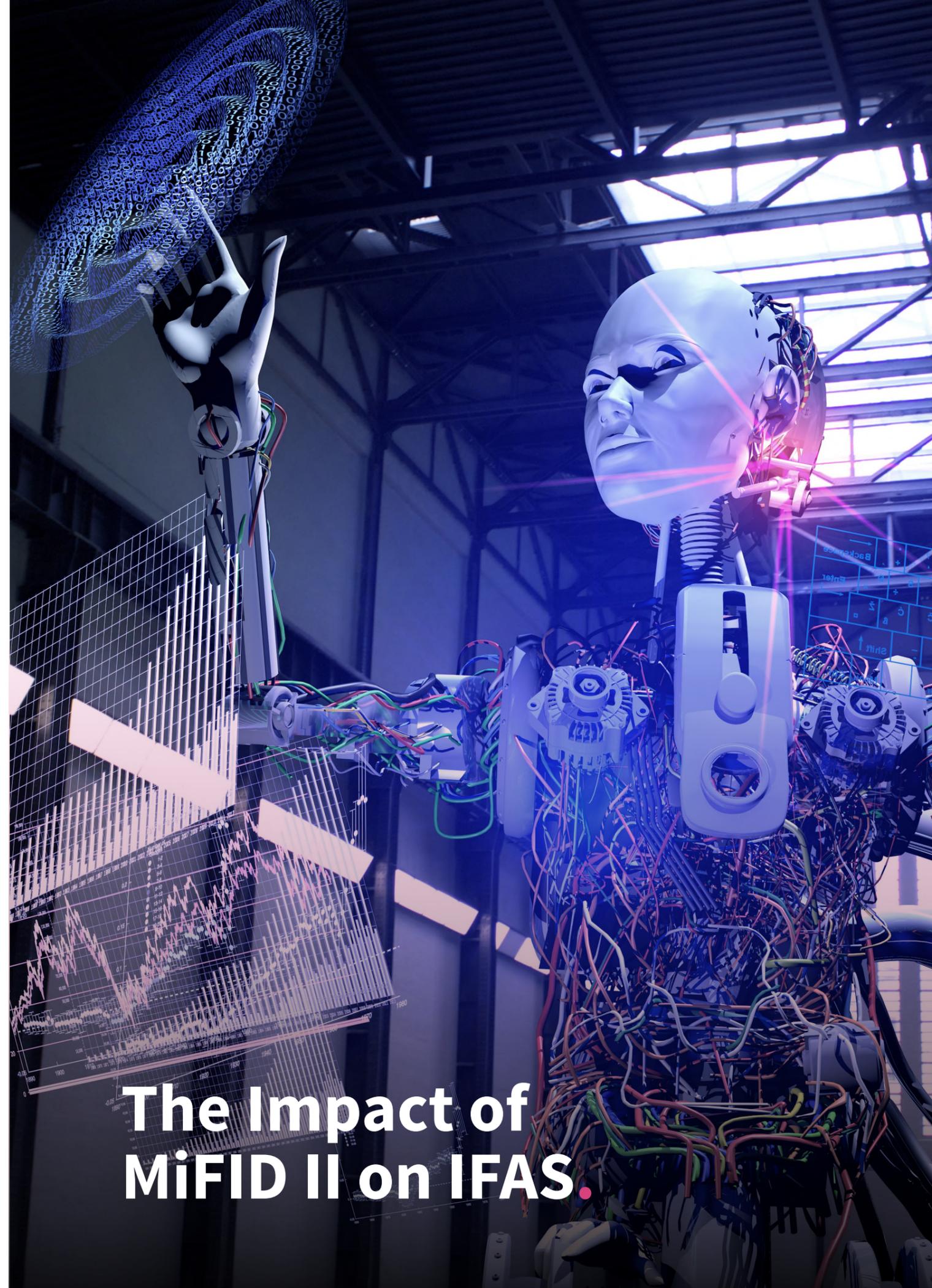
## Improved Best Execution.

A subtle change of wording tells companies all they need to know about their execution expectations, with MiFID's original obligations for firms to take 'all reasonable steps,' now requiring 'all sufficient steps.' Firms must now consider price, costs, speed, likelihood of execution and settlement, size, nature or any other relevant consideration,' and the explicit spelling out of these suggests that a more formalised approach will be taken by the regulator.

## Lower Cost Market Data.

Long-term investments in new technology, specifically machine learning driven artificial intelligence, will cut down the costs of back-room analysts and shrink wage bills as new ways of conducting reliable analysis take hold.

Additionally, the research needed to build an accurate picture of the market will now be 'unbundled,' and paid for clearly and separately, either as fully documented charges from fund managers, or specific and separate account for research consisting of customers' funds, which will also have to be fully documented and detailed to them.



