Regulator Assessment: Qualifying Regulatory Provisions

Title of proposal: Extending the MiFID II best execution requirements to Article 3 retail financial advisers and UCITS management companies

Lead regulator: FCA

Date of assessment: 28 February 2018

Commencement date: 3 January 2018

Origin: Domestic extension of EU legislation

Does this include implementation of a Cutting Red Tape review? No

Which areas of the UK will be affected? Whole of the UK

Brief outline of proposed new or amended regulatory activity

The FCA has existing rules in our Conduct of Business Sourcebook (COBS), which derive from the Markets in Financial Instruments Directive (MiFID), that place obligations on firms to put in place arrangements and monitoring to ensure they consistently achieve best execution on behalf of their clients when executing, transmitting or placing orders relating to financial instruments. So for example, an investment firm carrying our transactions to buy or sell shares or bond's on behalf of clients will need to assess the available brokers and/ or execution venues where it could transmit or execute those orders and assess which of these should provide the best outcome on a consistent basis for their clients in terms of price, cost, speed, likelihood of execution, and likelihood of settlement.

MiFID II enhances the existing best execution framework by strengthening the overarching standard firms will need to meet in delivering best execution to their clients. The new framework does not significantly alter the existing best execution regime, but incrementally raises the compliance threshold for firms and applies slightly more granular requirements in certain areas. Specifically, MiFID II requires investment firms that execute, transmit or place orders, including as part of portfolio management or advice services, to:

(i) provide more specific detail in execution policies and summary disclosures to clients;

(ii) be able to demonstrate the fairness of price when dealing in over the counter (OTC) products, and

(iii) publish an annual report listing the top five venues to which they routed client orders and a summary of execution quality achieved over the period (also referred to as RTS 28 reports and set out in Commission Delegated Regulation 2017/576).

The revised best execution requirements are designed to increase the transparency of order execution arrangements and order routing decisions, and to facilitate better scrutiny of performance by clients and their agents.

The FCA is extending the revised MiFID II best execution standards to financial advisers exempt from MiFID II under Article 3 on a modified basis, exempting them from the obligation to produce an annual report on execution quality.

The FCA also extended the full MiFID II best execution reforms to Undertakings for the Collective Investment of Transferable Securities (UCITS) management companies, with some minor modifications to ensure the requirements are tailored for collective portfolio management.

Which type of business will be affected? How many are estimated to be affected?

Article 3 financial advisers

The FCA has decided to proportionately extend the revised MiFID II best execution requirements to financial advisers exempt from MiFID II under Article 3. Typically, such firms are financial advisers who do not hold client assets. These Article 3 firms are currently subject to the existing best execution regime, therefore they already owe a duty of best execution to their clients in all circumstances when receiving and transmitting orders for the sale and purchase of financial instruments.

Based on firm permissions data held by the FCA, we estimate that the potential number of relevant firms impacted is up to 2,439. However, this is likely to represent an overestimate as although some firms may be flagged under the relevant permissions they may not undertake the specific activities which will result in increased costs as a result of the proposed changes. For example, many of these firms are financial advisors who may only provide advice without receiving and transmitting orders.

UCITS management companies

UCITS management companies are companies carrying out collective investment management activities for UCITS funds authorised under the UCITS directive. Although the MiFID II requirements do not automatically cover these firms, the FCA has made a decision to extend the MiFID II provisions on best execution to UCITS management companies.

As set out in PS 17/14, we estimate that there are 81 firms that will incur costs from our discretionary proposals to extend the MiFID II standards to UCITS management companies.

