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Bachelor Thesis in Finance

Markets in Financial Instruments Directive II

- And its effect on the principal-agent relationship within financial advisory

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Abstract

Through an interview based study this thesis investigates how MiFID II, a new EU directive concerning the European Union's financial markets, will affect the principal-agent relationship currently present between financial advisors and retail investors. Our sample consist of twelve representatives from Sweden's major banks, product manufacturers, and consultancy firms, all with a solid understanding of the Swedish financial advisory scene. Our interview results suggest that MiFID II will have a limited effect on the business model of financial advisors, at least in the short-term. However, increased transparency and new product governance requirements will enable retail clients to put pressure on their advisor and align the interest of the advisors to the clients' interest, thus decreasing the principal-agent problem.

Key Words: MiFID II, Financial Advisory, Business Model, Agency Theory, Principal-Agent Problems, Information Asymmetry, Adverse Selection, Moral Hazard

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1. Introduction

In recent decades, a paradigm shift has occurred; governments have shifted the responsibility of pension plans from authorities on to the individual. Combined with a longer life expectancy this change has forced retail investors to take on more responsibility to ensure their financial comfort (OECD, 2013). All over the world, retail investors seek advice from finance professionals to ensure that this responsibility is managed in the most suitable way. It is likely that retail investors are doing so since they feel incapable to manage their wealth in an optimal way themselves, due to a limited confidence and knowledge about the financial markets (Collins, 2010). Retail investors' lack of financial knowledge has given financial advisors a key role to play in the long-term wealth of the individual (OECD, 2013).

A financial advisor possesses more knowledge about the financial markets and available securities than retail investors and thereby performs a brokerage function on behalf of the retail investor by matching the investor with suitable securities based on the investor's needs (Greenbaum, Thakor, & Boot, 2015). In return for providing this service, the advisor charges a fee. This fee is typically included in either the management fee[1] or in the brokerage[2] (Ibid). Ideally, the advisor makes the retail investor achieve a higher return than his/hers benchmarking index[3], net of fees, so both the investor and the advisor become better off (Ibid).

The typical business model, namely how a firm generates value to its stakeholders (Casadesus-Masanell & Ricart, 2010), of financial advisors can be characterised as a freemium model. In a freemium model, the customer receives a service for free but must pay a subscription fee for other, more advanced services (Kumar, 2014). In financial advisory, retail investors get advice from their financial advisor free of charge. In exchange for providing this service, the advisor is remunerated through the fee of the product. Either through the fees generated by the advisor's firm's products or through a kickback paid by a third-party product manufacturer (Thévenoz, 2007).

The business model of financial advisors is interlinked with the business model of product manufacturers, and the two are often combined. A product manufacturer constructs products by, for instance, managing one or several funds which retail and institutional investors can invest in. The decision of retail clients to purchase the product is often based on the advice of

[1] The fee which the product manufacturer charges the investor for investing in their product.
[2] The up-front fee the investor pays to purchase a security.
[3] In this case the benchmarking index refers to the return the retail investors would have achieved by themselves

a financial advisor. The different market participants can be distinguished as integrated or standalone actors (Gainor, 2017). Integrated actors possess both a distribution channel through its network of financial advisors and product manufacturing through their associated product manufacturing departments. A standalone player on the other hand, possesses only one of the two channels which integrated actors possess, either as a distributor or a manufacturer (Ibid). The Swedish market is dominated by vertically integrated banks which provide both financial advisory and manufactures products (Finansinspektionen, 2015).

In Sweden, the universal banks are responsible for more than 80% of all financial advice to retail investors (Nilsson & Falk, 2015). However, the banks only manage 59% of the capital committed to funds in the country, which is lower than the corresponding figure of 1999 (Ibid). This is partly related to a system called open architecture which has developed during the past decade (Shaughnessy, 2009). Open architecture means that a vertically integrated distributor's product offering includes their own as well as external products (Ibid). When distributing the product of an external product manufacturer, the distributor generates revenue through a kickback paid from the third-party, as illustrated in figure one. The kickback can be provided either as a percentage of the brokerage paid by the client or as a trailer fee based on the management fee (Thévenoz, 2007).

Figure 1: In the open architecture system, the advisor is remunerated through a kickback from the product manufacturer.

1.1 Problem Discussion

As mentioned in the introduction, there are two main revenue streams for financial advisors, the management fee and the kickback. The management fee covers both the cost of advice as well as the cost of manufacturing and managing the product (Securities and Exchange Commissions, 2017). However, the margin earned by an advisor might be different from product to product, which might incentivise an advisor to promote some internal products more than they should do based on the product's characteristics (Finansinspektionen, 2015). The same problem occurs with external products if the kickback from one product manufacturer is higher than the kickbacks paid by other manufactures since it incentivises the advisor to distribute products from that product manufacturer (Ibid). Thus, it is clear that the business model which financial advisors operates under today has several inherent conflicts of interest since higher margins and commissions for the advisor tend to be associated with higher costs for the retail investor (Peck, 2011). Due to the information advantage possessed by the advisor (agent), the advisor can capitalise on the, generally, uninformed retail investor (principal) to benefit themselves, which causes a classical principal-agent relationship (Jensen & Meckling, 1976). Thus, the different margins and kickbacks received by the advisor might be detrimental to retail investors if the advisors try to promote the highest paying products rather than products that are in the clients' best interest (Peck, 2011). In the best of all worlds, the advisors' interests would be perfectly aligned with the investors', which would mitigate such a situation.

As of 2015, almost all financial advice in Sweden was financed by commissions (Finansinspektionen, 2015). Due to the reasons mentioned above, which may induce the intermediary to give advice based on how much kickbacks each product generates rather than how suitable they are for the client, the regulator deems this as problematic since it may create an adverse selection problem (Akerlof, 1970; Finansinspektionen, 2015). Mahoney (2004) illustrates that the total expense ratio, the cost of a fund, is negatively correlated with investor's return. Empirical evidence from the US shows that standalone advisors prefer to sell expensive funds which generate high fees and thus decrease investor returns (Bhattacharya, Hackethal, Kaesler, Loos, & Meyer, 2012). This implies that the principal-agent problem described above is far from a theoretical problem but rather a problem of significant practical importance. Therefore, regulations have been developed around the world and especially since the last financial crisis such regulations have become stricter to protect investors and hinder advisors from abusing their power (Moshirian, 2011). However, any regulation that tries to solve a problem on the financial market must take close consideration not to worsen other problems (Inderst & Ottaviani, 2012).

MiFID II is a new regulatory framework that is meant to promote transparency and increase the investor protection in the financial markets, which will have major implications for the financial advisory sector (ESMA - Securities and Markets Stakeholder Group, 2014). MiFID II is partly meant to deal with the conflicts of interests described above and increase the quality of financial advice (ESMA, 2014). Per MiFID II, independent advisors will no longer be able to accept any kickbacks, except minor non-monetary benefits, and must therefore develop a new payment model, while non-independent advisors must disclose all their fees and kickbacks to the client (European Commission, 2016). These changes will thus challenge financial advisors to find a suitable business model by which they can both comply with the regulation and motivate the fee to the clients when the transparency increases.

However, it is unclear how these changes will affect the principal-agent problems associated with the current business model of financial advisors. For instance, disclosure of received kickbacks might cause vertically integrated actors to promote more of their own products rather than external products (Inderst & Ottaviani, 2012), which does not ameliorate the principal-agent problem. MiFID II may also induce other changes to the business model of financial advisors and the effects of MiFID II for the principal-agent relationship between financial advisors and retail investors is yet to be explored.

1.2 Purpose

The purpose of this thesis is to investigate whether the implementation of MiFID II will affect the conflicts of interest arising from the information asymmetry in the financial advisory or not and, if so, how it will change. Our research question is thus,

What effects will MiFID II have on the business model of financial advisors and what will these effects imply for the principal-agent relationship between financial advisors and retail investors?

By researching this question, we will contribute to current research since the area lacks prior research, give an early policy evaluation to the regulators as well as a finding of practical importance. Our results have practical significance since one of the main targets of the MiFID II regulation is to increase the consumer protection in the financial markets, if we find that this is unlikely to be fulfilled with MiFID II the industry can expect and prepare for yet another round of regulation.

1.3 Delimitations and Disposition

Financial markets are highly dependent on the institutional environment they exist in, just within Europe are there many differences in conditions and how the markets functions (ECB, 2012). Due to market heterogeneity, conclusions drawn in one national setting might not be valid for another. Therefore, we have limited our research to the Swedish market. Furthermore, the principal-agent relationship is mainly affected by the parts of MiFID II that apply to the relationship between financial intermediaries and retail investors, which is why we have chosen to focus our research on these areas of the regulation.

The rest of this thesis is organised as follows; Section two briefly explains the characteristics of financial advisory on the Swedish market and gives a high-level overview of MiFID II. Section three introduces principal-agent theory which is at the heart of our study. Section four explains the methods used in the study and discusses the study's weaknesses. In section five we present our interview results which are then analysed and discussed in section six, section seven concludes the thesis while section eight introduces proposals for further research.

2. Setting the Scene

The Swedish financial advisory scene is dominated by the big domestic universal banks, Nordea, Swedbank, Svenska Handelsbanken, SEB, and their associated product manufacturing departments (Nilsson & Falk, 2015). The universal banks which today have strong positions in the financial advisory market, also have a strong position within the product provision market. That is mainly due to their extended network of retail branches in which they hold a natural distribution channel to retail investors (Klaus, 2016).

