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MiFID II

Getting ready for January 2018.

The meaning of MiFID II.

by John Morton

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The Markets in Financial Instruments Directive II (MiFID II) represents the European Union's ambitious attempt to create a single rule book for the region's financial markets whilst also governing third country access to its investors. A vast, sprawling piece of legislation that seeks to build on the existing requirements, adding in electronic execution elements of the Pittsburgh G20 Trading Commitment, to tackle an interconnected group of issues and ultimately:

- Extend the transparency of exchange-traded instruments to virtually all OTC markets.
- Strengthen investor protection.
- Increase market probity through stronger regulatory oversight.

Trade transparency.

Arguably the most significant change from the existing regulatory regime is the application of pre- and post-trade transparency to all OTC markets, similar to that experienced by practitioners in equity markets. From the expected start date of January 2018, firm quotes in liquid instruments below a certain trade size (Size Specific to the Instrument, or SSTI) will have to be made public prior to execution. Additionally, almost all trades will have to be made public on a post trade basis similar to the TRACE provisions in the USA.

Even though post-trade transparency is relatively uncontroversial, pre-trade transparency represents a significant experiment and proved to be the most argued-over element of MiFID II during initial negotiations. The intensity of the negotiations carried over to the creation of the delegated instruments and technical standards by the European Securities and Markets Authority (ESMA) which underwent significant modification following further negotiations among national regulators.

Investor protection.

MiFID II's provisions that are designed to strengthen investor protection will ensure investors receive far more information regarding the costs of investment and the effects of such costs upon potential returns. Such illustrations of likely returns will also have to include the results of potentially negative scenarios as well as positive ones in an attempt to ensure investors are fully informed of the possible risks of their investments. Additionally fund managers and firms executing client orders will have a strengthened duty of best execution with "…take all reasonable steps…" being replaced by "…take all sufficient steps…" applied to the provision of best execution.

Increased regulatory oversight.

Where many feel that MiFID II has become over-bearing is in the level of regulatory oversight brought in by the legislation. Regulators will receive details of all transactions including national ID codes and dates of birth of the principals involved. Investment firms will have to keep all records, including phone, email, chat, social media and minutes of meetings in an immutable format for up to seven years to be made available to regulators upon request. Compliance officers will have to monitor all records for potential instances of market abuse and store any investigations prompted by such monitoring. Lastly, regulators can demand the reconstruction of the major steps in any trade process, similar to the provisions in Dodd-Frank.

The future of MiFID II.

So even though MiFID II doesn't apply to everyone involved in financial markets, given managers of collective investment schemes are amongst those excluded, it is still fundamental for most participants operating in the European Union. Looking ahead however, two questions come to mind regarding MiFID II; will pre-trade transparency for cash bonds fatally damage capital provision for the real economy and, following Brexit, what will MiFID III look like?

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Top five things you should be doing ahead of MiFID II implementation.

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Industry participants, regulators and government ministers discussed the implications of MiFID II
and how firms should best prepare at a recent Bloomberg event in London.

1. Don't underestimate challenges associated with MiFID II implementation.

Firms already supervised by the UK's Financial Conduct Authority (FCA) will need to work on being compliant with the Markets in Financial Instruments Directive II (MiFID II), even though there is significant cross-over between their requirements and policies, according to Tracey McDermott, Acting Chief Executive of the FCA.

"Firms shouldn't underestimate the extent of the changes involved, nor the importance of carefully managing future compliance," with MiFID II, said McDermott.

Similarly, the expected 12-month delay for the introduction of MiFID II to January 2018 is not a signal for companies to rest on their laurels.

"If there is a delay to the implementation of MiFID II, the purpose will be to allow time for those changes to be made in a more effective way, not to provide an excuse to reduce the intensity of the preparation for implementation." said McDermott.

2. Get on top of transaction reporting processes.

Gary Stone, Chief Strategy Officer at Bloomberg Trading Solutions, highlighted the need for firms to have trade capture systems that are aligned with the way regulators plan to track trades.

