MiFID II: final countdown towards go-live

Authors
Jeroen van der Kroft (r)
Arjan Bom (l)[1]

The 3 January 2018, was a date marked in the calendar of nearly every financial market professional as the day the revised Markets in Financial Instruments Directive (MiFID II) effectively entered into force in the Netherlands/European Union. These past few months have seen frantic preparation and implementation efforts for what is shaping up to be one of the largest regulatory changes of the decade.

The first MiFID Directive[2] (MiFID I) was in desperate need of an update to reflect more than 10 years of developments in the financial sector. The first Directive was published in 2004 and effectively entered into force in November 2007. At the time it was unparalleled in scope, affecting the framework for the supervision of companies that offer investment services or carry out investment activities and the supervision of the market operator of regulated markets. In targeting the way financial markets function, the scope of MiFID I became very broad. MiFID I influences nearly all financial market participants regardless of whether they are banks, investment firms, asset managers, insurers or their clients themselves.

MiFID II builds heavily upon and refines the MiFID I requirements. It aims to enhance investor protection and further improve the operation of the markets by:

- Extending the asset class scope
- Increasing trading on venues
- Enhancing financial transparency and protection for investors

We already see MiFID II is a change driver to business models for Sales and Trading models as well as

market trading conventions. This article[3] aims to deliver insight into the MiFID II status quo exploring the bigger picture on what it means in terms of:
- Market structure: Greater transparency in the markets by forcing a greater level of trading from OTC to lit venues,
- Reporting: Increase in market transparency – both pre and post trade, including data on quality of execution,
- Investor protection: Greater protection and information provided to counterparties to improve understanding and transparency of trades.

Market structure

At its best, effective regulation is an enabler for the functioning of global financial markets, instilling the confidence that markets require to operate, and curbing unwanted side-effects of the Wild West scenarios that may occur in totally unregulated markets. Designing regulation is always a balancing act between allowing enough freedom and flexibility for a market to operate effectively, without putting so many restrictions into place that the market is effectively choked.

When MiFID I effectively entered into force in November 2007 this coincided with the onset of the financial crisis. The developments over the following years laid bare MiFID's shortcomings by having a core focus on equities rather than the many alternative investment instruments in use as traders moved towards unregulated markets. As time marches on, regulation must evolve accordingly.

With MiFID II financial market regulators also wanted to address what they call: *"tackling under-regulated and opaque aspects of the financial system"*[4] thereby reversing the unintended side-effects of MiFID I. This includes the enormous off-exchange markets, like those handling derivatives and bonds.

After the implementation of MiFID II, EU market participants will only be permitted to trade shares on a regulated market (RM), a multilateral trading facility (MTF) or Systematic Internaliser (SI). An equivalence regime applies for third country trading venues that have been assessed to be equivalent to an EU regulated market.

A new category of platform – known as an Organised Trading Facility (OTF) – is being introduced specifically for non-equities to properly regulate all kinds of organised trading in these instruments. Broadly this venue is subject to the same core requirements of a trading venue as other existing platforms. The main differentiator is that the operator of an OTF performs order execution on a discretionary basis. The OTF is still bound to rules on best execution obligations and transparency requirements. Products formerly traded Over The Counter (OTC) will be traded on lit venues similar to equities. This forces OTC dealers to move either towards full market makers or more hybrid systems. The operators of the trading venues themselves have the choice to either concentrate on the market participants engaged in trading on an RM / MTF or to broaden their services and start catering for market participants who would use an OTF.

Even this close to its introduction it is unclear what the impact of wedging the OTF's into the existing landscape will be. The resulting re-classification of trade activities may show either an increased market flow or impact the executable liquidity in non-equity markets.

Designing regulation is always a balancing act

That brings us to liquidity as the other big elephant in the room when discussing MiFID II: liquidity or rather illiquidity in financial markets. Banks and (certain) investment firms are subject to the requirements of the Capital Requirements Directive IV (CRD IV) regime which imposes heavy capital penalties for illiquidity and unstable funding pipelines. The recent discussion on a new prudential regime for investment managers[5] is exacerbating the existing uncertainty. As a result they may remain apprehensive to quote prices in the markets. Instead of facilitating trade the capital requirements regime may actually make it harder for financial institutions to operate as effectively within the new rules on best execution for non-equities.

The effects of MiFID II on liquidity will also be felt outside of the EU with an especially big impact on emerging markets and emerging market based strategies limiting options on both the buy and sell side. European investors are simply not allowed to trade on a third country exchange if it is not considered equivalent to an EU regulated market. The threshold for getting equivalence is quite high as the test focusses on whether EU trading in the shares admitted to trading in the relevant third country's regulated markets is of such significance in the EU that the EU's trading obligation is triggered with respect to shares admitted on an exchange in the third country. This could severely limit options, given that if the biggest available liquidity pool is on a third country exchange, they would be restricted to trading dual listed shares on an EU regulated market, MTF or SI. Furthermore, emerging markets tend to rely on foreign investors and as a potential remedy the process for obtaining EU equivalence is complex and time-consuming. If MiFID II shies trading away from third country investments, several emerging markets may see the trade flow dry up taking the 'emerging' out of emerging markets.

Well-established fully liquid markets like sovereign debt needn't worry as they will keep being in demand. It's the niche markets that have a reason either to worry or rejoice as they are either a viable alternative to current investment strategies or will be victimised as a result of MiFID II restrictions.

The full impact of MiFID II on the dynamics of the global financial markets remains a question mark with experts disagreeing over the likely developments. Barring another financial crisis the markets are not likely to change overnight after January 3. In the long run margin pressure from MiFID II will force strategic responses but so far not many market participants have taken public decisions to adjust their business models.

