



MiFID impact on investment managers

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Abstract

Purpose – The aim of this paper is to analyze the impact of the Markets in Financial Instruments Directive (MiFID) on investment managers but also on funds' units as financial instruments.

Design/methodology/approach – Starting from the innovative legislative structure and scope of the MiFID, the paper assesses the way investment managers and funds' units are impacted, knowing that investment managers and funds' units are already largely tackled by another Directive, the UCITS Directive.

Findings – In spite of increasing many organizational and process requirements within investment management companies, the MiFID will probably not create dramatic changes in the daily functioning of those companies. However, the linkage between the provisions of the MiFID and the UCITS Directive has not been clearly made by European legislative institutions, which leaves uncertainties in the way the national legislators and regulators will transpose the MiFID in order to get the best consistence between this Directive and the UCITS one.

Research limitations/implications – Final assessment should be made once Member States have transposed the MiFID Directive and have enforced it in practice.

Originality/value – The value of the paper is to set a bridge between two different directives (the MiFID on the one hand, the UCITS Directive on the other hand) which both impact investment managers and funds' units.

Keywords Investment, Investment funds, Portfolio investment, Financial management

Paper type Research paper

Until very recently many European investment managers – i.e. entities in charge of managing collective investment funds – considered that the European legislative framework was mainly based on the so-called “Undertakings for Collective Investment in Transferable Securities (UCITS) Directive”[1]. This Directive was aimed at ensuring that a specific type of collective investment fund, the so-called UCITS (for “Undertakings for Collective Investment in Transferable Securities”) could be passported without nearly no regulatory barriers across borders within the all European Union, as soon as the players (mainly the management companies, complemented by depositaries) would fulfill a set of conditions in terms of organization and functioning and as soon as the pattern of the funds themselves would comply with certain conditions as well. The original UCITS Directive was adopted in 1985 and amended in 2001 – in order to be upgraded to keep pace with financial product innovation and new business patterns. These amendments to the 1985 Directive were published in 2002[2] and were transposed afterwards by Member States.

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In the meantime, as soon as 2000, the European Commission (which is the single European institution having the power of legislative initiative among the three European institutions, which include the European Parliament and the Council as well) started working on another Directive, still in the field of financial services. Originally, this other Directive aimed at amending the existing Investment Services Directive (ISD)[3] in order to get rid of the so-called “concentration rule” of European stock exchanges and offering thus a higher degree of competition between multiple trading venues – to the benefit of investors in theory. This new Directive amending the ISD was named “MiFID” (for “Markets in Financial Instruments Directive”) and was adopted in April 2004[4]. Apart from its substance, the MiFID was also one of the first directives in the field of financial services to be “Lamfalussy-formatted” – thus paving the way to a series of Directives or Regulations which were adopted or are still under adoption today in the banking and insurance areas in particular.

After presenting the innovative legislative format of the MiFID Directive (1st part), we will examine the impact of the MiFID on the players of the investment fund industry, i.e. the investment managers (2nd part) before assessing its impact of the products of the investment fund industry, i.e. the funds’ units themselves (3rd part).

1. The Markets in Financial Instruments Directive: to date, the most comprehensive case of Lamfalussy approach (comitology as applied to financial services)

Before entering the substance of the MiFID, let us recall that the MiFID is one of the first European directives following the so-called “Lamfalussy approach.” Beyond that, the MiFID is more particularly the most comprehensive case of Lamfalussy approach to date.

1.1 What is the Lamfalussy approach?

In 2000, a Group of “Wise Men,” chaired by Baron Alexandre Lamfalussy and under the auspices of the European Commission (DG Internal Market), started working on the best procedural approach to be followed by the European institutions in order to achieve the financial services action plan[5] in the most appropriate way. In particular, the group looked for a solution aimed at ensuring the achievement of two different objectives. The first objective was to get a higher degree of harmonization between Member States when transposing European directives (or applying European regulations), knowing that in practice the degree of harmonization of European directives through their different national transpositions was rather disappointing until then. The second objective was to fasten the whole process of adoption – and of updating afterwards – of such European directives (or regulations), considering that financial services are part of the areas covered by the so-called “co-decision” institutional process, which imply similar powers for the Council of Ministers and the European Parliament – and, therefore, a rather lengthy process for the adoption of European legislative texts.