This is composed of 71 firms that perform only UCITS-related Collective Portfolio Management (CPM) activity without Individual Portfolio Management (IPM) permissions and 10 firms with both CPM and IPM permissions but that would not voluntarily choose to level up to the MiFID II standards across their business regardless of our decision.[1]

Among the firms who only carry out non-MiFID CPM activities there could also be a number of firms that delegate all of their management activities. Where a firm outsources all of their investment management, it will bear negligible (if any) costs from enhanced best execution

[1] Based on survey responses to an FCA CBA questionnaire, of those firms with both MiFID IPM permission and some form of CPM permission, 89% suggested they would voluntarily level up all of their business to the MiFID II standard, with only 11% suggesting they would not. Based on our estimate that there are 86 firms with a UCITS CPM and IPM permission, this suggests 10 firms will incur costs as a result of the FCA's decision to extend MiFID II standards.

standards, as these will be borne by the MiFID portfolio manager(s) to whom it delegates this activity. It will, therefore, only be a minority of UCITS management companies who do no MiFID business and manage their funds entirely or partly in-house, who will incur material additional costs from implementing the MiFID II best execution standards.

Price base year	Implementation date	Duration of policy (years)	Business Net Present Value	Net cost to business (EANDCB)	BIT score
2016	3 January 2018	10	-9.7	1.1	5.6

Please set out the impact to business clearly with a breakdown of costs and benefits

The FCA sent out a questionnaire to around 5,000 FCA authorised firms in September 2015, asking for data to support its proposals for consultation in respect of all MiFID II changes. It then consulted on its proposals in a series of consultation during 2016 and 2017 on which it sought feedback on the proposals and the accompanying cost benefit analysis (CBA).

In the section below the FCA outline the costs to firms for the discretionary actions described above. The details presented below are drawn from underlying analysis conducted for the CBA in CP16/29 and which was finalised in PS17/14 and additional calculations undertaken for this impact assessment in relation to the familiarisation & GAP analysis costs for Article 3 financial advisers.

Article 3 financial advisers

Familiarisation & GAP analysis costs

We expect the impacted firms to read and digest the relevant changes and subsequently perform a gap analysis where they will familiarise themselves with the detailed requirements of new the new rules and guidance, and check their current practices against these expectations.

Based on assumptions on the time required to undertake this analysis and the cost of this time to firms, we estimate that firms will incur an average cost of £185 to undertake this work. In aggregate this indicates an overall cost of £0.5 million.[2][3]

Remediation costs

In terms of remediation costs the impact on Article 3 financial advisers from the MiFID II changes is expected to be limited, given that they are already subject to the existing rules on best execution and that they will <u>not</u> have to comply with the annual reporting obligation linked to RTS 28 of MiFID II.

In line with current MiFID obligations, we expect these firms to have the necessary systems in place, in terms of their execution arrangements, policies and monitoring to understand how

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[2] The assumptions used to estimate these costs have been derived from a research project on compliance costs that involved consultation with firms and trade bodies, discussions with vendors, a review of previous CBAs, internal FCA consultation, and desk-based research. To put a cost on time, we have sourced salary information for a range of occupations in financial services. Figures for large and medium firms are based on the 2016 Willis Towers Watson UK Financial Services Report. Small firm salaries were sourced from a systematic review of adverts on the website of Reed, cross-referenced with other publicly available sources. We add an allowance for overheads of 30% to all time costs to account for non-wage labour costs, as advocated by the HM Treasury Green Book.

[3] This aggregate cost figure is likely to represent an upper bound estimate given the potential overestimation of the number of firms impacted.

and why orders have been executed in a particular manner. They are also already required to regularly review, at least annually, their execution arrangements and policy.

In terms of the changes under MiFID II, Article 3 financial advisers would have to review and update their execution arrangements and monitoring, as well as disclosures provided in their execution policies to reflect the revised requirements where these are relevant to their business model and activities. These are likely to involve negligible costs because the majority of these firms' activities are confined to the reception and transmission of client orders, particularly in units in collective investment schemes (UCITS). In general, the additional disclosures they would need to provide in their execution polices relate to greater transparency around costs, fees and venue selection. We would expect this information to be readily available for firms to disclose in their order execution policies. As they are already required to review policies and procedures at least annually, reflecting MiFID II updates should create negligible costs in this regard.