“Transaction reporting is actually a really big deal for firms and I would strongly encourage you to map out your processes now,” said Stone. “Some of these post-trade requirements are going to affect processes pre-trade and during trading.”

The FCA’s McDermott confirmed transaction reporting is one of the key elements of the legislation.

“Having firms zeroed in on getting their transaction reporting right will be one of our supervisory priorities,” McDermott said. “Particularly when it comes to seeing how successfully firms are implementing the legislation.”

What is your main implementation challenge?

- Lack of clarity and guidance on what the rules require of you
- Getting all the information you need to select solutions
- Budget constraints
- Making sure you will be ready in time for the deadline

SEE RESULTS

3. Explore the implications and opportunities in budgeting for research costs.

Regulators are keen to separate trading activity from research as part of the push towards greater transparency. While the final requirements haven't been decided yet, companies should start discussing with their clients how they are going to budget for these research costs in future.

"The communication with the clients about those budgets – what if you overrun or underspend – is a whole new area of practicality that we haven't had to deal with before," said Rob Alster, Head of Research at Close Brothers Asset Management.

At the same time, firms should be examining ways to maximize their spending, says Neil Scarth, Principal at Frost Consulting.

"For an asset manager, this really is a brave new world," Scarth says. "How do I as an asset manager with a finite research budget create the most value for my dollar spend in a more multi-polar research world, where I'm getting research from different sources?"

> **"For an asset manager, this is is a brave new world."**
>
> **Neil Scarth, Principal at Frost Consulting #MiFIDII**

4. Prepare to deal with a difficult regulatory environment with regards to instrument identifiers.

A vital part of transaction reporting and trade transparency is the availability of identifiers that cover all asset classes in an appropriate way. The current draft MiFID II rules mandate International Securities Identification Numbers (ISINs) as the single solution for instrument identification. This is against the advice of global industry groups including ISDA and the GFMA (see their letter to the European Commission). While it is unclear what the final rule will look like, market participants should anticipate difficulties, particularly for the identification of derivatives for post trade transparency and for transaction reporting.

"Serious questions remain about how ISINs can work in the context of derivatives which are trading on MiFID venues and traded by Systematic Internalisers. ISINs do not easily lend themselves to identifying all the economic terms of a derivatives contract, yet MiFID requires that they be obtained before any trading takes place. It is particularly unclear how ISINs can be issued in sufficient quantities, and in a timely enough manner, to meet the demands of derivatives trading," said Richard Young, Head of Regulatory Initiatives and Strategy at the Open Symbology Group[1] at Bloomberg L.P.

5. Keep innovating to increase market transparency and effectiveness.

Governments and regulators are looking for new tools to enhance transparency and firm-level surveillance for misconduct, according to Harriet Baldwin, Member of Parliament and Economic Secretary to the Treasury in the UK. The increasing use of electronic trading platforms has been a step in the right direction.

"Misconduct in the market has damaged trust and impaired effectiveness," said Baldwin. "Innovation led by new technology has and will continue to enhance the effectiveness of markets and reduce opportunity for misconduct in the future."

[1] Bloomberg Open Symbology Group is behind the FIGI standard, a free and open data standard and unique identifier of financial instruments across all global asset classes. In 2014 it was recognised as an international standard of the Object Management Group (OMG). Since then the FIGI standard is administered by Bloomberg under the auspices of the OMG.

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How MiFID II will impact the anatomy of the investment process / trade life cycle.

by Steve Niven, Bob Shea and Gary Stone

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As we began to work our way through ESMA's MiFID II implementation standards, we started to formulate a framework for understanding how aspects of the regulation are going to affect the investment life cycle on the buy side. Structuring this regulation is extremely important because at 585 pages for the regulatory technical and implementing standards alone (Annex I), MiFID II is an expansive document – and more is coming. At the end of November, ESMA will provide additional insight into the use of dealing commission, fixed income research and other areas.