At first glance, those two objectives of better harmonization and faster adoption and updating seemed difficult to conciliate. Getting a higher degree of harmonization requires providing more detailed rules to make sure that they will be implemented consistently across Europe. But providing for such detailed rules might then end beforehand in longer European institutional processes of adoption because of such more detailed texts. The work to be carried out by the Wise Men Group was, therefore, very challenging.

The outcome of the Group work, in February 2001, was judged very sound in the institutional approach that it proposed. The Wise Men suggested a four-level approach to European institutions and Member States, inspired by the already existing so-called “comitology” processes but significantly adapted to financial markets:

- *Level 1* should consist of European “framework directives” or “framework regulations.” By “framework” directives or regulations, the Group was meaning that such legislative texts should be strictly limited to “essential principles,” in order to get shorter directives or regulations and, therefore, faster adoption of the texts to be adopted in “co-decision.” An interesting comment by the Wise Men has to be noticed: they favored the use of regulations instead of directives, considering that regulations would help getting a higher degree of harmonization and also a faster application at national levels (as regulations have not to be transposed, they can save the time of national transposition texts).
- *Level 2* should consist of directives or regulations implementing the “technical details” of the essential principles set up by the Level 1 directives or regulations. Those Level 2 implementing measures (under the form of “implementing directives” or “implementing regulations”) would be adopted by the European Commission after possible amendments by a special Committee composed of national Treasuries, named the European Securities Committee[6]. The main advantage of Level 2 directives or regulations is that both can give details to the “framework” texts and at the same time they can be adopted and updated very rapidly in theory: the time for Treasuries meeting in the ESC to react on the draft measures to be proposed by the European Commission would be limited to three months. Those Level 2 “implementing measures” would be proposed by the European Commission under the form of proposals, on the basis of a prior “technical advice” submitted by the Committee of European Securities Regulators (CESR) – composed by all national securities regulators – to the European Commission.
- *Level 3* should consist of “guidance” or “standards” to be developed by CESR on the basis of Level 1 and Level 2 directives or regulations. The aim of Level 3 guidance would be to ensure that in practice regulators will enforce those measures in the same way – once again, in order to get a higher degree of harmonization across the EU.
- *Level 4* should consist of enforcement, to be carried by the European Commission. The aim is to make sure that if Member States are late in implementing, or do not apply, the Level 1 and Level 2 measures, then the European Commission would take action until going before the European Court of Justice.

This “Lamfalussy approach” was endorsed in March 2001 by the ECOFIN Council and led afterwards to an agreement with the European Parliament as well.

1.2 The MiFID as the most comprehensive case of Lamfalussy approach to date

The MiFID was not the first European legislative text to have been adopted under a Lamfalussy format. The two first ones were the Market Abuse Directive and the Prospectus Directive.

However, the real test of the Lamfalussy approach for the future will depend on the success or failure of implementation and enforcement of the MiFID. The Market Abuse

Directive and the Prospectus Directive were more specialized texts, oriented, respectively, to focused financial market infringements and to specific prospectuses for securities. On the contrary, the MiFID will be the driver for the whole organization of European financial markets in the coming years, through an extensive list of financial products (e.g. including various types of derivatives), a list of so-called “investment services” (e.g. brokerage, individual portfolio management, financial investment advice, reception and transmission of orders) and the subsequent organization of investment firms (internal organization, rules of conduct, best execution of orders, etc.).

In particular, the MiFID will impact investment managers to a significant extent.

2. The impact of the MiFID on investment managers

During many years, the single piece of European legislation covering the financial management industry was the UCITS Directive, dated 1985 and updated in 2001. European asset managers were familiar with this legislative framework and have not always anticipated the impacts of other European legal texts, in particular those of the MiFID, on their activities.

It appears that in fact the MiFID will impact both those activities carried out by European managers (but their activity of collective portfolio management) and also the funds' units as being part of the scope of the financial instruments caught by the MiFID.