Through their extensive branch network the universal banks mentioned above serves a wide client spectrum with investors in many different shapes, regarding both their wealth level and legal entity. The first distinction is often if the investor is an institution or a private person (UBS Group AG, 2016). Furthermore, the wealth level plays a key role; individuals are often segmented either as ordinary retail investors or Private Banking customers. Retail investors often use their "personal banker" at the local branch office, which offers advice on what products that fits the retail investor's profile and needs. In Sweden, Private Banking clients are often defined as clients with at least five million SEK in investable assets (Nordea, 2017). When a retail investor reaches this wealth level, the client is entitled to utilise the Private Banking services their advisor offer if they wish (Greenbaum, Thakor, & Boot, 2007). Private Banking clients are eligible for a wider product assortment and more services compared to ordinary retail clients (Ibid)

During the last decades, increasingly more retail investors have shifted their savings to discretionary investment management (EFAMA, 2015), even though discretionary mandates still are used mainly by wealthy individuals (Picardo, 2017). In discretionary investment management, the advisor becomes a portfolio manager for the savings with a mandate to buy and sell products as they see fit. Outside of discretionary mandates, clients must give their advisor an order to buy or sell a product before the advisor can act (Handelsbanken Asset Management, n.d)

2.1 MiFID II at a glance

Since the foundation of the European Union in 1958, the economic collaboration between the member states has been in focus. One of the main focuses of the EU during the past years has been the creation of a well-functioning single market (EU, 2016). As a part of this effort, the first version of the MiFID regulation was implemented across the Union in 2007 with the aim of creating a single capital market and union-wide consumer protection for financial services (ESMA, 2017). The 3rd of January 2018 MiFID I will be replaced by MiFID II and MiFIR, which is a regulatory framework that combines both a directive with regulation. MiFID II will be implemented the aim to improve and further harmonise the financial markets within the Union by promoting transparency and increasing investor protection in the financial markets (ESMA, 2014). The regulation is comprehensive and will have a widespread impact; this thesis will not discuss all elements of MIFID II in detail. However, to set the scene, we will provide a high-level overview of the aims with MIFID II as defined by the European Commission,

"MiFID II/MiFIR aim to enhance the efficiency, resilience and integrity of financial markets, notably by:

- *Achieving greater transparency: introduction of a pre- and post-trade transparency regime for non-equities and strengthening and broadening of the existing equities trade transparency regime;*
- *Bringing more trading onto regulated venues: creation of a new category of platforms to trade derivatives and bonds - the Organised Trading Facilities - and of a trading obligation for shares on regulated venues;*
- *Fulfilling the Union's G20 commitments on derivatives: mandatory trading of derivatives on regulated venues, introduction of position limits and reporting requirements for commodity derivatives, broadening the definition of investment firm to capture firms trading commodity derivatives as a financial activity;*
- *Facilitating access to capital for SMEs: introduction of the SME Growth Market label;*
- *Strengthening the protection of investors: enhancement of the rules on inducements, a ban on inducements for independent advice and new product governance rules;*
- *Keeping pace with technological developments: regulating high-frequency trading (HFT) imposing requirements on trading venues and on firms using HFT;*

- *Introducing provisions on non-discriminatory access to trading and post-trading services in trading of financial instruments notably for exchange-traded derivatives;*
- *Strengthening and harmonizing sanctions and ensuring effective cooperation between the relevant competent authorities.*

Finally, the overarching aim of the MiFID II/MiFIR regulatory package is to level the playing field in financial markets and to enable them to work for the benefit of the economy, supporting jobs and growth." (European Commision, 2016, s. 2)

Since we are interested in how the principal-agent relationship in financial advisory will be affected, we have chosen to focus on the strengthening of the investor protection and the increased transparency MiFID II will bring. The European Securities and Markets Authority (ESMA), have identified nine changes they think will affect retail investors the most, where the first is the classification of independent and non-independent advice. After the implementation of MiFID II advisors will need to disclose to an investor whether they are providing their advice based on a holistic overview of the universe of securities or a more limited universe (ESMA, 2014). To be considered an independent advisor the advice must be built on a holistic overview and without any benefits linked to the product, with an exception for minor quality enhancing benefits. Thus, independent advisors must reshape their business model going forward to compensate for the loss of commission based revenue (Lord, 2013). A non-independent advisor on the other hand, will still be able to receive a kickback as long as the kickback does not influence their ability to act in the client's best interest and they can show some quality enhancement in their service. However, per MiFID II non-independent advisors must clearly explain to the investors on which grounds their advice is non-independent and the limits to their product assortment (Ibid).

The other eight changes ESMA have identified are summarised below,

- Increased transparency of the benefits the advising firm receives by advising the investor to buy a certain product. In the future, an advisor must disclose all benefits they receive from the product sold. This is valid for both independent and non-independent advisors.
- Segmentation of costs and charges. To adhere to MiFID II, an advisor must disclose how much they charge in total and segment the total into how much of the total fee the investor pays that is for covering the cost of advice and the cost of the instrument

respectively. The firm must disclose how much they charge in total in absolute terms and not just as a percentage of the invested capital.

- Increased price transparency. After the implementation of MiFID II firms must disclose the prices offered to trade with more securities than today, such as bonds, derivatives, Exchange Traded Funds, and so on, on a trading platform.
- More stringent requirements for firms to provide investors with information before a purchase is made. The information must contain information about the costs, the risks, and if the product is intended for retail or professional investors. It must also be information about whether the product is provided by the firm itself, a related firm, or an independent firm.
- Stricter product governance, after the 3rd of January 2018 investment firms must take the best interest of the investor into consideration already in the development of new products. That means that a target market for the product must be identified and all risks understood already in the development phase.
- More power to regulators. Per MiFID II the regulators can ban products they deem as unsuitable for investors, conditional on several, specific, legal conditions.
- More products, for instance, structured products, will be classified as complex products. The requirements of a firm to assess the client's knowledge and experience before selling complex a product will also be strengthened.
- When safeguarding assets for a client, a firm can no longer use these assets for their own benefit. The firm must also make sure that the assets are secure if a firm fails. (ESMA, 2014)

2.2 Related Regulations

MiFID II are just one of the many regulations that surround the financial markets (Brunnermeier, o.a., 2009). This thesis will not compare MiFID II with other regulations, but it is important to have a basic understanding of some of these regulations for the remainder of this thesis since we sometimes relate certain effects of MiFID II to these regulations.

2.2.1 Commission Bans

Some EU-countries have implemented regulations with similarities to MiFID II regarding financial advisory. However, most of them are stricter when it comes to kickbacks (Caceis Investor Service & PwC, 2015). The UK regulation is named Retail Distribution Review or simply RDR. The RDR states that advisors of investment and pension products no longer can receive any kickbacks when advising retail clients. The Dutch regulation is even broader and includes a ban of kickbacks on all products sold to retail investors, including products from Execution-Only platforms[4] and portfolio management. Furthermore, the Dutch regulation lacks the grandfathering clause the RDR possess (Ibid).

2.2.2 UCITS

UCITS, an abbreviation of “Undertakings for Collective Investments in Transferable Securities”, is a regulation meant to improve the harmonisation of Europe’s financial markets by creating a standard for manufacturing and distribution of investment funds targeting retail investors. The EU made a distinction between financial products directed to professional and retail investors through the Alternative Investment Fund Managers Directive (AIFM) which was implemented in 2013. The AIFM directive covers investment schemes such as Hedge Funds, Private Equity Funds and Real Estate Funds, aimed at professional investors, while the UCITS-framework covers investment schemes aimed for any investor (European Commission, 2017). Since UCITS implementation in 1984, the framework has been updated four times, where UCITS IV from 2011 is the latest.

3. Theoretical Framework

Financial advisors have a fiduciary duty to act in the best interest of their clients, however since the advisors have diverging interest from their clients, the relationship can be characterised as a principal-agent relationship (Peck, 2011). In this chapter, we present previous literature about the principal-agent problem in general, and financial advisory in particular. The chapter is organised as follows; we start by defining the concept of a principal-agent relationship and the problems it gives rise to, namely moral hazard and adverse selection, before discussing the issue in the context of financial advisory. We then present solutions to the principal-agent problem, while finishing the section with a presentation about our analytical framework.

3.1 The Principal-Agent Relationship

A principal-agent conflict materialises when there is a separation of the control of a decision and the ownership of the outcome (Thomsen & Conyon, 2012). In the theory of corporate finance, this is often researched in situations where the ownership and control of a firm are separated, but the concept has many more applications. Research of the principal-agent

[4] An Execution-Only platform is a platform where retail investors can invest in securities without preceding advice from a financial advisor.

conflict within firms will be used to analyse the principal-agent conflict regarding financial advisors when applicable in the rest of this study.

Ross defined a principal-agent relation as follows,

"… an agency relationship has arisen between two (or more) parties when one designated as the agent, acts for, or on behalf of, or as a representative for the other, designated principal, in a particular domain of decision problems." (Ross, 1973, p. 134).

Jensen and Meckling offer a slightly different but similar definition,

"We define an agency relationship as a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision-making authority to the agent. If both parties to the relationship are utility maximizers, there is a good reason to believe that the agent will not always act in the best interests of the principal." (Jensen & Meckling, 1976, p. 308).

A principal-agent relation occurs to most of us frequently in our everyday life. For instance, a customer faces a principal-agent conflict every time he/she goes to the grocery story since the seller knows better than the client if the apple is organic or not. Furthermore, the customer and the store owner has conflicting interests. The customer wants to pay as little as possible for the apple while the seller wants to get paid as much as possible. However, principal-agent problem in these situations is often deemed irrelevant (Thomsen & Conyon, 2012). Much of the theory is instead focused on situations where the task is too complicated for the principal to conduct on his/her own and is, therefore "forced" to hire an agent to solve the task (Sappington, 1991). In situations where the principal-agent problem is researched the information asymmetry between the principal and the agent tend to be more severe than in "daily situations."

At the heart of the principal-agent conflict lies the problem of asymmetric information. Asymmetric information means that the agent has access to better, or more, information than the principal, which might be the very reason to why the principal is using the agent (Ross, 1973). As Jensen and Meckling (1976) points out in their definition, a principal-agent relationship might be detrimental to the principal if the agent is a utility maximiser, since the agent will try to maximise his/her utility at the principal's expense whenever he/she can. Thus, there is a conflict of interest between the agent and the principal. The conflict of interest arises since the principal and the agent does not have the same utility function which causes them to strive for different objectives (Thomsen & Conyon, 2012). This gives rise to what in agency theory is called agency costs, in other words the loss the principal suffers from outsourcing some decision-making authority to the agent. The principal's loss occurs since it is impossible to design a contract that perfectly aligns the interests of the principal and the agent, thus the principal suffers the residual loss (Peck, 2011). In general, there are two types of problems arising from the information asymmetry, adverse selection and moral hazard (Thomsen & Conyon, 2012).

3.1.1 Adverse Selection

Adverse selection occurs before a contract is signed and tells us something about which products that will be available on the market. A common way to explain adverse selections is as a lemons problem, which is how the Nobel Prize winner George Akerlof portrayed the problem. Akerlof's reasoning is illustrated with the following example, there are two types of cars in the world, good and bad, and the car owner knows which type of car he possesses but a potential buyer cannot distinguish between the two. Thus, there is an information asymmetry between buyer and the seller. Since the purchaser cannot differentiate between the two types of cars, he will offer the vendor a weighted average of the price of good and bad cars, $share\ of\ good\ cars \times price\ of\ good\ cars + share\ of\ bad\ cars \times price\ of\ bad\ cars.$ Since the owners of the car knows which type of car they possess, only the owners of bad cars will sell their cars at the offered price. By this mechanism, only bad cars will be available on the market. (Akerlof, 1970)

3.1.2 Moral Hazard

Moral hazard, sometimes also described as hidden action, takes place post contract. A moral hazard occurs when the principal cannot observe the actions of the agent, which enable the agent to take actions that is in his/her best interest but not in the best interest of the principal. In such a setting, the agent may be flying a corporate jet to a major business meeting just as well as to a family vacation. Even if the principal might observe some indications of the behaviour there is no way they can determine which case it is. (Thomsen & Conyon, 2012)

3.2 Principal-Agent Conflicts within Financial Advisory

Since different products generate different margins and commission to a financial advisor, as described in the problem discussion, financial advisors find themselves in a multitasking problem. On one hand, the advisor should give suitable advice to the retail investor, but on the other hand, the advisor has incentives to sell the securities that generate maximum revenue for his employers and thus maximises the agent's benefits (Inderst & Ottaviani, 2009; Peck, 2011). This is a problem since financial advisors are rational and want to maximise their profit while they should act in the best interest of individuals who wants to maximise their capital (Ibid). The Swedish Financial Supervisory Authority points out that the multitasking problem occurs both when the firm sells their own products, due to differences in the margins of products, and when the firm makes money out of commissions paid by other product manufacturers (Finansinspektionen, 2015). This conclusion is also supported by Inderst and Ottaviani (2009). Therefore, by seeking advice of a financial intermediary and typically trusting this advice without conducting a thorough background check (Chater, Huck, & Inderst, 2010) retail investors are exposing themselves to a substantial risk of being trapped in a suboptimal position by accepting to pay a higher than optimal fee (Mullainathan, Nöth, & Schoar, 2012). The suboptimal situation can occur since the financial literacy possessed by the average retail investor is significantly lower than the literacy possessed by the financial advisor. The financial intermediary, the agent, knows more about the universe of potential securities and the suitability of these securities than the retail investor (Lusardi & Mitchell, 2008; Inderst & Ottaviani, 2009). Furthermore, the agent knows more about how much commission/margin each product generates than the customer (Inderst & Ottaviani, 2009).