We have segmented the anatomy of an investment into eight functional activity groups.

- **Pre-trade** activity provides information to form an investment thesis.
- **Trading** involves order management functionality for timely and efficient execution.
- **Trade management** activity allows for straight-through processing and timely allocations.
- **Operations** activities cover the booking, settlement and fund transfer process, as well as the post trade regulatory arrangements.

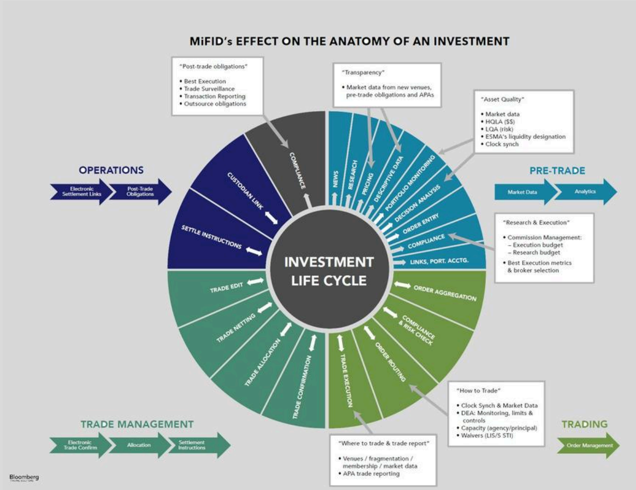
THE ANATOMY OF AN INVESTMENT

There are defined activities within each of the functional activity groups that constitute the end-to-end investment process (workflow). It is against that backdrop – when we overlay the MiFID II changes – that the buy side can start to identify where their world will be changed.

At a high level, we look at the MiFID II regulation as resting upon three pillars:

1. Best execution, information to clients and surveillance.
2. Monitoring, limits and controls.
3. Regulatory reporting and transparency.

When we break down the pillars into functional requirements, we see the regulation touching many of the workflows of an asset manager/owner.



Pre-trade.

New venues provide new data sources; APAs provide pre-trade transparency publications and post-trade publishing of trade information. Although ESMA is labeling assets as liquid/illiquid under MiFID II, each investment firm should use quantitative metrics to better understand the assets that they are placing in their portfolios. "Asset quality" quantitative metrics also require firms to identify the highly liquid assets in their portfolio to help them (pro-actively) manage their liquidity (redemptions). This isn't solely a MiFID II issue. The principles behind the U.S. SEC's proposal on fund liquidity are very similar. Guidance is needed as to whether the clock synchronization requirements extend into the order creation process for transaction cost analysis. We await the dealing commission guidance which may result in new compliance requirements for research and execution payments. For example, setting up independent budgets for research and execution, couple with appropriate best execution measures to demonstrate that such budgets are arrived at independently.

Trading.

MiFID II is very prescriptive on how investment firms should execute. There is tremendous concern about information leakage from the new pre-trade transparency requirements as well as the post-trade trade reporting. If the buy side become members of MTFs or trading venues, then they will need to institute new monitoring, limits and controls processes and technology in accordance with the new direct electronic access (DEA) pre-trade controls requirements. Moreover, MiFID II may result in more execution method choices, competition among venues, fragmentation of liquidity and order types – all of which will need to be stitched together. The regulation will also force a new regulatory workflow.

Operations.

New post-trade compliance processes will need to be formed, to deal with enhanced transaction reporting requirements, as well as the need for trade surveillance. In addition, firms outsourcing their trading and order management technology may need to develop new policies to supervise and govern their technology partners.