# The Impact of MiFID II on IFAS.

## More Explicit Costs of Trading and Investing.

While the entire financial industry is subject to a shake-up under MiFID II, the legislative changes that will impact IFAs specifically are far more niche, and centre largely upon the integrity of the client-adviser relationships.

**“The IFAs impact is specifically very niche and centre largely upon the integrity of the client-adviser relationships.”**

Additional compliance requirements also add an increased burden, so be mindful that the possibility to outsource this area of business will need more scrutiny than ever. But before you get to that point, get ready to reset your knowledge on these key cornerstones of your business.

## Product Governance.

The rules covering product governance tighten up considerably under MiFID II, which ushers in a new era of specification and streamlining at almost every step of the process, requiring an enhanced dialogue between manufacturers and distributors. While product providers will have to define a target market, MiFID II now makes it incumbent upon advisers to feed back as to how many of their clients are in that same market at the time of the product’s recommendation. The reporting and recording systems in place to safeguard the sanctity of this information must therefore pass muster, and the focus on ensuring the robustness of current systems is paramount. But the high-detail focus of this has already reached FCA scrutiny, who have stated that they don’t want the process to drown in unnecessary bureaucracy, therefore creating an important opportunity for

advisers to maintain a dialogue with the authority to let them know what is – and isn’t – working.

## Reporting to Clients.

Under MiFID II, the requirements for reporting increase sharply, with every step – and cost – of the process having to be clearly communicated to clients. Along with research costs, IFAs will now have to disclose all costs incurred during the year, including both on-going and one-off charges, transaction costs, costs relating to ancillary services and any incidental costs, along with the impact of these aggregated costs on the assets.

**“Under MiFID II, the requirements for reporting increase sharply, with every step – & cost – of the process having to be clearly communicated to clients.”**

The granular level of this reporting doesn’t stop with just the numbers, with an added requirement to produce a percentage breakdown to match the monetary statistics. And although an annual reporting requirement might seem satisfactory, the possibility of quarterly reporting sits somewhat awkwardly beside the fact that clients can now ask for these reports to be produced upon request, too. Lessons from the financial crash have inspired an emergency braking system, in the form of mandatory communication with a client if their portfolio drops by 10%, but as David Tiller, Head of Adviser and Wealth Management.

Propositions at Standard Life says, ‘The 10% rule is likely to only kick in at the most extreme market events, such as 2008 when, I suggest, it’s highly likely clients will already have a sense that something is up.’ The difficulty with this requirement is that there is no template agreed upon for how this information must be shown, so while the possibility to personalise your communications with your clients affords some freedom, the requirements for detail are more exacting than ever.

David Tiller, Head of Adviser and Wealth Management Propositions at Standard Life says;

*“The 10% rule is likely to only kick in at the most extreme market events, such as 2008 when, I suggest, it’s highly likely clients will already have a sense that something is up”*



## Communications.

Undoubtedly one of the biggest surprises and toughest challenges to meet under MiFID II are the new communication rulings that require scrutiny of a sort not seen before.

### “MiFID II’s new communication rulings require a scrutiny IFAs have not seen before.”

Designed to protect both sides of the investing partnership, these new regulations are the ones that will most drastically affect how IFAs run their business, requiring both practical and sensitive implementation. While audit trails are commonplace in the commercial world, MiFID II has its ambitious eye on one without omission, which even extends to the recording of all telephone and electronic communications, now known as ‘the taping rule.’ Buried deep in paragraph 16, article 6, it details how the outcome of the conversations doesn’t preclude their recording;

*‘...recording of conversations and communications with all clients where these relate to or intend to lead to the conclusion of a transaction, even where the transaction is not concluded must be made.’<sup>2</sup>*

In providing an objective and contemporaneous record, this is an undeniably effective measure for both investor and firm alike, but it does usher in an air of conspiratorial times, meaning that the professional reassurance of an IFA may not seem as solid with a tape-recorder whirring away in the background, as Nick McBreen, an IFA at Worldwide Financial Planning argues - ‘Even [with] the best

relationship in the world, I think if people know that a conversation is being recorded, it will change the dimension,’ he says, echoing fears of other IFAs.

But MiFID II answers back in its Recital 57, with an unambiguous reply designed to clarify such concerns. “Such records should ensure that there is evidence to... detect any behaviour that may have relevance in terms of market abuse, including when firms deal on own account,<sup>3</sup> it says, making clear its objective to safeguard the industry from the inside, too. While both a written record or an audio-recording satisfy the requirement to document conversations, in a move to foster consistency the FCA encourages that firms opt for one method or another, a strategy which will also stop investors from ‘gaming’ the system, the practicalities involved with upholding such legislation include the need for all recordings must be kept for a minimum of five years, which raises questions regarding data storage, and also leads to issues about the difficulties of meeting these obligations when it comes to mobile communications.