Golec (1992) also defined the relationship between an investor and investment advisor as a principal-agent relationship. The investor hires the investment advisor to supply investment information, implying a brokerage function of the advisor. To which extent the advisor fulfils the brokerage function is not directly observed by the investor. Instead, the investor observes the information in terms of excess portfolio return (Ibid). Since monitoring is costly for the principal, the advisor has no incentive to provide information to the portfolio unless the advisor has some other incentive to do so, in example via a compensation contract. For financial advisors, the fee is typically a percentage of the fund’s asset under management charged at the end of each year, which provide some incentive to maximise the investor’s return since the fee will be higher if the advisor generates a positive return (Ibid).

3.3 Solutions to Agency Conflicts

There are mechanisms to limit the agency cost that the principal must bear. One of the most popular methods to do so is to monitor the agent, which reduces the information asymmetry between the principal and the agent, and forces the agent to act in the client’s interest (Thomsen & Conyon, 2012). However, monitoring is costly and might be incomplete, which limits the usability in monitoring (Jensen & Meckling, 1976). Golec (1992) mentioned that due to their limited amount of capital monitoring is a relatively costly action for mutual fund investors in general, which is why they often does not monitor their advisor. When it comes to monitoring, regulation plays a significant role as well. Regulation will act both as a limitation to the agent's available options and as monitoring since the regulators will observe the actions of the firms to make sure that they only conduct measures that are within the law (Demsetz & Lehn, 1985). Furthermore, due to reputational concerns of the agent, the media have an important role to play when it comes to monitoring (Dyck, Volchkova, & Zingales, 2008). By acting in a non-optimal way for clients, a corporation can attract unpleasant attention from the media. On the other hand, the media is far from perfect and quite often target the wrong cases and individuals (Ibid). Another solution for the principal-agent problem is to align the agent's interest with the principal's by sharing some risk and profit with the agent (Jensen & Meckling, 1976). In the long run, and under efficient markets, competition will be another key component in reducing the principal-agent problems, for instance through price competition (Nickel, 1996) and benchmark opportunities (Hart, 1983), since bad firms will be driven out of the market (Thomsen & Conyon, 2012).

A possible method to mitigate the agency costs associated with third party distribution is mandatory disclosure of the commissions paid to the agents (Inderst & Ottaviani, 2009). Peck (2011) argues that disclosure of the benefits received by a product improves investment managers' execution of their fiduciary duty in two ways. First, by disclosure, it is harder for the investment manager to hide conflicting interests, which lowers the agent's monitoring cost. Second, it enables the client to identify competing interests. However, disclosure might be insufficient if the clients do not think that they will suffer from the disclosed fees (Campbell, Jackson, Madrian, & Tufano, 2011).

Since retail investors often is quite naive, regulators must be careful to make sure all conflict of interests is disclosed and not just the external agency problem when trying to regulate kickbacks (Inderst & Ottaviani, 2012). For instance, by forcing a distributor to disclose all commissions received, the regulation might benefit vertically integrated actors who do not receive any commissions but still has potential agency conflicts (Ibid). Therefore, any regulation trying to mitigate this problem must, therefore, consider both the positive and the negative aspects of commissions. Inderst and Ottaviani (2012) predicts that disclosure of commissions will decrease the level of commissions received, they also note that the disclosure of commissions might make retail clients unable to absorb other, pay-off relevant, facts. If the disclosure makes advisors more tied to a specific set of products, for instance, the products of one manufacturer, this might force clients to visit more advisors to obtain a complete picture of available securities (Ibid). However, Inderst & Ottaviani (2012) argues that increased transparency in financial advisory should improve the quality of the service by market forces.

3.4 Analytical Framework

The literature presented above describes why a principal-agent relationship might be detrimental to the principal's interest. In this chapter, we have shown that a principal-agent relationship materialises when there is a separation of the ownership, of the outcome, and control, of the decision (Jensen & Meckling, 1976; Ross, 1973). Due to the asymmetric information between the agent and the principal, this gives rise to agency costs (Thomsen & Conyon, 2012). The key agency costs a principal-agent relationship gives rise to is adverse selection and moral hazard (Ibid). In the financial advisory sector, these costs materialise since the agent has incentives to distribute the product which generates the highest revenue to the agent. This incentive might cause a situation where retail investors face an adverse selection problem since they are mainly offered overpriced products (Finansinspektionen, 2015; Inderst & Ottaviani, 2012; Akerlof, 1970). Furthermore, the chapter has introduced solutions, and their associated drawbacks, to the principal-agent problem, such as monitoring, alignment of interests, and competition (Thomson & Conyon, 2012; Jensen & Meckling, 1976; Ross, 1973). In the rest of this thesis, the theoretical knowledge will allow us to identify agency problems in financial advisory, and predict how MiFID II will influence these problems. By applying this understanding in a context with our interview results and the effect of the commission ban in the Netherlands and the UK, we will analyse the effect of MiFID II on the principal-agent relationship in financial advisory, as illustrated in figure two. Through this framework, we also answer our research question.

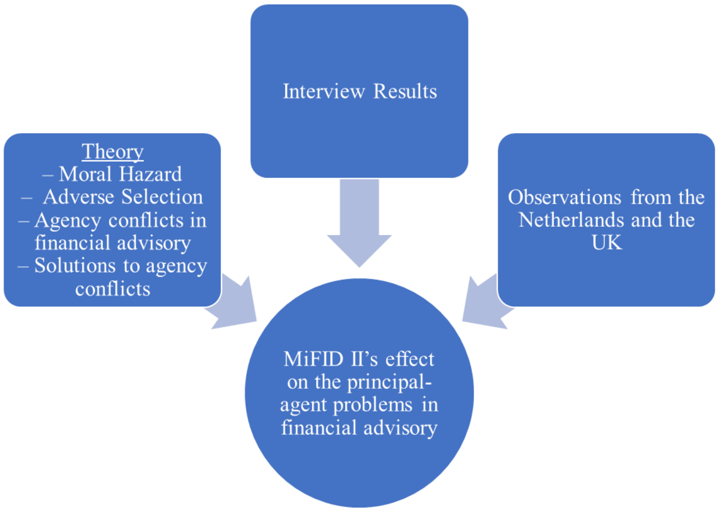

Figure 2: The analytical framework of the study

4. Method

Since the principal-agent problem is hard to measure, it is necessary to explore how and why MiFID II will affect the business model of financial advisors to thereby see how the principal-agent relationship between financial advisors and retail investors will develop in the new narrative. To answer the how and why questions this thesis employs a qualitative research method since it is the best way to,

" ... opening the black box" of organisational processes, the "how", "who" and "why" of individual and collective organised action as it unfolds over time in context" (Doz, 2011, s. 583)

The use of a qualitative method is further motivated by the fact that MiFID II is not yet implemented which means that there is no quantitative data about its effect available. In the following section, we describe which qualitative methods we have used to answer our research question in more detail. At first, we discuss the structure of our interviews, followed by a discussion about our sampling method and a short paragraph of why we have used observations from the Netherlands and the UK in our analysis**.** The section also includes a description of our data analysis and concludes with a section with critique of the chosen method.

4.1 Interviews

When conducting an interview, one can choose to either have a structured, semi-structured or unstructured interview. However, structured interviews are mainly used in quantitative interviews (Bryman & Bell, 2011). Unstructured interviews are often similar to a regular conversation, at most the researcher bring some brief notes about the topic, lets the conversation flow freely and, mainly listens to the interviewed (Ibid). A more commonly used method of interviewing is the semi-structured interview. In a semi-structured interview, the researcher brings an interview guide with predetermined but open-ended questions (DiCicco-Bloom & Crabtree, 2006). When conducting a semi-structured interview, the researcher must be careful not to "get stuck" with the interview guide and be alert and ask follow-up questions to capture what the interviewed views as important (Ibid). In the interview guide the first question might be the overall research questions, but at least five-ten smaller/more specific questions should be added. As the process goes on it, is not uncommon to change the questions somewhat over time as the researcher learns more about the subject (Ibid). We used semi-structured interviews for this thesis since it provided the necessary structure for our interviews which had specific topics we wanted to investigate. At the same time, the semi-structured interviews provided us with flexibility to modify the questions, based on what the respondents viewed as important and as we developed our knowledge.

4.2 Sampling

In a qualitative study, the group of respondents is not a sample in the same sense as in a quantitative study and normal sampling rules, for instance, random sampling, are not applicable. On the contrary, the respondents should be quite homogenous and chosen based on their knowledge of the matter at hand to ensure depth and richness of data (DiCicco-Bloom & Crabtree, 2006). To fulfil these requirements, we have chosen our sample on theoretical grounds. To choose a sample on theoretical grounds means that the researcher has an idea about the topic he/she wants to study and then chooses a group of individuals to interview based on their knowledge on the subject (Bryman & Bell, 2011). When sampling on theoretical grounds, the researcher cannot decide beforehand how many interviews that will be conducted (Strauss & Corbin, 1998). The researcher must continue to collect data until the topic is saturated with new information. A topic is saturated when no new or relevant data about a category is discovered, the category is well developed regarding its characteristics and variation, or if the relations between the categories have been well established (Ibid). To achieve saturation, we conducted twelve interviews of one hour with fifteen individuals who have insight into the Swedish financial advisory scene. These interviews gave us a holistic view of the chosen topic, and no new information about the identified concepts was identified in the later interviews.

For this thesis, representatives from all Sweden’s four universal banks, smaller product manufacturers, more recent entrants such as an online broker, as well as consultants from some of the world’s most renowned consultancy firms were interviewed. All respondents were granted anonymity in the thesis but a list of the functions our respondents held at the time of the interview is provided in the appendix. The interviews were recorded if the respondent did not oppose such a procedure. In total, nine out of the twelve interviews were recorded. Due to the level of the thesis, the interviews were not transcribed, except for the used quotations.

4.3 Benchmarking to the Netherlands and the UK

To put our interview results in a context and predict effects we sometimes draw parallels to the developments in the Netherlands and UK after the implementation their commission bans.

