MiFID and the quest for improved transparency / 'UCITS IV'

Urgent structural reforms in the European Investment Funds market

26 September 2007
Agenda

- **MiFID: Brief recap and focus on impact areas for Asset Management**
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- **‘UCITS 4’ – The Next Regulatory Wave**
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MiFID: Brief Recap and focus on impact areas for Asset Management

- Overarching objectives according to the European Commission are:
  - Protection of investors
  - Increasing transparency and
  - Promoting competition

- Aim of the ISD (which MiFID replaces) was to set out some high level provisions governing the organisation (www.europa.eu) and conduct of business requirements that should apply to firms;

- MiFID has the same basic purpose. But it makes significant changes to the regulatory framework to reflect developments in Financial Services and Markets since the ISD was implemented;

- MiFID is a major component of the Financial Services Action Plan which is designed to create a Single Market in Financial Services;

- The transposition deadline of February 2007 was missed by everyone bar Romania and the UK;

- However, most countries appear to be on track for adoption into national law by the deadline of November 2007.
MiFID: Brief Recap and focus on key impact areas for Asset Management

- Client Classification
- Best Execution
- Outsourcing
- Suitability & Appropriateness
- Client Order Handling
- Transaction Reporting
- Conduct of Business
- Conflicts of Interest
- Inducements
- Information to Clients
- Organisational Requirements
- Record-Keeping
- Reporting to Clients
- Safeguarding of Client Assets
- Pre/Post Trade Transparency
MiFID Transparency Regime: Key Touchpoints for Asset Management

1. Best Execution
2. Transaction Reporting
3. Conflicts of Interest
4. Inducements
5. Pre/Post Trade Transparency
MiFID and Best Execution

- MiFID’s Best Execution requirements aim to establish new standards in this area with a view to fostering investor protection, increased transparency and competition between trading venues;
- MiFID requires firms to adopt mechanisms to ensure order flows are directed to venues that allow them to obtain the best possible result for their client’s orders on a consistent basis;
- The goal is to foster competition between venues ensuring efficient price formation and hence efficient markets while at the same time promoting investor confidence by ensuring investment firms take all possible steps to execute their orders for the best possible result by choosing the most appropriate venue;
- MiFID now extends the Best Execution requirement to all product types;
- It applies to all retail and professional counterparties but not to ‘eligible counterparties’;
- Eligible counterparties can ‘opt down’ to professional/retail status in order to ensure they obtain Best Execution;
- Seeking the ‘best possible result’ means obtaining the best combination of price and costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order.
MiFID and Best Execution

- In addition to achieving Best Execution, firms must document their process for Best Execution in the form of an ‘Order Execution Policy’. This policy must cover all instrument types and document the requirements that are no longer solely price driven but require active steps to achieve the best possible result for the client;

- The approach for the retail client is slightly different. Best Execution for retail clients can be said to have been achieved when they have received the best price net of expenses – this can be thought of perhaps as the ‘best economic value’. This approach suggests that net price should be the most important determinant. The other factors are still relevant, just less so than the net price;

- Each firm will have its own unique viewpoint or frame of reference, a unique set of execution venues and trading entities, each firm will manage Best Execution within this set of relationships but the set will remain fluid as firms become aware of and review other external venues and seek out those that offer better trading performance;

- Difficulties to be faced dealing with large orders;

- Different considerations apply for dealing with small trades generated for example by automated trading algorithms;

- Non-equity market compliance – serious difficulties.
MiFID – Pre and Post Trade Transparency

- In the vast majority of EU MS today, trading in shares is concentrated on a regulated market, or, where it is permissible to transact away from a RMs systems it is typically reportable to an RM;

- This has the effect of consolidating trading information for each share in one or a few places which means that market participants benefit from a consolidated view of trading in a particular share;

- MiFID breaks down these concentration rules and aims to facilitate competition between different types of trading venues: RMs, MTFs, systematic internalisers, and investment firms trading away from RMs and MTFs (ie OTC);

- To support price formation and investor protection in a potentially more fragmented trading environment it also introduces universal transparency requirements across the EEA to facilitate price formation;

- The intention being that an adequate level of pre and post trade information contributes to the efficient operation of a market and to investor protection;

- It appears unlikely at this stage that the requirement will be extended to securities other than shares;
MiFID and Transaction Reporting

- Article 2 of the Level 2 Implementing Directive requires that details of any relevant transaction be reported to the relevant regulator as soon as possible following a transaction;

