MiFID II – Quality Enhancement and Solutions

Who this paper is for:
Compliance, Legal and MiFID II decision makers that need guidance on how to deal with inducements and how to enhance the quality of service to the client.

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The regulation brings with it many challenges, one of which is the new set of requirements dealing with inducements which aims to strengthen the protection of investors and increase clarity to clients as to the quality of services they receive.

As the impact of those changes will vary across countries, investment manager distributing funds across the European Union will need to rethink their strategy and adapt accordingly.

What are the key changes to inducements under MiFID II?

The MiFID II Directive 2014/65 deals with the payment to, and/or receipt from, a third party of inducements in relation to the provision of services to clients of investment firms. In general, companies are strictly only permitted to pay, or be paid, an inducement (namely, a fee, commission or non-monetary benefit) where the payment or benefit if designed to enhance the quality of service to the client and (sic!) at the same time do not impair the firm's ability to act honestly, fairly, professionally and in the best interests of its clients. According to the Delegated Directive (Commission Delegated Directive 2017/593), an inducement should not be accepted if it results in the provision of the relevant services to the client being biased or distorted. Furthermore, the existence, nature and amount of the payment or benefit must be clearly disclosed to the client.

With the additional and specific disclosure requirements, the mechanisms for recording and transferring any fees and, among others, the impact on independent advisers/asset managers, the MiFID II regime goes much further that that under MiFID I. Therefore, the new investor protection rules are set to likely reshape the financial markets' product and distribution strategies.

What is capable of enhancing the quality of service to the client?

It has been up to discussion as to when an inducement will be designed to enhance the quality of the relevant service to the client. The Directive provides further information, specifically such an inducement must meet three conditions, namely it must:

- be justified by the provision of an additional or higher-level service to the relevant client, (must be proportionate to the level of inducements received)
- not directly benefit the recipient firm, its shareholder or employees without tangible benefit to the relevant client; and
- be justified by the provision of an on-going benefit to the relevant client in relation to an on-going inducement.

In addition, firms must fulfil the above requirements on an ongoing basis as long as they continue to pay or receive the fee, commission or non-monetary benefit.

Online Investment Tools - quality enhancing solutions?

Non-independent financial advisors receiving inducements to distribute funds will need to ensure that the fees they receive sufficiently enhance the quality of service to the client. This may involve providing more ongoing services such as market insights, or, more comprehensive, via the provision of added-value services, such as objective information tools enabling the relevant client to monitor the instruments in which they have invested or providing personalised reporting. For this, third-party platforms and new services may provide innovative solutions to the fund industry. Especially the reporting on extra-financial criteria is worthwhile to mention. Environmental, Social and Governance (ESG) investment reporting is becoming mainstream. Major trends have contributed to this rise. And such ESG considerations have driven new regulations in a growing list of countries like France's mandatory reporting of climate risk or the new pensions directive passed by the European Parliament requiring EU workplace pension funds to consider ESG issues.

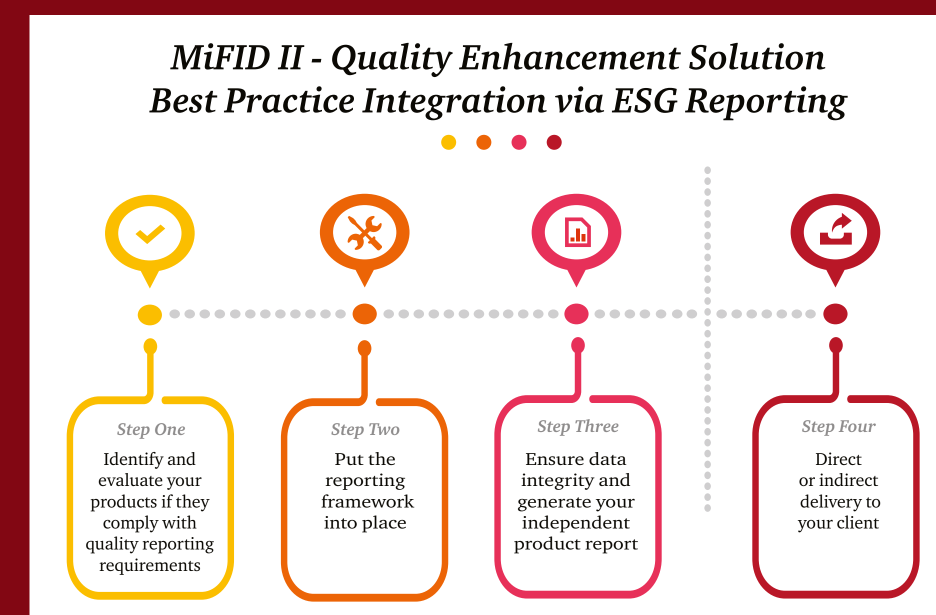
Best Practice Integration - added value for the client

As mentioned above, integrating ESG-policies and practices into a company's strategy and daily operations is increasingly regarded by investors as relevant to its ability to realise long-term value. Therefore, transparency around how a company manages ESG risks and opportunities is part of its value proposition. As a result, investors increasingly recognise that to thoroughly assess an investment, the relevant ESG factors should be analysed too. And this is where the quality enhancement fits in.

A well-structured ESG portfolio report enables the investor to understand the ESG exposure of the portfolio and provides a multi-dimensional risk assessment relative to benchmarks and peergroup. Materiality of information and its relevance for investors is a key consideration in determining the scope and content of a portfolio's reporting: ESG Benchmarking & Rating from a risk perspective and Controversies for Reputational and Global Norms Management are the key factors that such report should include. And add-ons like Business Involvement Screening and Impact Reporting (e.g. based on the UN Development Goals) will help the relevant clients to align with international standards.

A reporting structured this way ensures that the needs of all investors are satisfied and enable them to monitor their investments independently from their financial institution. Delivery by a trusted and objective third-party service provider is therefore the key to achieve compliance with the Directive.

And from a company's perspective, how can this be achieved? First of all, the various products (e.g. funds) in question need to be identified and evaluated if an ESG quality enhancement can be applied. If the analysis has been positive, the reporting framework is being put in place as a second step and the data integrity ensured for continuous reporting afterwards. And the last process is to ensure the delivery to the client, either via the company or directly by the service provider; which option is more suitable depends on the circumstances, taking the compliance and tracking requirements into account.



In relation to those inducements which are permitted, firms will be required to keep an internal list of all inducements accepted by the firm from a third party. With the reporting on extra-financial criteria there is the additional advantage that the requirement to demonstrate how the inducements enhance the quality of the service provided can be achieved easily.

Experience

One of the pioneers in this field is yourSRI.com. The international, independent online platform is specialised on the dynamic ESG & Carbon Screening of funds and portfolios. Launched in 2011 the platform screens today over 15 Trillion Euros on a daily basis. yourSRI offers an objective ESG & Climate investment reporting for all kind of portfolios, based on a transparent quantitative analysis combining data from CDP, ISS-Ethix, MSCI ESG Research and Thomson Reuters/Lipper. With such a service, non-independent financial advisors and intermediaries can offer their clients an additional, ongoing & independent online ESG & Climate investment reporting service qualifying as a quality enhancing solution.

Timeline

The inducements rules apply from January 3, 2018. However, affected firms will need to review their current policies and most likely need to spend considerable time in advance of that date in preparing for the new regime's implementation.

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