By using cases where similar regulations have been implemented, we enable ourselves and the respondents to answer how and why questions about the outcome of an intervention (Goodrick, 2014). However, we have only used benchmarking data when such information was mentioned during the interviews and we do not, in any way, attempt to conduct a full comparative case study.

4.4 Data Analysis

The field of data analysis might be the weakest point of a qualitative study since the conventions of how to analyse qualitative data are far from as pronounced as they are for quantitative data (Miles, 1979). We will handle our data with an approach inspired by grounded theory which is the most common way of analysing qualitative data (Ibid). We followed the key steps in grounded theory which are described below.

In grounded theory, an essential component is that the findings from the first interview are challenged, and used to direct, the following interviews, which is why our data analysis started as soon as any data had been collected. By doing so, the researcher can be sure to capture all the relevant aspects of the topic at the same time as biases can be avoided since each aspect discovered in one interview is tested in the next (Corbin & Strauss, 1990). When handling the data after an interview, the researcher should look for concepts and give these concepts different labels and try to fit concepts from later interviews to existing labels. If no suitable label exists a new label must be created (Ibid).

When concepts have been identified, similar concepts can be grouped together as a more general grouping takes place, namely categories. However, for a category to be defined, one must identify and specify under which conditions the category is valid. Over time many categories can be shaped and related to each other and then a theory of a phenomenon can be formed. As noted in the first paragraph, previous findings should constantly be challenged with new discoveries to avoid biases and improve the precision of the grouping. What initially could have been considered as one concept might be split into two or more sub-concepts of the first. Regularities and irregularities must become apparent in the grouping of the data. If some behaviour is the norm but changes under certain conditions, this variation must be accounted for in the analysis (Ibid).

To identify the concepts, the researcher must code the data. The coding process consist of three different stages, open, axial, and selective coding (Ibid) which corresponds to different levels of coding (Bryman & Bell, 2011). In the first stage, open coding, the data is broken down into small pieces that are then clustered together and rephrased to concepts and categories. After this process, the axial coding takes place in which connections between the categories are explored by examining links and causality between the concepts. The final stage is the selective coding whereas the main category is identified and the other concepts are related to this category (Bryman & Bell, 2011; Corbin & Strauss, 1990).

4.5 Critique against Chosen Method

Even though grounded theory is a well-researched method for qualitative research, it has several flaws (Bryman & Bell, 2011). Validity and reliability are two key concepts when evaluating a study, which is often used in similar applications in qualitative and quantitative studies (Ibid). Reliability refers to the opportunity for another researcher to replicate the study with the same result. Validity, in many aspects the most important criteria (Ibid), refers to the study's ability to reach conclusions which accurately represents the reality (Collins & Hussey, 2009). In this section, we will discuss some weaknesses of our study in the perspective of validity and reliability and present what we have done to mitigate the problems.

4.5.1 Validity

A weak point of qualitative studies is that there are no formal tests to conduct with the data in the analysis phase as in quantitative research. The lack of formal tests makes qualitative studies more subject to the researcher's interpretation and understanding of the data which limits the validity, and reliability, of the study (Bryman & Bell, 2011). To mitigate these problems, as far as possible, all the observed data was tested and challenged in the remaining interviews, as described by Corbin and Strauss (1990). By constantly questioning findings from previous interviews, potential biases from ourselves and the respondents were reduced. In the report, it has sometimes been necessary to raise topics which were only covered in one or a few interviews, in such cases this is made clear by a statement before the finding.

During our study, we have been unable to interview a respondent from the regulators, which is a drawback to the study. It would have been interesting to compare the regulators' interpretation of MiFID II to the market participants' interpretation. By interviewing a representative from a regulator, the regulator's interpretation of the guidelines and in which areas they will focus most of their efforts on would have been clarified. However, our sample has been chosen on theoretical grounds and includes most categories of actors on the Swedish financial advisory scene, including representatives from vertically integrated actors, standalone actors, and consultants. Thus, the sample includes most of the actors that will shape the future of financial advisory in Sweden, which is essential for the validity of the study. Thereby, aside from the regulator, we have captured a mix of respondents, which has enabled us to triangulate the effects of MiFID II. Triangulation is a control mechanism of qualitative studies and improves the validity (Bryman & Bell, 2011). Furthermore, most of the respondents described similar effects of MiFID II which is an indication that both the validity and reliability of the study is high.

The respondents have been granted anonymity throughout this thesis, while we are convinced that the anonymity has improved the quality of the data, by making the respondents speak more freely about the topic, it is understandable if it raises questions about the credibility of the study among readers. There is not much we can do to mitigate this problem more than once again stress that this has improved the quality of the data and thus, increased the validity of the study since the data captures a more accurate representation of the reality.

In the study, we, and the respondents have sometimes used extrapolation of what happened in the Netherlands and the UK to forecast the effects of MiFID II on the Swedish market. Due to the heterogeneity in the financial markets (ECB, 2012), the effect of these regulations in these markets might not be the same as the effect of MiFID II on the Swedish market. It is also important to note that these regulations are not the same as MiFID II, which can further worsen the problem of generalising results from one market to another. This heterogeneity might make it hard to reach conclusions that are generalisable across markets. To avoid this issue, we have mainly used comparisons when discussing isolated effects which should be valid across markets.

4.5.2 Reliability

Since it does not exist as strict guidelines for qualitative studies, as for quantitative research, on how to collect and analyse data, a qualitative study is more dependent of the researcher that conducts the study than quantitative studies (Ibid). Due to the different interpretation of the data and potential biases of various researchers, it is hard for another researcher to replicate the study, which is another limitation to the reliability of this study.

Another weakness of our study is the fact that MiFID II is an upcoming regulation which has not been implemented yet. If the regulators present more, or updated, guidelines for the implementation of MiFID II it is possible that our current findings and conclusions will become invalid. It is also important to note that the views expressed by the respondents are expectations of the future, rather than a description of the past which adds to the insecurity of the study. Furthermore, because the regulation is not implemented yet, we have been unable to compare our findings to other papers and observe any discrepancies, which could have served as an important control mechanism. Because of this uncertainty, the reliability of our study might be challenged if the interpretation of MiFID II changes before or after the implementation. In qualitative studies, this is a common issue since the ever-changing circumstances in the society might cause another researcher to get other results when trying to replicate the results of a study (Bryman & Bell, 2011). However, since MiFID II will be implemented only seven months after the publication of this thesis, and the actors need time to adjust their business model accordingly, any major changes before the implementation are unlikely.

Once again, we want to stress that this thesis deals with a future event which means that some variables might change before the implementation, which might change our conclusions. The uncertainty is especially pronounced when the long run effects are discussed, since it is easier to predict the state of the world in six months than in several years, due to the ever-changing circumstances.

5. Interview Results

When reviewing our interview results, we have identified several interesting concepts which have been grouped together in categories as described in the method section. In this section, each headline represents one identified category. In general, only issues that were brought up in most of, many of the interviews are presented. However, to capture different nuances of the findings, it is sometimes necessary to present findings only observed in one or two interviews as well. In such cases, we clearly express this by stating “as one of the respondents said…” or similar before the finding. The section starts with a presentation of the respondents’ thoughts of being classified independent or non-independent since the actors’ classification will influence the business model of financial advisors. We then continue by presenting two processes currently used to avoid potential conflicts of interest before we continue with our interview results regarding MiFID II’s effect on the financial advisors’ business model and product offering. The section then continues with a presentation of the increased requirements regarding product governance and the knowledge level of an advisor before finishing off with a presentation of the generally uninterested retail investor.

5.1 Classification as Independent or Non-Independent Advice

With MiFID II, commissions are only forbidden for independent advisors and in discretionary mandates (in discretionary mandates the advisor can receive a kickback but must then pass it on to the investor). Independent advisors cannot have any product manufacturing and must take a holistic view of the universe of securities when giving advice. In the Swedish market, the number, and relative size, of independent actors are small, while, according to the respondents, it is more common in the UK and the US. The Swedish market is dominated by the universal banks which will be classified as non-independent per MiFID II since they, for instance, manufactures a part of their product assortment themselves. Smaller actors have the opportunity to change their business model to become classified as independent. However, as of now, none of the respondents thinks that the competitive advantage of independence will be significant enough to incentivise the smaller actors to take a leap into the unknown as a change of the business model would mean. Thus, most of the smaller players will be classified non-independent as well since it generates the smallest change to the current regime. As a whole, the classification of independence can be summarised with the following quote,

"Depending on the business model one has today, it will be a natural choice; actors that manufacture their products will not have the opportunity to be independent. Most likely, a majority of actors will choose to be non-independent, at least initially."

- Chief Executive Officer, Vertically Integrated Fund Company

Non-independent advisors will still be able to receive kickbacks if they can provide some quality enhancement in their offering and if the kickback does not affect the advisor's fiduciary duty. According to the respondents, it is not well defined by the regulators exactly what services that qualify as a quality enhancement. Examples mentioned in the directive are a broad range of products (including external products), high accessibility (for instance, via a web service that is open 24 hours a day), and continuous feedback on the suitability and performance of the advice. It has been made clear by the regulator that just the provision of financial advice does not qualify as quality enhancement since advice is the core of the business already, or as on respondent put it,

"To give advice cannot enhance the quality of the advice."

- Group Responsible MiFID II, Universal Bank in Sweden

Since most actors will be classified as non-independent by MiFID II, the respondents predict that the direct effect on the business model of financial advisors will be limited. However, MiFID II also strengthen the documentation needed to prove that each recommendation is made in the client's best interest and not driven by the commission or margin earned. Per MiFID II, the advisor must show both the investor and the regulator that the given advice recommends the most suitable product to the investor based on the investor's needs, objectives, and characteristics. Two respondents from the major banks pointed out that many banks already have processes to manage conflicts of interest but they might need to make these processes more pronounced and transparent.

5.2 Processes to Manage Conflicts of Interests

As mentioned by the respondents, the Swedish financial advisory scene is dominated by universal banks which have inherent conflicts of interest in their business model. The actors are aware of these conflicts and have processes in place to mitigate the problem. Two methods to manage conflicting interest between an advisor and a client were presented during the interviews. The first process brought up by a respondent was a multi-step process. The process starts at an "independent" Macro analyst who forecasts how different geographical regions, currencies, and interest rates will evolve. The macro analyst is employed by the bank but "independent" from the bank since they are compensated based on how accurate forecasts they make; thus, their only incentive is to produce as accurate forecasts as possible. In the next step, an allocation strategist uses the macro forecast to develop an allocation strategy. With this allocation strategy in mind, an investment strategist then chooses an investment strategy and proposes suitable funds for the bank's advisors to recommend to their clients. This product offering is then the foundation of each advisory meeting in the bank's retail segment. It is important to note that this strategy is made to fit the retail investors in general, but every investor is unique. Therefore, the advisors might need to tweak the strategy to make it optimal for each investor. If the advisor chooses to recommend products outside of the strategy's proposed product offering, the advisor must document this, and the rationale for the decision. Another respondent from a large bank also brought up the importance of this process to avoid conflicts of interests. The respondent also said that due to the new regulation, this central governance of advisors might become stricter. By stricter the respondent means that the advisor's opportunity to recommend products outside the strategy will become more restricted, limiting the flexibility of the advisors.