MiFID II is an expansive regulation. As we work through the implementation guidance and receive guidance from the 28 EU NCAs, we will expand upon this framework

MiFID II set to disrupt investment research worldwide.

by Bloomberg Intelligence analysts
Sarah Jane Mahmud and Alison Williams

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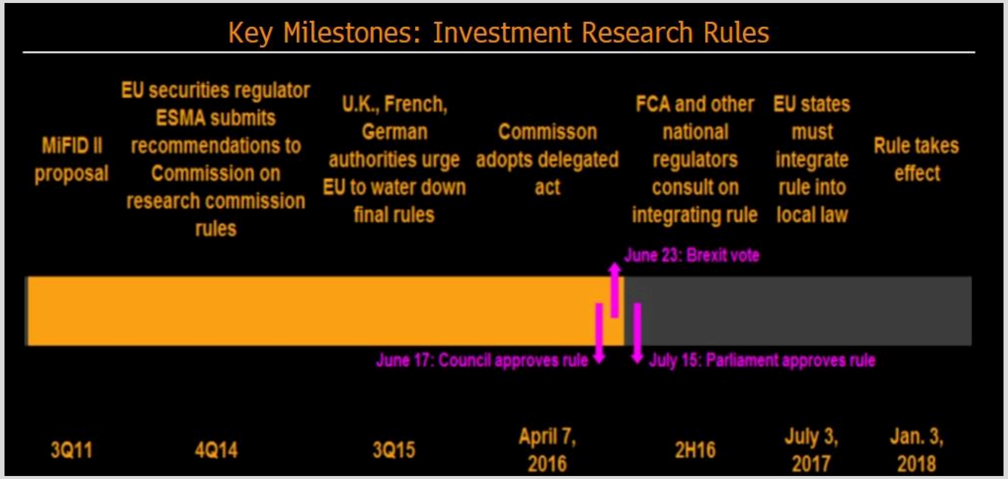
The EU's MiFID II rules will require investment research to be paid for in one of two ways: from a fund manager's own account, recoverable by raising fees, or via a client research-payment account. While regulators might permit research charges to be collected alongside transaction commissions, subject to stringent conditions, they maintain there should be no link to transaction value or volume. The move to an unbundled model would limit the long-held use of commissions, and may disrupt the industry worldwide.

Research commission rules forge ahead with clarity likely in 4Q.

More detail on MiFID II rules separating research costs from dealing commissions will unravel in 4Q. By year-end, the U.K.'s Financial Conduct Authority, and the other EU countries' securities regulators, will consult on integrating the rules into local law. They are likely to interpret and implement the rule differently, increasing divergence across the bloc. The European Commission's April 7 draft rule received Parliament and Council approvals on July 15 and June 17.



New EU research commission rules likely to drive global change.

Non-EU regulators haven't yet issued proposals seeking to separate research payments from dealing commissions. Without international convergence, EU companies could become less competitive than their overseas peers. Global companies could roll out an EU-compliant system on a worldwide basis to minimize operational strain, especially as non-EU brokers will be bound by MiFID II when providing execution and research services to EU managers. This may encourage non-EU regulators to adopt the EU approach.

The rule won't apply to non-EU investment managers that don't have a presence in the EU. U.S. managers would be able to continue paying brokers, including those in the EU, for research on a bundled basis, subject to compliance with local rules.

Unbundled pricing models likely to transform investment research.

Banks are reported to be adjusting pricing models for investment research in preparation for EU reforms that will prevent research from being paid for directly using dealing commissions. In an unbundled world, based on execution-only commission rates where payments for research are separated, competition in equity as well as fixed-income, currency and commodities research is likely to rise. Managers may look beyond traditional sources, triggering fragmentation. They may also move research in-house.

Research industry revamp gains pace as payment model develops.

Asset managers that opt to pay for research via a dedicated client account will need to follow a strict budgetary and disclosure regime. This may make use of such an account too burdensome. It also poses compliance risk. Failure to follow U.K. client asset rules, for example, usually results in a hefty fine. In a retreat from prior proposals, short-term market commentary that doesn't contain substantive analysis may be provided without charge, so not all sales or trading calls will classed as chargeable.

Research rules spark debate on implications for bond spreads.