2.1 Brief reminder of the main elements of the UCITS Directive

Main elements of the 1985 UCITS Directive:

- The major topic of the initial UCITS Directive was to offer the opportunity of setting up a type of pan-European fund – named coordinated UCITS – which allowed, once the conditions of the Directive respected, for its passporting throughout the European Union nearly without any “droit de regard” from the host country competent authority as soon as the home country competent authority would have agreed it. The conditions to be fulfilled to make a fund as UCITS-compliant were on the fund itself (e.g. scope of eligible assets, authorized strategies) and on the players involved in it (i.e. mainly the rules of organization and functioning of the management company and of the depositary).
- In 2001, beyond the extension of eligible assets and authorized strategies for instance, the amendments of the UCITS Directive allowed UCITS management companies to manage non-UCITS funds as well. In addition, the 2001 amendments allowed Member States (if they wished) to authorize UCITS management companies extending their activities further than the management of funds: portfolio management as another core service as well as investment advice in financial instruments and safekeeping/administration of UCITS as non-core services.

2.2 Brief reminder of the main elements of the Level 1 and Level 2 MiFIDs

Main elements of the 2004 (Level 1) and 2006 (Level 2) MiFIDs:

- The main topic of the Level 1 MiFID was to put an end to the rule of mandatory concentration of orders on regulated markets, which was required by the previous Directive, i.e. the ISD. As the Level 1 MiFID introduced, therefore, a competition between trading platforms for execution of orders by contrast with

the ISD, there was, therefore, the need for setting a rule of “best execution” or clients’ orders by professional intermediaries in order to ensure that in spite of the variety of trading platforms the client’s order would be driven to the platform ensuring the best execution of this order. Another significant evolution of the MiFID as compared to the ISD was to extend the scope of financial instruments as well as the scope of financial services covered.

- It appears clearly that management companies were not at the heart of the MiFID. However, the management companies will be impacted in two ways: first, all funds’ units (UCITS funds’ units and non-UCITS funds(units) are in the scope of the financial instruments covered by the Level 1 MiFID; second, all the activities of management companies – apart from collective investment management – are caught by the MiFID (i.e. portfolio management, investment advice and reception/transmission of orders).

Let us now clarify what the MiFID new regime is, in the two different cases of management companies managing UCITS funds and of management companies managing non-UCITS funds.

2.3 General consequence of the MiFID for management companies managing UCITS funds

The general impact of the MiFID is that targeted though significant provisions of the MiFID will apply to management companies managing UCITS funds.

For those management companies covered by the UCITS, at first glance just a few articles of MiFID will apply and only for activities which are different from UCITS management activity. Article 66 of Level 1 MiFID limits the application of MiFID for UCITS management companies to capital requirement (Art. 12), internal organization of management companies (Art. 13), rules of conduct to be applied by management companies for the provision of investment services (Art. 19). Let us recall that those rules will not apply for the management of collective portfolios, but will apply only to the investment services authorized to be provided by UCITS management companies according to Article 5(3) of the UCITS Directive, i.e. individual portfolio management and non-core services (investment advice and safekeeping/administration of funds’ units).

This quantitative limitation of MiFID articles applicable to UCITS management companies might appear as very narrow, but in fact the relevant provisions of the Level 1 MiFID were very given many details by around 40 articles of the Level 2 MiFID (i.e. Art. 5-43, 45, 47-49).

The practical consequences might, therefore, become very burdensome for UCITS management companies: as soon as they would develop the MiFID services mentioned right above, they would have to comply with a comprehensive set of rules regarding their organization and functioning, and would though still have to comply with the UCITS Directive provisions regarding their core activity of UCITS fund management.

2.4 General consequence of the MiFID for management companies not managing UCITS funds

For management companies not managing UCITS funds, but non-UCITS funds only (i.e. funds which do not comply with the UCITS Directive), obviously the UCITS

Directive does not apply but on the contrary, the whole MiFID applies potentially (apart from their activity of managing non-UCITS funds, which is neither tackled by the UCITS Directive nor by the MiFID Directive and which, therefore, remains regulated at national level only).

In any case, the practical advantage for such management companies (as compared to the UCITS management companies) is that they are not caught by two different Directives: in terms of organization and functioning the situation appears as relatively simpler.

2.5 Detailed and practical consequences of the MiFID for management companies

Many different provisions of the MiFID will have an impact on management companies when providing other services than collective portfolio management (see above). We can at least identify six areas of impact for those services apart from the management of collective portfolio management.

First, many functions have to be organized in an independent way (e. g. compliance function; risk management; internal audit). Although the MiFID provides that this requirement can be softened or exempted with a proportionality test (i.e. for SMEs in particular), some of these exemption cases will be offered only if the management company is able to prove that it fulfilled the conditions to be exempted (sort of reversal of proof).