- This obligation will apply to all transactions in financial instruments admitted to trading on a regulated market even if the trade took place on a venue other than a regulated market;

- The details to be reported include the names and numbers of the instruments bought and sold, the dates and times of execution and the transaction price;

- As noted in the CESR Feedback Statement on this subject in May of this year, in most cases, investment managers are not covered by this requirement in the sense that they typically execute trades directly only in rare circumstances and usually the reporting requirement will fall on the executing broker.
MiFID – Identification and Management of Conflict of Interest

- Investment firms must draw up a comprehensive Conflict of Interest Policy that identifies the steps that will be taken to identify and manage conflicts of interest that present the risk of damage to client interests;

- Where the steps taken are insufficient to ensure, with reasonable confidence, that risks of damage to client’s interests will be prevented, the source of conflicts must be disclosed;

- For example if a firm that underwrites a particular financial instrument may need to disclose a conflict of interest when providing investment advice to its clients in relation to this financial instrument. Sufficient detail must be provided to enable the client to take an informed decision with respect to the relevant investment or ancillary service;

- It is not possible to manage conflicts exclusively through disclosure, an over reliance on disclosure without regard to how conflicts may be managed adequately is undesirable: i.e. it may be used only if all other methods of managing conflicts are not possible.
Inducements - 1

(i) Purpose of the provisions on inducements

to ensure that the firm complies with its “duties” to act honestly, fairly and professionally in accordance with the best interests of each client
Inducements 2

(ii) Distinction

- Fee, commission or non-monetary benefit paid or provided to or by the client - AUTHORISED

- Proper Fee - AUTHORISED
  - Which enable or are necessary for the provision of investment services and
  - which, by their nature, cannot give rise to conflicts with the firm’s “duties”
Inducements 3

- Fee, commission or non-monetary benefit paid or provided to or by a third party or a person acting on behalf of a third party

**PROHIBITED... EXCEPT IF**

- disclosure to the client before provision of the service;
- inducement is designed to enhance the quality of the relevant service;
- Inducement does not impair the firm’s “duty” to act in the best interest of the client;
Inducements 4

(iii) How to deal with inducements paid or provided to or by a third party?

- Draw up a list containing all inducements falling within this category;
- Verify for each of these inducements whether it meets the following two criteria:
  - designed to enhance the quality of the service
  - compliance with the firm’s “duty”  
  Problem: Self-assessment, but CESR guidance!
  - if only one criterion is not met: prohibition of the relevant inducement
  - only if both criteria are met: authorisation of such inducement subject to

  Disclosure to the client!
Inducements 5

(iv) How to disclose?

- **Pre-MiFID**: a mere reference to the fact that an inducement was paid by a third party was sufficient
- **Post-MiFID**: no longer sufficient, must clearly disclose to the client
  - the existence,
  - the nature and
  - the amount

of the inducement *received or paid*, PRIOR to the provision of the relevant service.
Inducements 6

(v) Summary inducement disclosure possible

- Generic information that inducements may be paid or received: **not** sufficient;
- Or disclosure of “essential terms” necessary to allow the investor to relate the information to the service rendered;
- Provision of further details at the request of the client.
‘UCITS 4’ The Next Regulatory Wave

1. Introduction
2. Process and Timetable
3. Cross-border Mergers
4. Management Company Passport
5. Simplified Prospectus
6. Cross-border Notification
7. Private Placement
Introduction

- EU Investment funds have experienced five fold growth in Assets over the space of 12 years;
- Growth rates of around 10% per annum are expected in the period to 2010 bringing total assets to over 8 billion Euro;
- The cornerstone of the EU Framework for investment funds is the 1985 UCITS Directive;
- This has provided the focal point for an increasingly vibrant EU Fund industry;
- The market increasingly is organised on a pan-European basis. The passport is in widespread use;
- Cross-border fund sales represented 66% of total net industry flows in 2006;
- Challenge is to ensure that the framework remains up to date and dynamic.
Introduction

Issues

- Bottlenecks and failures of the product passport. Procedures for cross-border marketing take too long, are too costly and subject to too much supervisory interference;

- Sub-standard investor disclosures: the simplified prospectus does not help investors or their advisors to make sound investment decisions;

- Proliferation of small inefficient funds: The Directive provides no mechanisms to facilitate the amalgamation of funds or pooled management of assets. The European fund market is populated by small and relatively expensive funds, driving up costs;