The other process that was presented during the interviews aims to decrease the conflict of interest that occurs when a retail investor has bought a fund-in-fund solution. In such situations, the bank has incentives to only choose the banks own, expensive, active funds. To manage this problem, one of the universal Swedish banks views the fund-in-fund product as a part of the professional investment advisory supplied to investors, meaning that the fund manager of the fund-in-fund chooses the best funds available in a wide product universe including internal, external, active, and passive funds. According to the respondent, this is a substantial difference from before when integrated distributors focused solely on internal, actively managed, funds in their fund-in-fund products due to the higher revenue generated by these products.

5.3 The Current and Future Business Model

One of the respondents compared the current business model of financial advisors to how the music industry worked before it was disrupted by streaming services such as Spotify and Apple Music. Back then, the labels (product manufacturers) owned the artists (products) and collected several artists to their stable. The labels then used the artists to put together CDs (product offering) which they distributed through a network of distributors, typically physical stores (local branches). To incentivise the stores to sell the CDs of a particular label, the labels offered to share some of the revenue generated by the CDs with the store owner. These incentive schemes made the store owners push certain CDs based on how much revenue they got from the specific CD. Thus, not only the quality of the artist decided how many of the artist's CDs that were sold. The label's decision of how much revenue they would share with the stores was another key component. According to the respondent, this system obviously made customers miss great artists, which is similar to what is happening in the financial industry today, where a lot of decent products do not reach retail investors due to the distributors' incentive schemes.

If the regulators would have outright prohibited kickbacks one of the few respondents that supports a complete ban of commissions thinks that the problem, of decent product not reaching retail investors, would have been corrected. The respondent is convinced, that if a prohibition had taken place, the business model of financial advisors would have changed as the music industry developed when the streaming services entered the market. In this scenario, financial advisors would act as Spotify to whom the customer pays a continuous fee. The advisors would then give advice to the customers based on his/her preferences and what other clients in a similar situation seems to like. The product manufacturer would then be remunerated based on how good they are, measured by the amount of capital they attract. With this regime, the respondent thinks that fair structures that benefit good products would have developed since the best products would generate the highest revenue. On the other hand, other respondents argue that this model would severely limit the competition in the market since such a system could cause vertically integrated actors to focus their distribution solely on their own products. According to the respondents who oppose a ban, the consequence of a complete kickback prohibition would have been severely restricted distribution opportunities for standalone product manufacturers.

5.3.1 Structural Changes

According to the respondents, MiFID II is unlikely to modify the business model of financial advisors as drastically as described in the previous paragraphs. However, the increased transparency MiFID II will bring, as well as other regulatory changes, will influence the business model of financial advisors. According to some of the respondents from the fund companies, there might be growing opportunities for standalone product manufacturers to distribute their own products on in the future. The respondents expect this to be driven mainly by the fact that product manufacturers will be able to provide tax-favourable accounts directly on their platform in the future. This is not regulated, nor required, by the EU but in the national law and could leave the value chain one step shorter. However, it must be noted that retail investors are slow movers, which is why the respondents think that this development is unlikely to happen overnight but rather over the next decade. This development will likely increase the separation between advice and the products, even in the integrated universal banks. When the separation increases, the clients might conduct a stricter evaluation if the received advice is worth paying for and whether they provide decent products. In the long run, the respondents forecast this development to benefit the best, active and passive, products while other products will fall victim for the increased competition.

The respondents expect the structural changes that are likely to happen over the coming decade, and the increased transparency MiFID II brings, to force already established actors to change their business model somewhat as well. A scenario for how this change might happen, as stated by one of the respondents, can be illustrated by an analogy to what happened with flight tickets after the deregulation in the 1990s. Before 1990 a flight ticket was quite expensive, at least compared to today’s standard, but everything was included. Today, a traveller might need to pay extra for luggage, choosing a seat, and even a cup of coffee. According to the respondents, it is not unlikely that we will see a similar system for financial advice in the future. In the long-run, a retail investor might be able to choose whether they want no advice, advice at one occasion, or continuous advice, and pay accordingly in a more convenient way than today. Due to the increased separation between the products and advice, some respondents expect the total expense ratio of funds, the cost of a fund, to decrease but on the other hand, the retail investor must pay an advisory fee instead.

Due to MiFID II, and other trends in the society, the respondents expect new competitive advantages to evolve in the long-run. According to the respondents, it is likely that more independent advisors will establish themselves in the Nordic market since it might be a competitive advantage that is more pronounced after the implementation of MiFID II as seen in the following quote,

"In the long run, is it possible that we will see a growing segment of independent advisors since they thereby can create a new competitive advantage."

- Chief Executive Officer, Vertically Integrated Fund Company

However, as pointed out by one respondent, independent advisors have a short-term disadvantage compared to the integrated actors, at least in Sweden, since "pure" advice is taxed with VAT while the products themselves, which finance the advice given by the universal banks, are not. Additionally, the respondents expect eventual new entrants to focus on wealthy individuals with lower price sensitivity due to "ordinary" retail clients' unwillingness to pay for advice.

5.3.2 Low-cost Alternatives

Almost all the respondents agree that the increased transparency MiFID II brings will further spur the growth of low-cost alternatives such as Execution-Only platforms, passively managed products, and robo-advice on the Swedish market based on the experience of the Netherlands and the UK. According to the respondents, the drivers to this development are the fact that retail clients are unwilling to pay for advice and that the regulation will impose new costs on financial advisors, which might make them reluctant to provide advice to retail investors without a substantial amount of capital.

In the UK and the Netherlands, which have prohibited commissions, retail investors with limited capital have been observed to be unwilling to pay directly for financial advice. Per MiFID II, the cost of counsel can still be included in the management fee/kickback, but the advisor must disclose to the client how much of the total fee that is used to finance the advice.

According to the respondents, this will make retail investors more aware of the cost, especially since the advisor by MiFID II will need to show the total cost in monetary terms under different scenarios and not just as a percent of the capital. Several respondents mentioned the monetary terms as a fundamental difference in the transparency requirements since a significant fraction of retail investors fail to conduct even simple percentage calculations according to studies. The respondents expect the increased fee transparency to cause more retail investors to choose robo-advisors over personal advisors since advice by robo-advisors is cheaper than advice from a personal advisor. It is also worth noting that due to the global digitalization trend, this is an already ongoing process but it might be further spurred by the implementation of MiFID II.

One respondent described a robo-advisor as equivalent to an Independent Financial Advisor regarding the business model but instead of having a conversation with another human being the investor inputs data about time horizon, risk preferences, and so on to a computer software, a robot, which then allocates the capital accordingly. A potential negative aspect of robo-advisors, as several respondents mention, is how robo-advisors will retrieve updated information about an investor’s financial situation. Today, a large bank receives this information “for free” since the bank, for instance, knows when the client takes out a mortgage and can then adjust the savings accordingly. However, other respondents mentioned that other regulations, such as the second Payment Services Directive, might mitigate this problem in the future by making more information about the clients’ financial situation accessible for robo-advisors and other outsiders.

According to the respondents, the increased price transparency might also push more clients to buy Exchange Traded Funds (ETF) and other passively managed products, which are typically cheaper than actively managed products. The respondents forecast this trend to be particularly pronounced among independent financial advisors since they do not have any incentive to advise a client to buy an expensive fund with a high kickback. The respondents also predict that the growth of robo-advisors will spur the growth of ETFs since robo-advisors often base their allocation strategy on ETFs. Some respondents also mentioned that ETFs might increase in popularity under discretionary mandates since some banks will choose not to accept any kickback at all. In such cases, ETFs might be a good alternative, at least in the short run, due to the lack of kickback-free mutual funds.

5.3.2 Complex Products

Complex products in general, and structured products in particular, are two areas which will be heavily influenced by MiFID II. According to the respondents, structured products, typically securities that consist of two or more securities to achieve a certain pay-off profile, is one of the product categories that fraudulent actors have maltreated the most historically. The respondents explained that the maltreatment has been possible because structured products are harder for retail investors to understand and evaluate than plain vanilla products, such as stocks and bonds. Furthermore, even though the product might have a lifespan of several years, the commission for structured products has typically been paid upfront, which has made it profitable to distribute new structured products. Thus, fraudulent advisors have had incentives to first sell a structured product to a retail investor, advice the investor to sell the product before maturity, and then try to make them buy a new product, which has not been in the best interest of the investors as stated by one of the respondents,

"According to the Swedish Financial Supervisory Authority, you will no longer be able to receive Up-Front remuneration. For instance, for a Stock index bond running for three years, the distributor receives the entire remuneration immediately. It does not matter if the customer sells the instrument before maturity; the distributor has already received the compensation. Therefore, selling a new product might be considered as something positive. The Swedish Financial Supervisory Authority have said that this is to the client's disadvantage."

- Group Responsible MiFID II, Major Universal Bank in Sweden

According to the respondents, MiFID II improves the investor protection regarding structured products mainly by classifying structured products as complex products. Furthermore, the regulation increases the investor protection regarding complex products in general through several measures. First, more products will be classified as complex and before purchasing a complex product all retail clients must undergo an appropriateness test. Due to this change, the distributors will be forced to alter the interface of their internet platforms to ensure that complex product can be accessed only by clients who have undergone such a test. Second, MiFID II strengthens the appropriateness test to ensure that the investor understands how the complex product works and which risks it exposes the investor too. In an advisory meeting, the opportunity to explain the security for a client who does not understand the product in the first place is limited due to the time constraint of the meeting. If an investor does not understand the product after the meeting, the advisor must advise against buying the product, even if the client still wants to buy it. Thirdly, by MiFID II distributors of complex products can no longer be compensated for the distribution upfront. From January 2018, the distributor must be remunerated over the lifespan of the product instead. The respondents expect these new changes to decrease the popularity of complex products.

5.3.3 Product Assortment

What effects MiFID II will have on advisors' product assortment was a topic of contradiction among the respondents. Since customer will become more aware of how much they pay, some respondents argued that MiFID II will increase the price competition in the market. Therefore, these respondents argued, having a broad product assortment will be less profitable, causing the assortment to decrease. On the other hand, financial advisors that will be classified as non-independent must prove quality enhancement to be allowed to receive kickbacks from product manufactures in the future. As the respondent pointed out, a wide product assortment is one potential way of doing this, which could cause the product assortment to increase. For instance, a universal Swedish bank lately transformed their fund platform to an open architecture platform which might have been partially due to their MiFID II preparations according to two of the respondents. Currently, most vertically integrated actors only distribute external products in areas they feel unable to provide good products on their own. However, according to the respondents, there is still uncertainty regarding the scope the product assortment must have to be considered as quality enhancement by the regulator. One respondent also mentions that the complete prohibition of kickbacks in discretionary mandates might cause discretionary managers to focus more on internal products to maintain profitability since they generate higher margins.

