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MARKET COMMENTARY

MiFID II: A Marathon Turns into a Sprint

The marathon that has been the second Markets in Financial Instruments Directive (MiFID II) for the past couple of years is turning into a sprint for many financial institutions. Some of them are only now realizing the breadth, depth, and complexity of achieving compliance in the next six months.

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The European Securities Market Association (ESMA) has already extended the deadline once by a year and has given every indication that January 3, 2018 is now a non-negotiable go-live date. Feedback from the industry suggests most of the bigger banks will be ready, or as ready as they can be given some of the grey areas in the new rules that are still open to interpretation. However, it seems that a host of smaller banks and brokers will still have lots of work to do.

MiFID II seeks to build on its forerunner 10 years ago by increasing transparency across the trade life cycle and extending coverage from equities to cover all asset classes, including derivatives and other structured products previously only traded on an Over-the Counter (OTC) basis. The intention is to increase investor protection by providing them with the information required to make informed decisions about where to trade, how to trade, and who to trade with.

Avoiding a Repeat

At the same time, it strengthens market surveillance and allows regulators to have visibility of any potential build-up of systemic risk, as well as enable investigations into market abuse. These rules are designed to run in parallel with those mandated by the Basel Committee on Banking Supervision (BCBS) which require banks to strengthen capital buffers to be able to offset market risk and absorb losses arising from unusual market volatility and other surprises. Together they are intended to prevent a repeat of 2008.

Compliance with MiFID II is already making many financial institutions (both buy-side and sell-side) re-examine business models and even areas of activity. Many institutions will have to re-think core businesses as the shady areas of dark pools and broker crossing networks will effectively disappear as ESMA forces transactions into the open where they can be reported on exchanges, or other trading venues now known as Multilateral Trading Facilities (MTF) or Systematic Internalizers (SIs).

THE FUTURE OF FINANCE IS OPEN

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Dealing with Data
The biggest challenge for all concerned is going to be dealing with the mass of data involved, compiling it in the manner required, delivering it to regulators in the speed required and being able to store that data for five to seven years depending in which regulatory jurisdiction they reside. At the pre-trade level, this will apply to operators of trading venues, while every other institution will be responsible for their own post-trade reporting data to be able to demonstrate best execution.

Another major headache is the requirement that research be unbundled from trading so that it is no longer seen to be paid out of commissions charged to institutional investors and can therefore no longer be used as the carrot to attract flows. Research will have to be charged for through visible processes and, given the vast duplication of research, particularly on high volume and large market cap stocks, it is expected large parts of this business will cease to exist. Where firms have a specialist edge through local market or asset class knowledge there will still be opportunities to charge for it.

The result is not only expected to satisfy the regulatory desire for safer and fairer markets, but also, as a result of the transparency, increase competition and drive down costs, thus loading further pressures on already battered sell-side margins.

Leveraging Technology
While greater use of technology will be essential for institutions to become compliant with the regulator's expectations, it is also going to be vital in terms of developing a sustainable, more efficient, and lower cost operating base for those businesses that have more than just survival instincts. It will require much greater automation to ensure the data flows smoothly and quickly and without the intervention of often error-prone—and hence costly to correct—manual actions.

For this to occur, firms really have to adopt a strategic approach to becoming MiFID II compliant and even look at dealing with it in the wider context of other regulations such as the Securities Financing Transactions Regulation (SFTR), the European Market Infrastructure Regulation (EMIR) Review, Dodd-Frank and the forthcoming Fundamental Review of the Trading Book (FRTB). All these require far more detailed and sophisticated management and analysis of the core data that is already flowing through the bank. They are all probably measures that smart businesses should have been initiating themselves to both improve customer service and strengthen

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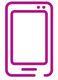

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internal intelligence and decision-making capabilities. But banks have not been the best at being pro-active in those areas which load more costs on the business.

Nevertheless, the cost and availability of the technologies required to provide better data storage and analytics have plummeted in recent years and made the regulators' expectations much more viable. These can also be complemented by cloud-based, Platform-as-a-Service (PaaS) offerings that not only significantly reduce bank overheads, but shift them from capital to operating expenditure.

From Regulation to Innovation?

Regulation could therefore be the trigger for the transformation that the industry has been crying out for. And some are grasping that with what we now see being called Regtech strategies. But for many banks, individual regulations like MiFID II are still being treated in isolation by small IT teams tasked with an allocated slice of budget to achieve compliance. It is those that will be most in danger of missing the January 2018 completion deadline and, in the process, just adding more layers of complexity to already creaking and vulnerable IT systems.

In many of those banks, there has also been a disconnect between various areas of the business that will not only be affected by MiFID II, but with whose involvement compliance could become more successful and deliver other benefits to the business. It is critical that teams from risk, finance, and trading are involved in how this is deployed, not just IT and compliance. It emphasizes the need for a strategic approach and support from the C-Suite and directors.

Nobody expects the regulators to take a hard line in terms of fines or other sanctions for non-compliance from the outset. But a dim view will be taken of any financial institution that is not able to demonstrate it has both a plan and can then show how advanced it is in implementation.

The message could not be clearer: get a plan together now! It needs to be viable and strategic in order to not only become regulatory compliant but also to lay the foundations for a sustainable and competitive business. It needs to be ready for both increased competition and the many variables and unknowns that we expect to be regular features of the capital markets moving forward.

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