- Obstacles to functional and geographic specialisation. The Directive requires concentration of all value chain activities in one Member State: only the fund can be ‘passported’. These legislative restrictions prevent the fund industry from taking full advantage of all locational and specialisation benefits on offer in the single market.
Process and timetable

- Consultation process began 2004 with report of Expert Group on Asset Management;
- Publication of ‘Green’ paper in July 2005 followed by creation of Expert Groups
  - Market Efficiency
  - Alternative Investments
  - Private Equity
- No concrete proposals on AI/PE side other than call for evidence on Private Placement;
- Possible timeframe for implementation is end 2009 – this is not too ambitious given the fact that DG internal market has consulted widely and appears to have the support of the European Parliament;
- We need to start planning now.
DG Internal Market’s Mission to Reform the UCITS Structural Landscape

- Remove costly administration interference when harmonised funds are sold cross-border;
- Support consolidation of the fragmented fund industry through mergers and asset pooling;
- Allow fund managers to manage funds established in another Member State;
- To provide investors with meaningful and concise information about costs, risks and potential rewards when deciding to invest in a fund;
- Commission’s view is that publication of Eligible Assets Consultation and associated CESR Level 3 work on this subject together with industry surveys confirm that no expansion of UCITS investment powers is currently necessary;
- Call for evidence regarding the need for a Pan-European Private Placement Regime.
Cross-border Mergers - Why?

- Average European fund 1/5 of size of a US fund;
- 54% of European funds manage less than Euro 50 million of assets;
- EU Commission studies suggest that up to Euro 6 billion of scale savings are available.
Objective

- **Objective**: create a facilitating framework while ensuring effective protection of the rights of investors

  - **Principle**: right to merge UCITS but subject to prior regulatory approval

  - **Broad scope**:
    - Three fund merger techniques:
      - Merger by absorption
      - Merger by creation of a new fund
      - Scheme of amalgamation
    - Cross-border & domestic fund mergers
    - Between UCITS of any type (or sub-funds)
Merger approval proposal

- **Regulatory approval:** - Commission’s preferred option
  - Competent authority of disappearing UCITS has complete control;
  - No veto possibility for receiving UCITS Regulator but to be informed if potential detriment to receiving UCITS’ investors;
  - Pioneer should lobby strongly against this: our view should be that dilution levies and the receiving fund’s obligations viz-a-viz its investor base will be sufficient to protect the interests of receiving investors.

- **Criteria:**
  - Compliance with home state provisions on fund mergers;
  - Receiving UCITS notified for marketing;
  - No need for objectives/policies/names etc to be similar.

- **Decision: within 15 working days**
- **Necessity to comply with other national law provisions**
Merger Approval

- **Third-party control:**
  - Disappearing UCITS depositary to check conformity with law and fund rules
  - Disappearing fund’s independent auditor to report on the asset valuation method and the calculation of the exchange ratio

- **Information to Disappearing Fund Regulator:**
  - Common draft terms of the proposed merger
  - Approval by depositary of draft terms
  - Draft auditor report
  - Information to be provided to dissolving UCITS’ investors
Investors’ information & rights

- **Investor information:**
  - Enable investors to make informed decision on merger’s impact
  - Sent at least 30 days before merger
  - Principles only – detailed content & format at CESR Level 2/National Law
  - Receiving fund investors to be informed in certain cases. At a minimum, commission suggests that receiving Fund Regulator be made aware of the merger.

- **Investor rights:**
  - Voting where provided for by national law (75% max. threshold)
  - Exit free of charge (in certain cases, also receiving fund’s investors, again to be resisted)
  - Costs: not to be borne directly or indirectly by investors
Management Company Passport - Why?