Second, the restrictions and internal disclosure of personal transactions of management companies' staff will be regulated in detail by the MiFID. This might raise concerns as for instance, the scope of relevant persons is now extended to relatives (including partners for instance) and professional relations. Regarding relatives, we do not know yet how Member States will be able to strike the right balance between this requirement and the European and national obligations on data protection (which have to be applied for the MiFID transposition – see Recital 43 of Level 1 MiFID). In addition, those transactions will have to be disclosed “promptly” (Art. 12(b)), which might create some difficulties of organization in the daily work of compliance officers of management companies.

Third, the management companies will have to deal not only with actual conflicts of interest but also with potential ones (Art. 21 Level 2 MiFID). It might raise difficulties as by nature some potential conflicts of interest are not always easy to anticipate. . .

Fourth, the relationship with clients will imply that in order to be authorized to provide a service the management company will have to get a comprehensive knowledge of the total wealth of those clients. In the case of the service of individual portfolio management, it might not be easy to get the knowledge of the total wealth of the client, for instance, regarding real estate. But the Directive is silent of the potential legal consequences of misleading or incomplete information on investment managers.

Fifth, the files of clients of management companies will have to be reclassified as the MiFID introduces a distinction between eligible counterparts, professional clients and retail clients. But the question of a grand-fathering clause for the treatment of existing clients' files (requiring or not new information today for already existing clients' files) is not answered by the MiFID.

Sixth, regarding the best execution of transactions, even though this full requirement is only imposed to investment firms executing the transactions themselves (in general, the brokers), management companies will have to comply

with it in the following way. When management companies provide for the service of individual portfolio management or for the service of reception/transmission of orders, they have to transmit the orders to brokers for execution. The MiFID will require that the management companies will have to provide for a “transmission policy” which will ensure that brokers have been selected by the management companies among those presenting the objective criteria of offering a high probability of best execution of orders. It means that management companies will not be responsible for the best execution of orders in practice as those orders are executed by the brokers, but that they will have to justify the way they have established their “transmission policy” (obligation of means and not obligation of results).

3. The impact of the MiFID on funds’ units

Whatever the relevant funds are UCITS or non-UCITS funds (i.e. covered or not by the UCITS Directive), they are all impacted by the MiFID Directive as “units in collective investment undertakings” are explicitly part of the financial instruments covered by the Directive according to Section C of Annex 1 of the Level 1 MiFID.

At least three series of topics can be mentioned in this context.

3.1 How to define what a subscription/redemption of funds’ units constitutes within the frame of the MiFID ?

In particular, the response to this question will help knowing if subscriptions/redemptions of units are covered by the obligation of best execution. It will also help knowing if subscriptions/redemptions of units can be considered as reception/transmission of orders otherwise.

If subscriptions/redemptions of units were considered as covered by the obligation of best execution, it would require that the channel chosen for subscription/redemption of units would be the cheapest, including the fees, for the investor. But the point is that very often funds’ units are distributed by third-party distributors that are not always identified by the relevant management companies. Therefore, such a requirement of “best execution” for funds’ units might be very difficult to implement in practice by management companies.

In any case, in our opinion subscriptions/redemptions of units cannot be considered as covered by the “best execution” principle, for the following reason.

The principle of “best execution” of financial instruments (including funds’ units) can be applied only in the context of the investment service of “execution of orders” (according to Art. 21 of the Level 1 MiFID). But the definition of “execution of orders” itself means acting to conclude agreements “to buy or sell” a financial instrument (according to Art. 4(1) and (5) of the Level 1 MiFID).

But in practice, the process of subscription/redemption of units is not similar to the one of buying/selling a financial instrument. In the context of subscriptions/redemptions, there is the intervention of a so-called “centralisateur” which will centralize all the subscription and redemption orders before acting for ensuring the right achievement of such orders. Moreover, contrary to purchases and sales of other financial instruments, subscriptions and redemptions are not undertaken on a secondary market. It explains in particular why the value of units is determined according to the Net Asset Value, and not by the market price coming from opposite buying and selling orders (like on equity markets for instance). Therefore, the process of subscribing/redeeming units cannot fit

with the definition of the service of “execution of orders”. And, therefore, the requirement of “best execution” cannot apply to the specific category of financial instruments which consists of funds’ units.