5.3 Product Governance

MiFID II will bring higher requirements on both manufacturers and distributors product governance. The increased requirements will force manufacturers to identify a target market, to whom the product is meant for, for each product early in the development process. According to the respondents, most serious actors already fulfil these requirements by using common sense in the development of new products. Especially for UCITS-funds, the effect of the new product governance rules is unlikely to have any major effects since the funds are directed to a broad range of clients. However, the respondents mentioned that not everyone manages this process in a formal and well-documented way. Thus, the respondents think that the main change caused by the product governance requirements will be a more structured approach to product development, an increased documentation of the process, and the provision of more information to distributors, clients, and regulators. MiFID II also requires each product manufacturer to supply each distributor with information about the target market for every product. The product manufacturers must also evaluate the chosen distribution strategy to ensure that the products are distributed to the intended investors. To monitor the distributors and retrieve, and distribute, the necessary information will most likely be a minor problem for the universal banks which have plenty of resources to manage such requirements. On the other hand, smaller distributors and product manufacturers might be more affected by the higher requirements since this process might consume much of their resources. Finally, distributors will be forced to review their knowledge and competence to make sure they have the necessary skillset to sell a specific product in their distribution channels.

Another area which will be more affected by the product governance requirements according to the industry representatives is complex products. Complex products are more affected by the product governance requirements since they are more specialised and directed to a smaller target market which, according to the respondents, will limit the distribution possibilities of complex products. As seen in the following quote, this is something that the market participants have adapted to already,

"Complex products will most likely decrease in popularity, and to some extent, the actors have already adapted to this by selling fewer complex products."

- Head of Fund Products, Vertically Integrated Fund Company

However, as a part of a portfolio, complex products might still be applicable for a client outside its target market. The distributor can sell a product outside the target market, without discouraging the client, but only if a specific product is deemed a good fit for the investors' portfolio according to the client's needs, objectives, and characteristics.

5.4 Product Prohibition

After the implementation of MiFID II in January 2018, regulators will be able to ban investment products they find inappropriate to a greater extent. According to the respondents, a product can be inappropriate in multiple ways; it can either be outright bad, sold extensively outside of its intended target market, distributed by distributors who lack the necessary knowledge, or any combinations of these. However, we found a clear consensus during our interviews that the new authority will have limited effect on the mutual fund market. Before listing a fund in Sweden, the Swedish Financial Supervisory Authority must give their approval. If the regulator then in a later stage would ban an already listed mutual fund they would admit to being wrong first place, which the respondents deem as unlikely due to the loss of prestige, as seen in the quote,

"I find it hard to believe that the Swedish Financial Supervisory Authority are going to stop mutual funds. You must remember that the Swedish Financial Supervisory Authority approves the fund rules, the rules of how a fund is designed. First, they would find the fund suitable and reasonable for savers and then in a second stage stop its distribution. I find this difficult to imagine. It is structured products the regulators are after."

- Compliance Officer, Fund Company

Once again, the respondents think that MiFID II will have a bigger effect on the assortment of complex products which may not fit the needs of the mainstream retail client, and have a history of being miss-sold.

5.5 Educational Requirements

The MiFID II framework aims to reduce the information asymmetry between financial advisors and investors, which requires the advisors to be able to explain the products to the investors. According to the industry representatives, an advisor's knowledge needs to meet a higher requirement than before to become MiFID II compliant. In a post-MiFID environment, every advisor needs to sustain enough knowledge to explain how the products in their assortment work, what risks the product exposes the investor to, what tax-effects the product brings, how the product's payment is managed, and what the accumulated costs under the product's lifetime are under different scenarios. To make sure that the sold product is the most suitable product for the client, the advisor must also have enough knowledge about the product he/she does not sell. As an effect of this, today's educational requirement will become stricter. To fulfil the stricter educational requirements, SwedSec the license needed to give financial advice in Sweden, will be upgraded by the yearly knowledge control, making advisors passing the test MiFID II compliant.

5.6 The Uninterested Retail Investor

Many of the regulatory effects presented in this chapter increases transparency which enables retail investors to collect more information to put pressure on their advisors. However, according to the respondents, most retail investors are neither interested in financial markets nor savings related matters or as one respondent put it, *"People, in general, do not understand basic finance and have a highly-limited interest for finance related issues."*

- Chief Compliance Officer, Fund Company

Many respondents consider this general lack of interest in finance, and other savings related issues, as a problematic area since it has made some of the actors on the Swedish market comfortable in their situation since they have attracted retail investors anyhow. Which advisor retail investors choose is mainly driven by which bank they are a customer in since retail investor, in general, does not pay much attention to finance related issues. According to the respondents, this also decides which manufacturer they utilise since the banks typically promote their own funds first and foremost. On the other hand, an advantage, brought up by the respondents, with this system is that the bank can consider the investor's entire life situation and recommend whether it is better to invest or pay down the mortgage. The banks can use this to their advantage by building a long-term relation with the client. In the future, many respondents expect the long-term relation to be of even higher importance to easier motivate the more apparent costs the new regulatory regime brings.

In the Netherlands and the UK, advisors have been unable to motivate their costs, and retail investors have been observed to be unwilling to pay for financial advice. If the experience of the Netherlands and the UK holds true in Sweden as well, MiFID II risks leaving retail investors with less advice than today when the cost of counsel becomes more apparent to investors. Many respondents fear that this effect will be particularly pronounced among non-affluent clients because it might be hard for an advisor to motivate each cost charged to individuals with limited capital. Wealthy investors on the other hand, may be more willing to bear the costs since they tend to have a better understanding of the value the advisor creates. Since this might leave individuals with the greatest need of financial advice with least access to advisors, the respondents consider this effect to be one of the major drawbacks of MiFID II. However, the respondents also mentioned that, due to their general lack of interest in financial issues, most retail investors lack the interest to assimilate the information about costs. Thus, they might continue to evaluate the funds based on their performance just as today. The media was brought up as a potential counterforce to this negligence by the respondents. When the transparency increases, the media is likely to scrutinise the cost of advice and the system of kickbacks in detail as seen in the quote, *"I believe this* (kickbacks and product governance)*, will attract much attention in the media and the Swedish Financial Supervisory Authority will go out and control this to put the spotlight on it. I do not believe that any bank wants to attract negative press."*

- Senior Consultant, Consultancy Firm

On the other hand, as one respondent pointed out, only a fraction of the population is likely to act after negative media coverage,

"Studies have shown that 80% of the population do not care what the press writes, 20% cares, and only half of the 20% actually take action."

- Chief Compliance Officer, Fund Company

Due to the increased transparency MiFID II brings, the respondents expect retail investors to evaluate their advisor more than today, forcing advisors to prove their value. As of now, most retail investors assess their funds by their performance rather than how much extra value they get for the fees paid according to the respondents. When retail investors get more information, the respondents think that the banks must improve their offering in the future and that it will be even more important to take a holistic overview of the client's needs and make sure to focus on one's fiduciary duty as an advisor in the future. However, many respondents pointed out that this is a process which most banks have tried to adopt for many years and is not new with MiFID II.

6. Analysis and Discussion

Since most actors will still be able to accept kickbacks, MiFID II will have a limited direct effect on the conflict of interests caused by the difference in margins and kickbacks among products. However, MiFID II will still affect the business model indirectly and the principal-agent problems in financial advice will be affected in many ways. When analysing the changes MiFID II will bring, it is important to keep in mind that many of the trends MiFID II will spur are likely to have happened anyway. In the following chapter, we analyse our interview results and what they will imply for the principal-agent relationship based on the theories presented in chapter three. The analysis is divided into four parts, where we analyse our interview results from the perspective of information asymmetries, adverse selection, and moral hazard. Finally, we discuss whether an outright prohibition of commissions would have been better regarding the principal-agent problems or not.

6.1 Information Asymmetries

Ross (1973) described that information asymmetries is one of the key concerns in principal-agent problems. By mitigating the information asymmetry between the principal and the agent, principal-agent problems can be reduced (Ross, 1973). From our interview results, we have identified two categories that will reduce the information asymmetry in financial advisory, increased transparency in general, and increased information requirements regarding complex products.

6.1.1 Transparency

Our interview results show that MiFID II will impose stricter transparency requirement on distributors of financial products. The disclosed information must include the cost of advice, the cost of the product, the kickbacks received for the distribution, and the sum of the total cost. The increased information provided to retail investors will probably have a significant impact on the principal-agent problems since it reduces the information asymmetry. By forcing distributors to disclose this information, the regulators will reduce the information advantage which advisors currently hold (Lusardi & Mitchell, 2008). MiFID I has already imposed disclosure requirements but MiFID II will make these requirements stricter. According to our respondents, an important change with MiFID II is that the regulation requires that retail investors understand the disclosed information. By reducing the information advantage (Ross, 1983) currently held by the advisors, the regulator makes it easier for retail investors to evaluate the performance of their advisor and if the product is worth the price (Peck, 2011), thereby putting pressure on financial advisors to prove their worth.

According to the respondents, the dominant position of the universal banks on the Swedish market has made it a natural choice for retail investors to invest at the banks. Because of their historically strong position, the banks might have been comfortable in their position, which have reduced their need to improve their offering. Since competition reduces principal-agent problems (Thomsen & Conyon, 2012), the banks' dominance might have spurred agency conflicts due to the lack of competition. With the increased fee transparency MiFID II brings, retail investors might put more pressure on their advisor to prove their value. By forcing the advisors to prove their value, the increased transparency might improve the quality of advice and increase the pressure on manufacturers to produce good products relative to their price. The principal-agent problems can thereby be reduced by increased competition, which is in line with Nickel (1996). However, this effect might be dampened by the general lack of interest for financial issues among retail investors as reported in our interview results, and the relatively expensive monitoring (Golec, 1992; Jensen & Meckling, 1976). On the other hand, several respondents say that the media is likely to take an interest in this additional information. In the new regime, the media can serve as an important monitoring mechanism by informing retail investors about the costs and kickbacks (Dyck, Volchkova, & Zingales, 2008). By informing the public about the fees and kickbacks associated with financial advice, the media can mount pressure on financial advisors to prove their worth, in line with Inderst and Ottaviani (2012). Thereby, advisors can be forced to deliver the best product to their clients to avoid negative press, which will limit the adverse selection problem described by Akerlof (1970). Having that said, the increased disclosure requirements also pose the question if retail clients will be able to absorb all the information or if it will make retail investors unable to absorb other, pay-off relevant facts (Inderst & Ottaviani, 2012).