- Currently a requirement to establish a fully functional passport in each Member State where a promoter domiciles funds;
- This adds costs and hinders specialisation (clustering gains);
- Multiple Boards of Directors and layers of control structure to satisfy the varying demands of each Management Company Supervisor;
- Why necessary when our MiFID firms can operate unhindered across all 27 member states;
- Passport currently available in the Corporate (SICAV) type funds (UK & Italy implemented into National Law) but Directive does not provide for it in the case of contractual type funds;
- Accepted principle is that the Depositary will remain domiciled in the home state of the fund.
Management Company Passport (Options)

Option 1 ‘Full’ Management Company Passport

- Management Company in one Member State allowed to provide the full range of collective portfolio management services remotely – i.e. can manage a Lux domiciled fund completely from Ireland;

- This is in accordance with the principle of free movement of services and is in line with other similar passports;

However, perceived ‘cons’ are:

- It could empty the fund domicile of all substance; - what is left to connect the fund to its supposed domicile; this in turn could lead to:
  - An inability for the Fund Regulator to regulate since all aspects of the management of the fund are done in another country;
  - A perception that the tax domicile of the fund may change as a result of such an untrammelled passporting right.
Management Company Passport (Options)

Option 2 ‘Partial Passport’

- The Management Company can manage funds remotely;
- The domicile of the fund will be ensured by requiring sufficient substance in the country of domicile – this means that (a) the shareholder register must be located and maintained there and (b) NAV should be calculated and released there;
- Management Company could perform foreign Management Company services through a branch, however;
- Commission recognises that this approach is a watering down of the freedoms available to other financial services intermediaries but appears unwilling to make the Regulators co-operate to overcome dual supervision concerns;
- Given that Pioneer follows an outsourcing model – custody/FA/TA largely outsourced; - the obligation falls on our service providers to have and maintain resources in each location where we need to domicile funds.
Simplified Prospectus Reform

Why?

- Simplified prospectus was meant to provide investors with concise and understandable information about investment policy, risks and associated charges of a fund;
- Has suffered from national gold-plating and inconsistent implementation;
- The current Pioneer Funds Prospectus is 59 pages long – the SP is 119 pages long(!);
- The exposure draft introduces a completely new approach;
- ‘Key Investor Information’ – not necessarily embodied in a specific document.
**Simplified Prospectus**

**Objective**
- Concise, relevant product disclosures for potential investors, reduced compliance costs for managers;
- Commission proposes to do this by deleting Schedule C of the current Directive (‘content of the SP’) and leaving only the principles in the Level 1 Directive;
- Detailed rules on content and format are to be agreed in a Level 2 ‘Implementing’ Directive;
- Principles however are as follows:
  - Disclosures need to take account of the fact that few M/F sales are through direct sales – the majority are through intermediated sales/wrapping or structuring;
  - Information needs to be delivered in a timely manner at the point of sale;
  - Information limited to that which is useful and meaningful for the end investor;
  - Level 2 measures should take account of possible waiver of these disclosures where product is aimed at professional investors.
The Fund Passport (Notification Procedure)

Why?

- Procedures for x-border notifications are cumbersome, costly and subject to illegal supervisory interference;
- Delays, intrusive checks during the notification procedure, additional information requirements, or requests for notification all undermine the credibility of the fund passport;
- The soundness of the product derives from the checks performed by the Home State Regulator; protracted delays destroy and impose significant opportunity costs;
The Fund Passport (‘Notifications Procedure’)

Objective

- A complete root and branch overhaul;
- Almost total reliance on Regulator to Regulator communication;
- Submission of complete suite of documentation to Home State Regulator together with translations of the ‘key investor information’ in the language of each target member state and the description of marketing arrangements;
- Question mark over need to provide other constitutional documents in local language Pioneer should push for these to be in English only;
- Home MS Regulator verifies pack is complete before transmitting to foreign Regulator. They will include an attestation that fund is duly authorised as a UCITS;
- Promoter can begin marketing 3 days after transmission by home member state;
- Host MS Authorities have no grounds ex ante to oppose the marketing of the funds in its member state; Emergency powers to suspend marketing rights being considered;
- Any concerns ex ante relating to advertising or marketing should not prevent the promoter placing the UCITS in the host country market;
Call for Evidence on a Private Placement Regime

- Private placement is a specific sales method for investment products – it’s an unregulated ‘sales space’ where buyer and seller can conduct transactions if they, and the deal concerned comply with certain conditions;

- There is no common definition in use, no private placement concept in some member states and where it does exist, no compatibility with other member states;

- Investment Banks and other players are free to repackage unregistered product and see it on a harmonised basis in other Member States through the Prospectus Directive;

- Despite this, PAI is currently not permitted to sell Momentum product to other MiFID intermediaries – Why?

- Using the definition of ‘Professional Investor’ or ‘Eligible Counterparty’ found in the Directive to formalise what product can be sold to whom would be a major step forward;

- Leakage to underlying non-professional investors can be catered for using the ‘suitability and appropriateness’ requirements Directive.