Reporting

A hotly debated topic over the last few years is supervisory authorities' voracious appetite for data. Unsurprisingly, MiFID II is no exception to this rule; it is a disclosure challenge from a data, technological and timing perspective. As discussed above, MiFID II aims to push financial activity from unregulated markets towards regulated markets. This articulates the desire from the supervisory authorities to move trading towards electronic venues, which have better audit trails. For market participants this will mean the reporting of a wave of data points likely to be measured in petabytes rather than gigabytes. A large part of the cost of compliance for MiFID II is going to just enabling the reporting.

While regulatory reporting isn't new, the high frequency of reporting under MiFID II is a new experience for many firms. Test runs of the Northern TRS' (NTRS) reporting system[6], that have been taking place since mid-2017, have made it abundantly clear that reliable reporting requires that significant automated fail-over capacity is built-in to the reporting process. Given the volume of data and frequency of reporting there is little time to remediate if a process derails. Market participants are in the final stages of outsourcing the reporting process or performing dry-runs with sophisticated solutions as this is no longer something end-user computing can handle with the help of Excel.

An often overlooked consequence is the infringement MiFID II poses upon the privacy of individual traders and portfolio managers. They will be identifiable as individuals and more accountable than ever for their contribution to the appropriate data quality driving the reporting. From an extraterritorial perspective we already see the EU demands for personal data causing problems in other jurisdictions with diverging privacy regulations. The European authorities are struggling to come up with a satisfying answer to the dilemma as they themselves are adopting a more stringent policy in the move towards the General Data Protection Regulation, which is supposed to safeguard the privacy of European citizens.

Investor protection

When talking about financial regulation, the spotlight tends to be on financial institutions such as banks, investment managers, pension funds etc. whilst their clients are often overlooked. There are few pieces of legislation with such a profound impact on the fundamentals of the relationship between these institutions and their clients. In particular, the protection of retail investors has a large impact on business as usual. In years prior the trend in legislation, courts and society as a whole is to heavily protect retail clients. While at times this approach has been taken to a level that seems almost to deny clients' own accountability for their investment decisions, there have of course been well documented examples where financial sector actors have not adequately protected their clients' interests.

Reporting is no longer something end-user computing can handle with the help of Excel

The protection of retail investors has been the driver for large-scale remediation trajectories across the EU. Often in Dutch case files, the problem was not necessarily the nature of the service provided to the client but rather a more fundamental problem of lacking key information as well as robust documentation in order to reconstruct and evidence decisions made.

The practical problems occur at the front-office where client information has to be collected and decisions have to be made by the client. Lessons learned from the past decade illustrated that a solid client file should not only document the goals and the decisions made by the client but also the alternatives offered, the rationale as to why the client made a decision, and why the product chosen was suitable for their situation.

With professional clients who truly have the expertise in-house to make founded decisions this may not pose much of a problem, other than the actual documentation process itself which is time-consuming. Retail clients who lack knowledge about financial instruments may pose a bigger challenge as the level of understanding is often lower no matter the quality of information provided. In that sense the stricter MiFID II requirements are not only about the choices clients make but also about the choices they don't make.

Another heavily debated move from the regulators in the area of investor protection is that brokers will now have to pay for the research they base their investment decisions on. Brokers used to receive this research for free with the fee being built into the trading fee. That trading fee is usually paid by the broker's clients. The regulators view this as a conflict of interest at the heart of the trading process. Their move to combat this is known as 'unbundling' and follows the wider trend of making costs more visible. In that way it is very similar to the earlier introduced inducement ban in the Netherlands.

In the long run this may give institutional investors and fund managers more incentive to be critical of their brokers and their results. A response from brokers is sure to follow and they are likely to research alternative ways to execute their trades. Currently, there seems to be no consensus across the industry as to what shape these alternatives may take.

Conclusion

MiFID II will push up expenses throughout the entire value chain requiring investments in technology and compliance. Firms starting from a position of poor efficiency will be especially vulnerable to the resulting squeeze on profitability as they have less options to offset cost growth via wider spreads and diversification in either client groups, market or services. The largest firms are in the best place to identify and achieve economies of scale.

For the vast majority of financial market participants MiFID II has major strategic implications and requires significant changes in business and operating models, systems, data, people, policies and processes. The MiFID II requirements have taken considerable time and effort to implement, but the implementation date of 3 January is just the beginning. Once the legislation is finally in force, regulators will continue to produce additional guidance and Q&As that will help market participants to operationalise MiFID II. Compliance departments and internal audit are going to start looking at whether people are adhering to the new regime.

The MiFID II requirements have taken considerable time and effort to implement, but the implementation date of 3 January is just the beginning

There will inevitably be bumps in the road of MiFID II implementation and likely some unintended consequences as is the way with all regulation. The full impact will only be apparent once the system has been up and running for some time. When it comes to the effects of MiFID II the inward contradiction is clear; individual firms state large changes are pending for everyone but for themselves it's just business as usual. After all, absolutely everyone is agreed implementation should be first-time right since no-one wants to remediate and end up in a MiFID III world. ■

Notes

1 Jeroen van der Kroft is Executive Director EY Financial Services.
Arjan Bom is Manager EY Financial Services
2 Directive 2004/39 /EC.
3 The article was finished in December 2017.
4 See Leaders' statement of Pittsburgh Summit 24-25 September 2009, http://www.pittsburghsummit.gov/mediacenter/129639.htm.
5 See for example in this context the EBA's response to the EC's call for advice on the prudential treatment of investment firms. EBA/Op/2017/11.
6 The NTRS system is the reporting system cooperatively between the supervisory authorities of Denmark, Finland, the Netherlands, Sweden and Norway.