

# Distribution of Financial Products - Will there be a New Client Experience?

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# Agenda

- Definitions and preliminaries
- Scope – what constitutes client experience?
- Types of services
- Compensation models and their requirements
- Product governance
- Suitability

with a view of client experience, under both MIFID II and FIDLEG

# Definitions and preliminaries

- «Bank» and «Distributor» means
  - any type of point of sale and
  - is meant in a non-technical sense (execution only, non-advised offering, or advisory service) (i.e., not in CISA sense)
  - Under MiFID this means «investment firms that offer or sell financial instrument and services to clients”
- «Distribution» means
  - any type of sale and services activity of Distributor
  - meant in a non-technical sense...
  - ... but principally not in scope of this presentation: discretionary investment management/portfolio management mandates
- «Client» means
  - customer of an investment service
  - purchaser of investment instrument
  - retail/private client, unless otherwise indicated
- Martin covers MIFID II and Sandro FIDLEG/Swiss law; concentration on certain points, not overview on conduct duties as a whole (for this, see presentation of Messrs Schmies and Schmockler)
- Caveat: Regulation as moving target; in particular fate and content of FIDLEG bill yet uncertain

# Scope - what constitutes client experience?

- What types of services may I get?
- How (much) and how do I pay for it?
  - Different compensation types for Distributors depending
    - on service
    - (in)dependency
  - How do I judge value for money?
- What product shelf may I be offered: Product governance requirements for product manufacturers
- What are ongoing obligations of Distributors and product manufacturers to me: product governance and suitability

# Types of services (excluding discretionary mandates) - overview

- MIFID II: Execution only without appropriateness test, non-advised with appropriateness test, advised either independent or non-independent
- FIDLEG: Execution only, non-advised, advised only on instrument level, advised in portfolio context
- MIFID II: dependent/independent (see also next slides)
- FIDLEG: no such concept (see next slides)

# Compensation of Distributor

# C. of D.: Overview

- General shift from (co-)compensation of Distributor...
  - by product manufacturer and,
  - depending on service, also Client
- ... to (only) direct compensation of Distributor by Client
- MIFID II rules on compensation differ depending on independent/non-independent services:
  - More restrictive treatment for independent advisors and discretionary managers
  - More flexibility for non-independent advisors and execution-only platforms
- FIDLEG (Message Federal Council): no (more) such concept, but other rules that may lead to similar effects as under MIFID II

## C. of D.: MIFID II – independent advice

- Independent investment advisers (and portfolio managers):
  - must return to Clients **any monetary third party payments** received in relation to the services provided to that Client
  - **as soon as possible** after receipt by transferring the monies received to the client money account.
  - This equals a de facto ban on commissions. No set off allowed



## C. of D.: MIFID II – independent advice

- Self-select basis and does not have to cover all of business channels
- Firms must assess and compare a sufficient range of financial instruments
- Can be proportionate to the service provided
- Number and range must be adequately representative
- Can include in-house products but proportion must be proportionate
- Must consider relative risk, cost and complexity and client needs

## C. of D.: MIFID II – non-independent advice

- Although retrocessions and other payments can be paid by product manufacturer to Distributor they must meet a **quality enhancement test**.
- Where inducements may be justified by the provision of **an additional or higher level service** to the relevant Client, proportional to the level of inducements received, such as:
  - the provision of non-independent advice on and access to a wide range of suitable financial instruments including an appropriate number of instruments from third party product providers having no close links with the investment firm; **[Conditions for open architecture advice]**
  - the provision of non-independent advice combined with either: an offer to the client, (...), to assess the continuing suitability of the financial instruments in which the client has invested; or with another on-going service that is likely to be of value to the client ( ...) **[Conditions for closed architecture advice]**

## C. of D.: FIDLEG – different concept...

- FIDLEG (per Message Federal Council)
  - No differentiation between independent/non-independent service
  - inducements allowed in all constellations
  - inducements regulation, however, and different to MIFID II, applicable to all financial services
- Distributor may receive and keep third party payments in any Distribution constellation, thus also in advised situations and services (and even in discretionary mandates)
- Investor protection ensured by
  - extensive transparency requirements (art. 28) and,
  - where applicable, art. 400 para. 1 CO Client waiver requirement

## C. of D.: FIDLEG – ...with same effect

- Regulatory and civil law duties...
  - make it difficult to implement advisory services with inducements from product manufacturer
  - (and render such practically impossible in discretionary mandates):
- ... specifically
  - duty to inform on considered market offerings (art. 9 para. 2 lit. d),
  - strict and broad best execution requirements (art. 20), and
  - duty of loyalty (art. 398 CO as interpreted by Swiss Federal Court 138 III 755, 779)

# C. of D.: Direct compensation – tough on transparency

- MIFID II
  - Full transparency,
    - in € and %,
    - of both advisory and product costs,
    - aggregated over recommended holding period of the investment,
    - shown on an ex ante estimated basis and regular historic cost basis.
  - This will direct a spotlight onto value for money of both products and advisory services
- FIDLEG
  - Extensive transparency requirements for costs at level of services (advice, if any; brokerage; custody) and product
  - This, besides the best execution duties and duty of loyalty, where applicable, will compel directly paid Distributors to pay particular attention to price efficient investment instruments when composing their products shelf