The Financial Conduct Authority has said it expects tighter bid and offer spreads in credit markets as a result of EU proposals – agnostic as to asset class – that seek to decouple research from trading. Fixed income research costs are typically embedded in the spread, which helps pay for the trade, and has been treated as part of a wider service. Many brokers maintain that spreads won't change as they are competitively formed. Yet they may face regulatory pressure to reduce them when MiFID II comes into force.

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MiFID II: Make some assumptions and get on with it.

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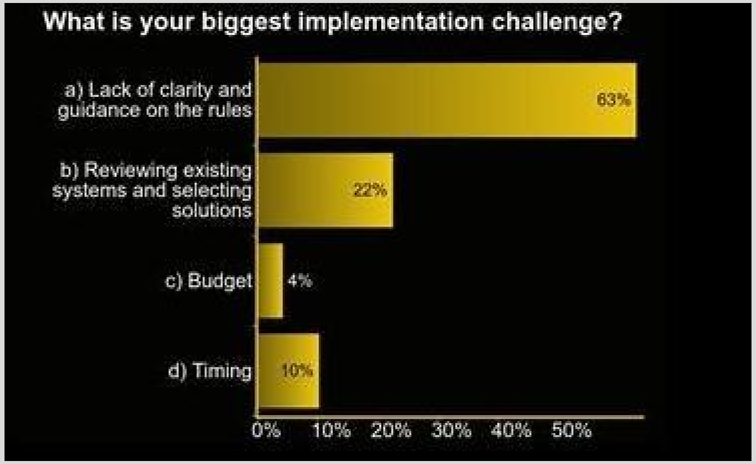
The biggest implementation challenge to MiFID II continues to be the lack of clarity and guidance on the rules. This was the overwhelming opinion of the over 200 participants who attended the MiFID II: The Market Practitioner's View conference held at Bloomberg London on 19 October 2016.

Although little over a year is left before MiFID II starts to apply on 3 January 2018, panelists agreed that most rules are likely to be finalized only next summer, as senior regulators across the EU have indicated. Practically, this leaves five months for major systems to be built, with participants expressing their desire to begin testing of transparency and transaction reporting services in September 2017.

When the implementation delay was being discussed in November 2015, this is why we argued that a simple 12 month push-out of all the dates was not sufficient, but instead the market needed more time between the finalization of the rules and their applicability.



It doesn't matter. The view of the market practitioners at our event could be described simply as: "it's time to make some assumptions and get on with it."

Specifically, in three sessions, "The Impact of MiFID II on the Functioning of the Markets", "How are Investment Firms Meeting the Challenges of MiFID II?" and "MiFID II Related Data", panelists almost uniformly suggested that planning, reparation and building now means creating robust systematic processes, procedures and supporting technology based on educated assumptions. More importantly, firms should document the reasoning and principles behind their decisions where there is ambiguity or guidance is pending. Waiting for clarity isn't an option because you will simply not be far enough down the path to compliance if you don't move forward now.

Fortunately, regulation entering into force while the guidance is still evolving is not a new concept. Most recently, the European Market Infrastructure Regulation on derivatives, central counter parties and trade repositories (EMIR) and the Market Abuse Regulation (MAR), went into force with guidance still pending. In both cases, the regulator's examination and enforcement posture seemed to prioritize getting it right. The level of initial compliance for MiFID II expected on 3 January 18 similarly seems to focus on whether firms are making "legitimate and sensible" efforts to meet the requirements. Firms should be expected to "prove" that they are making progress through demonstrable processes, procedures, documented logic and audit of those initial decisions.

We believe that this view is implicitly confirmed by regulators when they describe MIFID II implementation as "a process, not an event."

However, firms should also take heed of the insights offered by keynote speaker, Jenny Knott, CEO of Post Trade Risk and Information at ICAP. According to her, MiFID II provides the industry with an opportunity to serve its clients better. In order to achieve that objective, firms will need to think, behave and act differently. If you do not re-engineer your processes, the technology will not work. Technology alone does not automatically eliminate inefficiencies and reduce costs.

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Thank you for reading

Get in touch to learn more about how we can help with MiFID II