If commissions and kickbacks are scrutinised in mainstream media, there is a risk that vertically integrated distributors will limit their supply of investment products to their own products to avoid critical questions by the press (Inderst & Ottaviani, 2012). This would not solve the principal-agent problem but make them internal rather than external (Ibid). However, MiFID II has several measures to manage such problems. First, the advisor must have a process in place where they can motivate why a recommended product is the most suitable for the client, which many actors already have had in place for many years as pointed out by three of the respondents. Second, the regulation enables kickbacks to be received only if the advisor can prove that the kickback enhances the quality of the service. As the respondents pointed out, a broad product offering is one of the examples of quality enhancement mentioned by the regulator, which could incentivise integrated distributors to include third-party products in their offering. Finally, MiFID II requires advisors to explain on which grounds their advice is non-independent, which together with increased transparency makes it possible for the client to identify even the internal potential conflict of interests (Peck, 2011). Thus, a situation in where the retail investors are unaware of the internal problems, as Inderst and Ottaviani (2012) feared, can be mitigated. However, once again it is up to the clients to act based on the information and to understand that the kickback might be detrimental to their return. The dependence on clients to act is a limit to transparency due to the generally uninformed retail investor (Campbell et al., 2011) and the cost of monitoring (Golec, 1992).

6.1.2 Complex Products

As the respondents pointed out, complex products in general, and structured products in particular, have been a problematic area in the industry since many fraudulent actors have maltreated them. By MiFID II these problems will be mitigated in several ways. First, by requiring that the client must understand the product the regulator decreases the information asymmetry described by Ross (1983) and thereby the retail investor's information disadvantage, which is beneficial for the investor. By obtaining more information before purchasing the product, retail investors can make sure that the product is suitable for them, based on their needs, which reduces the adverse selection problem. The problem is reduced since the adverse selection problems occur when the buyer can evaluate the product only after a purchase is made (Akerlof, 1970). However, due to the lack of financial literacy among retail investors (Lusardi & Mitchell, 2008), many respondents fear it will be hard for an advisor to explain a complex product in a meeting with limited time. The challenge of explaining a security to a retail investor might limit the available universe of securities for the investor, which is a potential drawback to regulation (Inderst & Ottaviani, 2012). Second, the increased price transparency will make the clients aware of the total cost of a structured product. Due to the complexity of the products, and retail investors' lack of financial knowledge (Lusardi & Mitchell, 2008), it seems likely that retail clients are unaware of complex products total cost today. Thus, by increasing the fee transparency, MiFID II enable retail investors to put more pressure on distributors and manufacturers to motivate why the product is worth its price since retail investors' cost of monitoring decrease through disclosure (Peck, 2011). On the other hand, this effect might not be as big as it maybe should be due to the lack of interest for financial issues among retail investors as the respondents brought up during the interviews.

6.2 Adverse Selection

Adverse selection is one of the most famous concepts in economics. According to Akerlof (1970), adverse selection problems causes only non-optimal products to be offered on the market. Out of the concepts in the interview results, we have isolated three concepts that will reduce the adverse selection currently present in financial advisory. First, by spurring the development of new segments in financial advisory, MiFID II will decrease the adverse selection problem through competition. Second, the regulation imposes more stringent product governance requirements and increases the administrative requirements when products are sold outside of its intended target market, which incentivises the distributor to stay within the target market. Finally, by giving the regulators an increased mandate to ban inappropriate and maltreated products, MiFID II might improve both the regulatory and internal monitoring. The three concepts and their effects on the adverse selection problem are discussed in more detail below.

6.2.1 New Segments

The industry representatives are convinced that the new regime will spur independent financial advisors and robo-advisors to increase their presence on the Swedish market, at least in the long run. If they can be truly independent, we believe that they can provide a valuable mitigation of the principal-agent problem. The business model of independent financial advisors is designed as the Spotify analogy presented in the beginning of the previous chapter. According to one of our respondents, this business model would provide fair structures without any inherent conflict of interests. However, independent advisors are associated with other agency conflicts. If they are not monitored properly, or in any other way incentivised, they have no incentive to provide return generating information to the investor's portfolio (Golec, 1992). To mitigate this problem, we believe competition will play a significant role. Based on the experience from the Netherlands and the UK, mostly affluent individuals will be willing to pay for independent advice. Wealthy individuals should have more incentive to monitor their advisors since they have more capital to invest, considering that the reason why retail investors in general does not monitor their advisor more closely is the relative cost (Ibid). Thus, affluent investors are more likely to benchmark their advisor to other advisors, which serves as an important mechanism to mitigate agency problems (Ross, 1973). However, a problem many respondents fear with this business model is that it might leave the individuals with the greatest need of advice with less advice than wealthy investors which reaps the benefits of the increased transparency.

Due to the unwillingness among retail investors to pay for financial advice, as seen in the Netherlands and the UK, most respondents believe that robo-advisors will increase their market share. Robo-advisors typically use Exchange Traded Funds to allocate the committed capital, which in general is substantially cheaper than equity funds (Poterba & Shoven, 2002). Since investor return is negatively correlated with a fund's expense ratio (Mahoney, 2004), we are convinced that this will be in the best interest of investors. This development is contingent on retail investors leaving the safe harbour of their retail bank and use the service available. If they do so, they will challenge the dominant players to change their advice model to focus on only the best active funds and the cheapest passive funds by increasing the competition (Nickel, 1996; Ross, 1973). Thereby, today's adverse selection problem can be reduced through increased competition caused by the new segments.

6.2.2 Product Governance

MiFID II will bring stricter requirements for product governance. The regulation forces product manufacturers to identify a target market early in the development process of new products and to distribute this information to the distributors. These more stringent requirements will affect different product manufacturers differently. Many fund companies already fulfil these requirements due to the UCITS-regulation. Furthermore, UCITS-funds are directed to a broad target market, which is convenient to identify. Producers of complex products on the other hand, will most likely be more affected by this new regulation according to the respondents. Due to their risk, and pay-off profile, complex products have a more limited target market than UCITS-funds. Even though many of the serious actors have processes to identify a target market already, the increased regulation will require more documentation from the manufacturer to both the regulator and the distributor. The more stringent product governance regulation will also affect financial advisors. After the implementation of MiFID II, advisors must be able to prove that a product fits the retail investor's needs, objectives, and characteristics. When advising a retail investor to purchase a product to which the investor is not within the intended target market, the advisor must also argue why the product is a better choice than other products, to which the retail investor is within the target market.

By this process, the regulators will have an increased opportunity to monitor the advisors to make sure that the given advice is in the clients' best interest. Thus, the efficiency of the regulatory monitoring is likely to increase, which should reduce the principal-agent problems associated with these products (Demsetz & Lehn, 1985; Jensen & Meckling, 1976). Furthermore, since documentation is time-consuming and costly, by increasing the administrative requirements when stepping outside of the target market the regulator incentivises the advisors to stay within the target market. As Jensen and Meckling (1976) described, alignment of interest is an efficient method to ensure that the agent undertakes actions desired by the principal. Together, these effect is likely to decrease the adverse selection problem that sometimes occurs when an advisor advises retail investors to purchase, expensive, complex products which are not suitable for the investor. On the other hand, by incentivising the advisor to only advise the clients to buy products to which the investor is within the intended target market, the regulator risks to limit the available universe of securities to retail investors. As stated by some of our respondents, sometimes products, to which the retail investor is outside of the target market, would be a suitable part of the investor's portfolio. Due to the administrative requirements, the advisors might avoid these all together. Thereby, the regulation risks to create a new adverse selection problem where suitable products are not offered to retail investors due to the administrative burden, which is a drawback to the regulation as Inderst and Ottaviani (2012) warned for.

Several respondents forecast the increased transparency to attract media attention if any actor comes to manage the target market insufficiently. Due to the reputational concern among the advisors, this will complement the monitoring of the regulator (Dyck, Volchkova, & Zingales, 2008), further underlining the importance of staying within the target market. As mentioned above, staying within the target market is in many situations within the retail investors' best interest but the advisors must also be competent enough to see when it is suitable for the investor to purchase a product which is not meant primarily for retail investors with the investor's characteristics. Thus, there is a risk that the media will target the wrong cases as Dyck and Zingales (2002) pointed out. This might cause advisors to stay within the target market even when it is suitable to recommend another product. However, according to our respondents, the increased product governance is most likely to be in the clients' best interest in the long run.

6.2.3 Banning Products

Since MiFID II enables regulators to ban outright bad products and products which have been sold outside of the target market to a large extent, the rules concerning the banning of products is closely related to the product governance regulation. On paper, this will increase the possibility of regulators to intervene by stopping products they find inappropriate for the market. In reality, the respondents expect this effect to be limited. Most fund companies on the Swedish market manufacturers already heavily regulated UCITS-funds which must be approved by the regulator before being listed on the market. Furthermore, UCITS-funds are, according to the respondents, aimed for a broad range of investors which makes it unlikely that they will be banned due to too much sales outside of the target market. Thus, the effect of the regulatory pressure, as Demsetz and Lehn (1985) brought up as an important mechanism to mitigate the principal-agent problem is, in this context, expected to be quite small. On the other hand, the regulatory pressure might be tougher for products not covered by the UCITS-framework, such as structured products, which, according to the respondents, have been maltreated to a greater extent. A ban of the products is likely to be costly for the manufacture, both in terms of reputational and direct revenue losses. Since banning products mainly affects the products manufacturers the rules incentivise the manufacturers to make sure they provide the distributor with the necessary information and that the distributors do not maltreat the products. Thereby, it can improve the monitoring of distributors, which is an important tool to reduce principal-agent problems (Jensen & Meckling, 1976).

6.3 Moral Hazard

Since the agent and the principal have different utility functions, the problem of moral hazard occurs (Thomsen & Conyon, 2012). Moral hazard problems occur when the agent undertakes action in his best interest at the principal's expense. Based on our interview results, moral hazards are mainly present in financial advisory when it comes to discretionary mandates and the distribution of complex products. By MiFID II, new policies regarding the remuneration for distribution of complex products will be imposed and kickbacks will be prohibited in discretionary mandates. In the following section MiFID II's impact on the moral hazards currently present in these contexts is discussed in more detail.

6.3.1 Remuneration of Complex Products

As shown in the interview results, distributors of complex product will no longer be allowed to receive compensation for distribution of complex products upfront. The change in the remuneration policies for distribution of complex products is likely to have a positive effect on the moral hazard problem associated with these products. By forcing distributors to be remunerated throughout the lifespan of the product, the regulators will remove the incentive distributors currently hold to sell new complex products as distributors now will earn as much from letting the old product sit with the retail investor until maturity. Per this regulation, the regulator aligns the interest of the advisor and the client, thereby the regulators mitigate the moral hazard associated with structured products (Jensen & Meckling, 1976). Thus, this change is likely to leave the clients better off since they are more likely to keep the products until maturity and thus avoid several fees.