## Advice.

While advisory firms will still be able to give a mixture of independent and restricted advice, individual advisers will now need to decide on giving one or the other.

### “Individual advisers will now need to decide on giving independent or restricted advice. According to the FCA, this is a move designed to streamline and clarify the services offered. They state that clear & consistent delineations of service will work much better in the long.”

According to the FCA, this is a move designed to streamline and clarify the services offered, and argue that even though currently, it is deemed acceptable to switch between both if it is made clear to the client, clear and consistent delineations of service will work much better in the long-term for the client.

## Investor Protection and Appropriateness.

Under MiFID II, increased investor protection equates to ironing out the ethics of investing, with stringent guidelines introduced to ban commissions in respect of investment advice and portfolio management.

### “The biggest factors for protecting the investor is to learn more about them when providing investment advice.”

But one of the biggest factors for protecting the investor is to learn more about them when providing investment advice or execution-only services, ie, to gauge their appropriateness to be sold the product that they are. So, all those customers who want to buy complex financial instruments without advice must now clear the hurdle of an appropriateness test. Somewhat awkwardly, MiFID II does not give specific instructions as to what this may mean, which affords a murky degree of interpretation, but the FCA has ruled out the option of a client ‘self-certifying,’ by simply saying that they have the appropriate knowledge. For IFAs, the majority of funds either considered or sold will be non-complex, but they must still decide what their overall approach to satisfactorily gauging client ‘appropriateness,’ will be, and consider this questionnaire as key a document as their CIP.

<sup>3</sup> <http://westondigital.com/index.php/about-us/news/73-mifid-ii-concerning-communications-recording>

Another area for IFAs to consider is their marketing materials and risk warnings, which are also now subject to some serious updates. Prior to MiFID II, risk warnings were only provided to contrast the bountiful suggestion of big profits, giving an ostensibly glossy balance. But now, risk warnings must be included irrespective, which may paint a gloomier picture than intended. In addition, the risk warnings themselves must be in a comparable font and type to the rest of the communication, and if all that wasn't enough, future performance scenarios must now be provided, covering both positive and negative scenarios, giving a client a far grittier picture of what they could face in lean times.

### **Conflict of Interest.**

Conflicts of interest should be easy to avoid and the rules as they have stood under MiFID have given clear, if not complex, guidelines to help ensure this. But under MiFID II, while the picture remains the same, the depth of detail required to evidence pro-active management is far greater.

**“Prior to MiFID II, risk warnings were only provided to contrast the bountiful suggestion of big profits, giving an ostensibly glossy balance.”**

It will no longer be sufficient to simply disclose and document conflicts of interests as and when they arise; it's now a legislative assumption that all COIs will be actively managed to successful conclusion and that only those without clear resolution will be disclosed. The procedural requirements of this legislation will also create a need for far more exacting in-house governance, including policy reviews, robust questioning, and training for all staff to help them identify and make clear their obligations. And all staff, however junior, are subject to the guidelines too, including those which state remuneration requirements cannot be awarded in such a way as to give rise to any conflict of interest what-so-ever.

Finally, those firms that have an internal DFM function to offer a more bespoke service, particularly with regard to centralised investment propositions, may need to take even further action, as a wider breadth of services offered by such a firm invariably heightens the risk. 'There is a conflict of interest there, no question,' said Chris Gilchrist, director at Fiveways Financial Planning in Western-Super-Mare, with regards to DFMs. 'Most people are managing it very proactively, [but] it seems to me on MiFID II they're going to have to pay a little more attention to that.'



# Key Challenges.

## Centralised Investment Proposition.



One of the most fundamental structures you have in place, your CIP will fall under several important areas of MiFID II, including governance, reporting and communication, so it's never been more critical to return to the drawing board to check and refine its integrity.

**“One of the most fundamental structures you have in place, your CIP will fall under several important areas of MiFID II.”**

From the very first decision to outsource its design (or not), and to who (which will require due diligence), before making sure it matches the needs of your clients (under the ‘appropriateness test,’) and actively managing (remember?) any conflicts of interests, it's worth creating a comprehensive checklist to make sure that it passes muster under MiFID II. Taking into account the needs to now clearly and correctly assess client appropriateness, never before will retrofitting be a more serious error, so a review of your risk profile questionnaire will be necessary, irrespective of how recently it's been checked. Keep a close eye on your due diligence if you've opted for segmentation with the inclusion of a discretionary fund manager, when it comes to governance, your Management Information and File Review processes will have to be unimpeachable, lest the regulator come knocking.