# C. of D.: Platform services and fees

- Platform fees as means of compensation from manufacturer for pure technical services provided to it by Distributor.
  - MIFID II:
    - When paid by the manufacturer these still qualify as inducements and are only justified where they meet the quality enhancement test:
      - the provision of access, at a competitive price,
      - to a wide range of financial instruments that are likely to meet the needs of the target market,
      - (...) together with either the provision of added-value tools, (...),
      - or providing periodic reports of the performance and costs and charges associated with the financial instruments.
  - Swiss law:
    - Swiss Federal Court 138 III 755, 766 leaves room for non-qualification of true (!) platform payments as non-inducements, i.e., as possible also in an inducement free set up
    - Wording in FIDLEG (art. 28, same as in art. 400 para. 1 CO, «in Zusammenhang mit») implies same result
    - SFAMA Cost Transparency Guideline stipulates transparency also on fees for technical distribution

# C. of D.: Overall impact on experience of product manufacturer, Bank, Client?

- Greater pressure to reduce costs on overall investment performance for investor (but UK example of unbundling shows that overall cost to Client may not fall)
- Tougher competition amongst product providers on costs, and on best after cost performance
- Greater segmentation of Clients. Mass retail Clients increasingly directed by banks to execution-only platforms or discretionary managed fund of fund platforms to minimise regulatory costs.
- Small Clients possibly excluded from advised offerings, as direct point of sale-fees prohibitive compared to investment volume or move back to vertically integrated models

# Product governance



# P. g.: MIFID II – product manufacturers

- Under MIFID II, product manufacturers must:
  - Ensure product design does not adversely affect end Clients or lead to issues of market integrity
  - have procedures to avoid conflicts of interest
  - have proper controls and governance both on launch and on an ongoing basis
  - identify at a sufficiently granular level the **potential target market** for each financial instrument and
  - **specify the type(s) of Client** for whose needs, characteristics and objectives the financial instrument is compatible.

# P. g.: MIFID II - Distributors

- Manufacturer target market analysis
  - Must be **shared with Distributors** and allow distributors to understand and recommend or sell the financial instrument properly.
- Distributors in turn have to conduct target market analysis (not the same as suitability!)
  - Identify circumstances and needs of Clients
  - must ensure non-MiFID firms give them sufficient information
  - must regularly review products they distribute to ensure consistency with circumstances and needs
  - report back to manufacturers with information on sales and of results of product reviews

## P. g.: FIDLEG – easy going?

- No product governance or target market definition provisions
- Basic aspects thereof potentially implied in general regulatory organizational and conduct requirements
- MIFID II's specific product governance and target market requirements of relevance, though, also under Swiss law, for crossborder (outbound and inbound) situations

# Suitability

# S.: MIFID II – upgrade only

- This is NOT a new process but requires an upgrade of existing processes?  
MiFID 2 requires the suitability process to focus on three key sets of criteria:
  - Does it meet the investment objectives of the client in question, including Client's risk tolerance?
  - Is it such that the Client is able financially to bear any related investment risks consistent with his investment objectives?
  - Is it such that the Client has the necessary experience and knowledge in order to understand the risks involved in the transaction or in the management of his portfolio?
- MiFID 2 leads to focus on suitability in two areas:
  - Greater focus on risk profiling and individualisation of Client recommendations at the start of the relationship
  - greater focus on review and update of Client recommendations on an ongoing basis

# S.: MIFID II - key questions to be asked

- To what extent is the **risk profiling consistent** with disclosure in PRIIPs KIDs/ UCITS KIIDs ? How will they distinguish between product risk and portfolio risk?
- To what extent does the firm's suitability process link into the **product manufacturer's target market assessment**
- What sort of **risk profiling tools** will advisory firms develop to provide **greater granularity** of client recommendations?
- How will Client information be kept **up to date**?
- What are the situations where a Client is likely to need to seek advice to bring a portfolio of investments back in line with the original recommended allocation, for example where there is a probability that the portfolio could deviate from the target asset allocation?
- Outside jurisdictions such as UK and Netherlands how will this be integrated into requirements to provide an ongoing service to keep ongoing commissions?
- How will firms take into account **relative cost and complexity**?

# S.: FIDLEG – not upgrade only, but more limited in scope

- Suitability duty of FIDLEG only upgrade insofar as it is
  - principally in line with court practice on relevant duties in discretionary mandates and comprehensive investment advisory mandates
  - but more formalized and documented process prescribed
  - thus, for comprehensive mandates upgrade only
- Suitability duty of FIDLEG new, however, insofar as it applies to any investment advice (=personal recommendation!) considering the Client's portfolio, even if not within an explicit or implied mandate
- No suitability check required by FIDLEG for investment advice limited to single transactions
  - «only...» appropriateness check required

# S.: FIDLEG – impact on Client and Bank experience

- Strict (due to regulatory nature) and formalized suitability duty (including appropriateness check, nota bene) will have huge operational impact (IT systems, organization) on traditional «advisory only» private banking model whose feature is to apply a holistic view on the Client and his portfolio, and not a «sales trading» model that could profit from the delta to MIFID II
  - private Clients will experience strong shift away from «pleasant», informal model towards formalized, to be compensated for, advisory mandate agreements
- Caveat: Above is only correct when no foreign laws apply
  - which will even increase the operational complexity



# Final comments and discussion

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