November 2015

News & Views

For Professional Clients and, in Switzerland, qualified investors

BNY MELLON

MIFID II'S FUND OF FUNDS FALL-OUT

By Fergus McCarthy, head of UK intermediary distribution, BNY Mellon Investment Management

As with all regulation, the devil will be in the detail, but initial analysis of Mifid II shows there could be some unintended consequences for product ranges.

A cull of UK fund of funds (FoFs) is a likely result stemming from the latest EU directive update, Mifid II, due for implementation into national law over the next year (provided there are no delays).[1] While many have discussed the implications of the directive's focus on adviser remuneration and independent criteria (much like the UK's RDR), I believe there are other far-reaching aspects to Mifid.

The FCA is expected to publish a consultation on the implementation of Mifid II in December (with another due in early 2016) but the UK largely has to adhere to the EU proposals as they stand. This includes a more restrictive complex and non-complex product classification that designates what can or can't be bought on an execution-only basis. Coupled with its rules banning inducements and product attrition becomes a natural consequence of Mifid II; FoFs are therefore likely to be among the worst casualties, being replaced with lower cost multi-asset products.

Complex considerations

Mifid II rules assert that products classed as 'complex' cannot be bought by retail clients without advice or an assessment of "appropriateness". And yet advice, under the same directive, will have to be paid for if independent, which as we know from the UK's experience can be off-putting to some consumers.

So what constitutes complex? As the directive is currently being interpreted, Non-Ucits funds (as well as products like structured Ucits) will be classified as complex products. In the UK this includes all non-UCITS retail schemes (NURS) portfolios, which include a good number of the industry's FoFs. Many product providers opted to construct these multi-manager portfolios under the FCA's NURS structure as the rules offered slightly more investment flexibility than Ucits. Specifically, NURS funds can be more concentrated, invest in bricks & mortar property funds and to a limited extent in gold and unauthorised funds. If a company doesn't want to sell a fund into Europe, a NURS structure has been attractive from the aspect of manager flexibility.

Once Mifid II has been implemented, if product providers wish to maintain a broad retail clientele for their NURS funds, they will likely have to convert them to Ucits to avoid the more restrictive criteria. In light of costs associated with conversions and in an effort to focus attention on funds of a certain size or appeal, it seems inevitable many FoFs will close as part of this move.

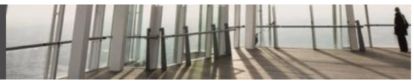
In common with RDR, Mifid II will create advice independence standards, leading to expectations of investment outsourcing by advisers. However, while many people purported FoFs would be a recipient of an outsourcing trend under RDR, it didn't work out that way. The post-RDR world has become a cost-conscious one in which many FoFs are deemed expensive. In contrast, model portfolios and/or risk targeted (or risk-profiled multi-asset) funds cost relatively less.

While there will still be room for low cost FoFs and those with captive distribution channels in a Mifid II world, I'd expect to see greater migration to multi-asset portfolios, despite how broad that term has become.

---

[1] Mifid II is effective from January 2017 but must be adopted into national law six months prior by EU-member states –by legislation from the UK Parliament and FCA Handbook rules. FCA.org.uk/news/mifid-ii-the-road-ahead

I’d also expect further pricing pressures resulting from Mifid II will incentivise savvy advice firms to start or expand robo-advice offerings. A growing area in Europe, these automated decision-tree tools could help cover any advice gaps resulting from the headwinds created by these regulation changes.



Important Information

For Professional Clients. In Switzerland, this is for Qualified Investors only. In Germany, this is for marketing purposes only. Any views and opinions are those of the investment manager, unless otherwise noted. This material may not be used for the purpose of an offer or solicitation in any jurisdiction or in any circumstances in which such offer or solicitation is unlawful or not authorised. This material should not be published or distributed without authorisation from BNY Mellon Investment Management EMEA Limited. BNY Mellon is the corporate brand of The Bank of New York Mellon Corporation. BNY Mellon Investment Management EMEA Limited is ultimately owned by The Bank of New York Mellon Corporation. BNY Mellon Investment Management EMEA Limited is the distributor of the capabilities of its investment managers in Europe, Middle East, Africa and Latin America. Investment managers are appointed by BNY Mellon Investment Management EMEA Limited or affiliated fund operating companies to undertake portfolio management services in respect of the products and services provided by BNY Mellon Investment Management EMEA Limited or the fund operating companies. These products and services are governed by bilateral contracts entered into by BNY Mellon Investment Management EMEA Limited and its clients or by the Prospectus and associated documents related to the funds. Issued in the UK and Europe (ex- Switzerland) by BNY Mellon Investment Management EMEA Limited, BNY Mellon Centre, 160 Queen Victoria Street, London EC4V 4LA. Registered in England No. 1118580. Authorised and regulated by the Financial Conduct Authority. Issued in Switzerland by BNY Mellon Investments Switzerland GmbH, Talacker 29, CH-8001 Zürich, Switzerland. Authorised and regulated by the FINMA. Issued as at 18/11/2015. CP16461 – 18-02-2016 (3M).