6.3.2 Discretionary Mandates

Until the implementation of MiFID II the 3rd of January 2018, financial advisors executing discretionary mandates can collect the kickbacks generated by products bought on their investors' behalf. Until then advisors with a discretionary mandate are stuck the multitasking problem as Inderst and Ottaviani (2009) described. The multitasking problem occurs since advisors maximise their own revenue by choosing the products that generates the highest kickback while simultaneously having a fiduciary responsibility to the investor. The conflicting interests creates a clear case for a moral hazard (Thomsen & Conyon, 2012). MiFID II will prohibit advisors from receiving and keeping kickbacks in discretionary mandates, meaning that advisors can either chose to not accept kickbacks or take kickbacks but pass them on to their clients. Thereby, discretionary mandates will no longer be exposed to the moral hazard described above since the interest divergence is mitigated (Thomsen & Conyon, 2012). On the other hand, advisors with discretionary mandates will lose a part of their revenue stream. According to some of the respondents, the lost revenue can be replaced in two ways, either the advisor increases the price of their service, or promotes more of their own products. Due to the challenge of raising the price and the dominance by vertically integrated actors on Swedish scene, the prohibition of kickbacks in discretionary mandates might cause the internal moral hazard problem to increase. This increase occurs because the difference in profit margin between internal and external products increases when external manufacturers no can longer compensate the distributors through a kickback. Therefore, the advisors have incentives to select as much internal products as possible, leaving the advisor in a multitasking problem once again (Inderst & Ottaviani, 2009).

Since the advisor’s interest still is not perfectly aligned with the retail investors’ after MiFID II we see a risk that the regulation, on one hand, will remove the external moral hazard but on the other hand, worsen the internal problem in discretionary mandates due to the tendency to focus more on internal products (Golec, 1992). By reducing the advisor’s incentive to look for investments outside of the internal assortment the regulator risks to limit the universe of available products in discretionary mandates. The reduced universe of securities might cause retail clients to miss out on decent investment opportunities which can be classified as an agency cost (Jensen & Meckling, 1976). Thus, there is a risk for interest divergence, and therefore a moral hazard is still present in discretionary mandates (Thomsen & Conyon, 2012).

A potential mitigation of the internal moral hazard is the mandatory disclosure of independence or non-independence. Since retail investors choosing a discretionary mandate is typically in the wealthier spectrum of investors (Picardo, 2017), they have a stronger incentive to monitor the advisor than ordinary retail investors considering that the why reason investors do not monitor their advisor is their limited wealth (Golec, 1992). By disclosing the non-independence to the client, the advisor reduces the information asymmetry (Inderst & Ottaviani, 2012) and makes it possible for the client to realise that the advice might be biased

(Peck, 2011). Thus, the client might require the advisor to follow a routine that ensures the best possible portfolio allocation for the client, which is demanded by the regulator as well, and therefore increases the monitoring (Demsetz & Lehn, 1985).

6.4 Would an Outright Prohibition of Commissions Have Been Better?

By following the Netherlands and the UK and prohibit commissions, the regulator would have eliminated the problem of advice given based on how much kickback each product generates altogether. However, these markets, especially the UK, consist of more independent financial advisors that act on a standalone basis compared to Swedish market which is dominated by vertically integrated actors.

Thus, by outright prohibiting kickbacks, as pointed out by the respondents, the regulators would have risked a situation where the vertically integrated players sell only their own products and thereby limiting the universe of securities available at each distributor (Inderst & Ottaviani, 2012). By banning kickbacks altogether, the regulators would have risked decreasing market competition since many standalone product manufacturers are dependent on the banks to distribute their products. That is not an optimal scenario considering that competition reduces principal-agent problems (Thomsen & Conyon, 2012). The discussion above implies that a prohibition of kickbacks would have eliminated the external principal-agent problem but risked increasing the internal principal-agent problem. However, it is also worth noticing that, according to the respondents, most of the vertically integrated actors already promotes their own products first and foremost.

Additionally, one respondent argued that a prohibition of kickbacks could have spurred the development of independent financial advisors acting as the Spotify of financial advisory with associated benefits to the clients. On the other hand, the experience from the Netherlands and the UK tell us that many, non-affluent, retail investors might have stopped seeking advice if they were forced to pay upfront for advice. Not seeking advice might be more detrimental than the current system for retail investors since no advice might cause them to keep more capital on savings accounts rather than on the market, causing them to lose the opportunity to gain the market risk premium. However, it is possible that we will see this effect already with MiFID II due to the new fee transparency. At such it is difficult to tell whether a prohibition of kickbacks would have been better than the chosen way in MiFID II for retail investors or not. However, we argue that MiFID II took a proper first step, and leave the opportunity to prohibit kickbacks open for future regulation if the evaluation of MiFID II should prove it necessary.

7. Conclusion

This thesis was written with the purpose to investigate how MiFID II may affect the business model of financial advisors and what this change might imply for the principal-agent relationship in financial advisory. By interviewing a broad range of markets actors, we have found that MiFID II is expected to have a significant impact on the market for financial advice, but maybe not as significant as we first thought when we started to write this thesis. Due to the opportunity to continue to receive kickbacks as a non-independent actor, the business model of financial advisors will most likely be stable, at least in the short run according to the respondents. This means no direct change for the currently inherent principal-agent relationship within financial advisory. However, due to the increased transparency requirements imposed by MiFID II, retail investors will probably be in a better position to evaluate their advisor since their monitoring cost decrease when the advisors are forced to disclose more information. In our interviews, we have found that many respondents expect the media to scrutinise the new details carefully. Since the media plays an important part in the monitoring of the agent, we expect this to mount pressure on the advisors to put their clients' interest first. On the other hand, the increased information might also make retail investors unable to absorb all the information, causing them to miss out on prudent investment opportunities.

The distribution of complex products is an area which MiFID II is expected to influence more directly. In the analysis we have identified three, main, changes that MiFID II will bring that are likely to change the principal-agent problems associated with these products. First, by increasing the clients' understanding of the products, the regulator enables retail investors to assess whether the product is a good fit for them based on their needs, and if the product is worth its price, in a more convenient way. Second, by requiring a defined target market, the distributors' distribution opportunities will probably be more limited than today. Even though distributors post MiFID II will still have the opportunity to distribute complex products outside of the intended target market, it requires more, costly, documentation which should incentivise distributors to stay within the product's intended target market. Finally, by forcing distributors of complex products to receive their remuneration throughout the product's lifespan, rather than up-front as of today, regulators will hopefully mitigate the incentive distributors currently hold to sell as many new complex products as possible. Taken together, these regulatory changes will most likely decrease the principal-agent problems currently associated with these products. Due to the maltreatment of these products in the past, as pointed out by the respondents, this is something we deem as very positive.

While MiFID II will probably decrease the principal-agent problems associated with complex products, we expect it to be more of a double-edged sword when it comes to discretionary mandates. By prohibiting advisors from collecting kickbacks in discretionary mandates, MiFID II is likely to remove the incentive the advisor currently holds to base the investment decision on how much kickback each product generates. However, by banning kickbacks, the difference in profit margin between internal and external products will increase, which one respondent mentioned might cause advisors to focus more on internally produced products. This negative effect of the regulation might be somewhat mitigated since investors who uses discretionary mandates are typically wealthier than ordinary retail investors, increasing the chance that they will monitor their advisor.

In the long-run, the respondents expect that MiFID II will spur the growth of independent financial advisors on the Swedish market. If this happens, it might fundamentally change the principal-agent relationship between financial advisors and retail investors. This system would keep the present principal-agent problem at a minimum because many of the current conflicts of interest are mitigated in such a setting. The conflicts of interest are mitigated since independent advisors must consider securities from the whole market universe, charge the client directly for the advice, and neither manufacture any products nor accept kickbacks. If independent advisors establish themselves on the Swedish market to a large degree, already established actors might be forced to change their business model accordingly as well. However, since retail investors in general are slow movers and unwilling to pay for financial advice, a potential drawback to independent financial advisors might be that only wealthy retail investors find it worth to pay for. Thus, leaving non-affluent clients without access to advice and thereby possibly worse off than before. To summarise we, and the respondents, expects the business model of financial advisors to be stable in the short-run while we expect the principal-agent problem in financial advisory to decrease by MiFID II through the increased transparency requirements.

8. Proposals for Further Research

Based on what has happened in the Netherlands and the UK many of our respondents have hypothesised that the accessibility of financial advice might decrease in Sweden. This is due to the increased fee transparency MiFID II will bring, which will make retail investors more aware of the cost of financial advice. An interesting research question is thus, whether financial advice, as of today with all its flaws, is better than no advice at all.

Furthermore, MiFID II is a regulation which will impact far more areas than just financial advice as we have covered in this thesis. Another interesting research question is therefore how the increased transparency on the bond market and new requirements for block trades will affect trading patterns and market efficiency.

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Appendix

Interview List

Account Manager, Third Party Distribution, Niche Bank	18-04-2017
Chief Executive Officer, Vertically Integrated Fund Company	07-04-2017
Chief Compliance Officer, Fund Company	07-04-2017
Compliance Officer, Fund Company	06-04-2017
Consultant, Consultancy Firm	07-04-2017
Consultant, Consultancy Firm	07-04-2017
Consultant, Consultancy Firm	08-05-2017
Fund Manager, Fund Company	06-04-2017
Group Responsible MiFID II, Major Universal Bank in Sweden	04-04-2017
Deputy General Counsel, Industry Association	18-04-2017
Director Risk Advisory, Consultancy Firm	30-03-2017
Head of Asset Allocation & Products, Major Universal Bank in Sweden	24-04-2017
Head of Business Development, Nordic Investment Bank	06-04-2017
Head of Fund Products, Vertically Integrated Fund Company	05-04-2017
Head of Private Banking Advisory, Nordic Investment Bank	06-04-2017

Interview Sheet - MiFID II and the Nordic Fund Market

1. Which actors (integrated, distributors, Asset Managers, White labelling) exists on the market and how influential is each actor?
2. The choice of being classified as independent or non-independent
    a. What are the pros and cons with each alternative?
    b. What choice do you think the different actors will make and why?
3. Competitive landscape
        i. Which are the key advantages today and how will they change by the new regulation?
    b. Strategy
        i. How will the offering to clients change?
            1. How will the actors motivate the different costs that they know will be forced to make the client aware of?
            2. How will the regulation affect the popularity of ETFs?
            3. By MiFID II regulators will have more authority to cancel products from the market, what will be the effect of this?
            4. Which effect will the increased requirements of product governance get?
        ii. Will the supply of funds increase or decrease?
    c. Fees
        i. How will the payment be designed?
            1. Will the cost of advice be moved to the product?
            2. What will happen to the total fee paid by consumers?
    d. Increased costs
        i. Per MiFID II the regulators will force asset managers to move trading, i.e. block-trades, to regulated markets which might increase the costs
            1. Higher membership fee on the exchanges?
            2. Higher price impact?
        ii. What effects will the increased costs of equity research get?
        iii. How will asset managers compensate themselves for these cots?
            1. Higher AuM fee?
            2. Trade in fewer and more liquid shares?
        iv. Information requirements
            1. How will this be managed?

2. Through new investments or existing systems?

v. Do increased costs induce a shift in terms of which clients advisors target?

1. Will the increased costs cause the actors to focus more on affluent individuals?

a. What will happen with an average individual's access to financial advice and products?

e. Out of the actors we talked about in the first question, which will be benefited and which will suffer from the regulation?

4. Effects of MiFID II

a. Will the regulation cause consolidation?

i. If yes, where in the value chain (horizontally or vertically)?

b. Will the new regulation cause new, international, players to enter the Nordic fund market?

i. Do they possess economies of scale that becomes more attractive when the clients' awareness about the cost increases?