Although MiFID II also indicates that order execution polices should be more tailored to reflect the class of financial instrument and type of service provided, this represents only an incremental change to the MiFID requirements. In the FCA's view, it is likely to have less impact on retail advisors given their relatively simple business models, so should not involve significant changes or costs.

Given the nature of their services and activities which is limited to the reception and transmission of client orders, some of the enhanced best execution obligations may not be relevant, for example, the requirement to check the fairness of price in relation to OTC products.

UCITS management companies

While the MiFID II best execution regime is broadly comparable to the current requirements, UCITS management companies will have to review their execution arrangements to ensure they are meeting the higher standard of taking all sufficient steps to achieve the best possible results. They will also have to review and update the disclosures in their execution polices to reflect the new MiFID II requirements. Some of the new disclosures include information on venue selection and fees as well as third party payments. Also, when taking decisions to deal in OTC products, firms will be required to check the fairness of the price proposed to the client.

The main change for UCITS management companies will be the requirement to annually publish the report consistent with RTS 28 on execution quality achieved during the year and the top five venues or entities to which orders were passed for execution. The FCA expects this to be the primary source of implementation costs for the relevant firms based on a CBA survey conducted before the FCA's original consultation, with lower or negligible costs from updating general policies and arrangements to reflect the general enhancements to the MiFID II best execution standard.

Most firms carrying out investment management activities have indicated to us that where they undertake both MiFID and non-MiFID business, they will apply any new MiFID II requirements to their non-MiFID business as part of their standard operational procedures, thereby reducing the implementation burden. Given that these firms have confirmed that they will adopt a common approach based on the MiFID standard across their MiFID and non-MiFID business, the majority of such firms will incur only marginal incremental costs of extending the MiFID II best execution enhancements to their non-MiFID business.
As explained in Chapter 13 of PS 17/14 (see page 96), our decision not to extend the MiFID II best execution requirements to full-scope UK AIFMs, incoming EEA AIFM branches, small authorised UK AIFMs and residual CIS operators reduces the cost estimate provided for the discretionary proposals in the CBA in CP16/29. As a result we estimate the one-off industry costs for firms to range between £1.4 million – £3.1 million. This is based on 81 firms being

impacted, at an average cost per firm of £50,285, and a further assumption that between 33-76% of those firms do not delegate all of their investment management activity.[1]

Meanwhile the on-going costs are estimated at between £0.5 million and £1.2 million, based on an average cost of £18,970 per firm for the same population, and assuming the same outsourcing range as noted above.

The changes proposed to extend best execution requirements to Article 3 retail financial advisers and UCITS management companies are expected to benefit consumers. For example, the reduction in information asymmetry between consumers and their agents should allow consumers to better select the firms they wish to work with. These benefits to consumers and society are likely to exceed costs to firms. However, under the Act, benefits to consumers and society are out of scope for impact assessments. These benefits are considered in our cost benefit analysis (CBA) prior to rule changes.

Please provide any additional information (if required) that may assist the RPC to validate the BIT Score.

The relevant FCA consultation for these provisions is: FCA, September 2016, CP16/29: Markets in Financial Instruments Directive II Implementation – Consultation Paper III, https://www.fca.org.uk/publication/consultation/cp16-29.pdf

The relevant FCA policy statement for these provisions is: FCA, July 2017, PS17/14: Markets in Financial Instruments Directive II Implementation – Policy Statement II, https://www.fca.org.uk/publication/policy/ps17-14.pdf

The European Commission published an impact assessment alongside its initial proposal for MiFID II, which included the best execution proposals, which can be found here: https://ec.europa.eu/info/file/33578/download_en?token=EMcmdZOS

[1] Those that 100% delegate investment management will bear no direct costs, since these will be borne by the firm to whom they delegate. The latter firm will be undertaking MiFID portfolio management services and as such its costs are a direct result of EU legislation and are not relevant to this assessment.