The remaining question is then to wonder if subscribing/redeeming funds’ units could fit with the service of reception/subscription of orders. In our view, it is not the case either. According to Articles 45(2), (4), (5) and (6), the service of “reception/transmission of orders” is always related to the subsequent service of “execution of orders.” As we have just concluded that the service of “execution of orders” is not applicable to the process for subscribing/redeeming funds’ units, therefore, the service of “reception/transmission of orders” cannot fit either.

At this stage, no definition of the different investment services is, therefore, applicable as such to subscriptions/redemptions of units.

3.2 How to define what a retrocession of commissions constitutes within the frame of the MiFID?

The MiFID has introduced very stringent conditions for the practice of “inducements” (Art. 26 of the Level 2 MiFID). According to this Article, a management company could receive commissions/benefits only in three cases. The first case is when the commissions/benefits are paid or provided to or by the client (or by a person acting on his behalf). The second case occurs when the commissions/benefits are paid or provided to or by a third party (or by a person acting on his behalf) if two cumulative sub-conditions are fulfilled: disclosure of such commissions/benefits to the client plus need for enhancing the quality of the service through the payment of the commission. The third case happens when the commissions are necessary for the provision of the services and cannot give rise to conflicts of interest for ensuring acting in the best interests of the client.

It is difficult to predict yet how Member States will transpose such a provision. This provision might create difficulties for retrocessions of commissions between distributors of funds and management companies – as this provision does not fit really with this very commonly shared practice.

3.3 Will MiFID give more flexibility for cross-border marketing of funds’ units?

MiFID applies to all funds’ units, i.e. UCITS funds’ units and non-UCITS funds’ units. In addition, MiFID deals with the distribution of financial instruments in general. Could, therefore, MiFID by itself help developing cross-border marketing of funds’ units in the EU?

We have several arguments against such an approach. First, at no stage in the discussions surrounding the Level 1 and Level 2 MiFIDs the idea of using the MiFID for such an aim was discussed. Second, it would then lead to a paradox: it would mean that non-UCITS funds (e.g. hedge funds/funds of hedge funds; real estate funds; private equity funds) could be freely passported just by the MiFID rules when the UCITS, which are the less complex products, would have to comply both with the MiFID Directive but also with the UCITS Directive. Third, even if such an approach were to be followed, it would not solve the main important issue today: from the demand side, the issue is that some types of institutional investors (e.g. insurance companies) are not currently allowed to invest in such products in some Member States, and retail investors have no access to such products either.

Finally, it appears that the MiFID will have a significant impact on investment managers. This impact will imply many changes in the organization and functioning of management companies and distributors of funds' units. However, these changes will consist more in evolutions than revolutions: many changes will occur, but not many significant changes.

Beyond the impact of MiFID on investment managers, we could wonder which opportunities the MiFID will offer to them. At this stage it is too soon for making a sound assessment of such opportunities. Though, we can already state that it will mostly depend on the behavior of national treasuries and securities regulators in the coming years, both in the process of transposition of the MiFID into national laws and regulations as well as in the way they will act when enforcing the provisions in practice.

Notes

1. Council Directive of December 20, 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) (85/611/EEC), OJ L 375, December 31, 1985, p. 3.
2. Directive 2001/207/EC of the European Parliament and of the Council of January 21, 2002, OJ L 41, February 13, 2002, p. 20 and Directive 2001/108/EC of the European Parliament and of the Council of January 21, 2002, OJ L 41, February 13, 2002, p. 35.
3. Council Directive 93/22/EC of May 10, 1993 on investment services in the securities field, OJ L 141, June 11, 1993, p. 27.
4. Directive 2004/39/EC of the European Parliament and of the Council of April 21, 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC, OJ L 145, April 30, 2004, p. 1.
5. Adopted by the European Commission in 1999, and composed of 42 legislative measures to be achieved by 2004 in the field of financial services.
6. Afterwards, an inter-institutional agreement allowed the principle that European Parliament could deliver an advice on any Level 2 draft measures to come and to vote an "ultra vires" resolution in case the European Commission would trespass its powers' scope for Level 2 measures as limitatively defined in each of the relevant Level 1 texts.

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