## GDPR.



2018 is a big year for new regulation as just five months after MiFID II, the EU's GDPR (General Data Protection Regulation) goes live with its new legislation entering British law on May 25th. While a wholly separate issue to MiFID II, the requirements of GDPR, which add serious muscle to 1998's Data Protection Act, focus on the data held on individuals, and their rights of access to it, and will add greatly to 2018's workload for IFAs. But ripe opportunity lies in that the preparations for MiFID II may help IFAs tick some of the boxes in advance of May, by ensuring that the data they hold on their clients is both accurate and up to date.

**“2018 is a big year for new regulation as just five months after MiFID II, the EU's GDPR (General Data Protection Regulation) goes live with its new legislation.”**

## Brexit Uncertainty.



The biggest political soap-opera of the decade, it would be easy to assume that the turbulent nature of the Brexit negotiations would throw a spanner into MiFID II - but you'd be wrong.

**“It would be easy to assume that the turbulent nature of the Brexit negotiations would throw a spanner into MiFID II.”**

In fact, one of the key messages that needs to be heard is the need to prepare for its implementation, regardless of the noise surrounding Brexit, as Mike Kennedy, head of policy at threesixty services, a Manchester-based compliance consultancy, explains – ‘I can categorically say to those firms that if you are involved in any way in providing an investment service to your clients, although you will be outside a lot of the MiFID changes, it is going to impact you,’ he said. ‘The FCA is required to make sure that firms meet what they call “equivalent status”. And you will fall under MiFID when it comes to the promotion and provision of certain financial products.’<sup>4</sup> The ramifications of this are clear; no matter the inter-continental wranglings, the UK is still a member of the EU and as such, will need to adhere to all its regulations until, or if, we leave. And in the case of the latter, we will need to maintain a similar regulatory regime to be able trade globally. So, as we eye a future outside of the EU, the timings mean that we are still bound by contemporaneous Brussels regulations. Put simply, firms will be gravely mistaken if they think Brexit will give them a get-out-of-MiFID II-card next year.



# MiFID II and Technology.

The enhanced requirements surrounding communication mean a move into the future when it comes to choosing how to meet them. The boom in artificial intelligence and machine learning mean that setting up technology to do the dirty work for you can set you free to focus on other parts of your work, and MiFID II is key to helping people see

**“The boom in artificial intelligence & machine learning mean that setting up technology to do the work for you can set you free to focus on other parts of your work, & MiFID II is key.”**

It’s finally forcing people to realise that they need a large, curated data set that tracks all of the decisions and the input to the decisions, and that’s going to be a tremendous asset for those firms who do it well,’ says Tom Doris, CEO of OTAS Technologies, of the new legislation. Indeed, MiFID II pushes unashamedly for greater automation regarding trades in some asset classes, and while not yet mandatory for everything, the necessity to turn to AI is definitely proof of a new era dawning. But technology has rarely proved itself to be flawless, as AI expert, Graham Martin, explains -

*‘Whilst the prospect of instant access to the suite of global investment solutions may be a heady prospect, what about legal ramifications if it is later proven that the AI software did NOT indeed offer best advice, say ten years previously. Who will pay compensation, the IFA or the AI developer?’*

Drawing parallels with the spectre of mortgage and PPI mis-selling, the points that Martin raise sound a warning note of caution, and give rise to questions such as what will be the gold standard, who will train new users and how will compliance be handled? As a nascent technology, artificial intelligence poses as many challenges as it does benefits, and the financial services sector could go through its own very real growing pains as it seeks to find the blend between man and machine. Finally, because of the automation that’s made mandatory by MiFID II, the regulators will now give less warning and even less justification should they need to come calling; after all, you’ve got it all automatically recorded, right?

**“Automation made mandatory by MiFID II.”**

## To The Future And Beyond.

MiFID II is unquestionably necessary, but it's easy to see why it's also such a daunting prospect. Heavy on detail, its implementation requires grass-root changes in working practices across the board, while it also lets itself down with occasional failures of clarification which leave key rulings open to interpretation. But where there's challenge, there's opportunity and nowhere is this truer than MiFID II; for all its flaws, it gives the green light to greater innovation, structure and security, shoring up an industry that is still recovering its reputation, if not its assets, from the financial crash.

And so, despite its occasional ambiguity, it's crucial to remember that while it changes the landscape, it also provides the map - a nuanced warning that to those who fail to follow its directions, they leave themselves open to serious repercussions.

**Clever.**  
Watergate House  
Watergate Street  
Chester  
CH1 2LF

01244 346343  
mail@cleveradviser.com  
cleveradviser.com