

MiFID II: Demystifying the challenges



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1 Background

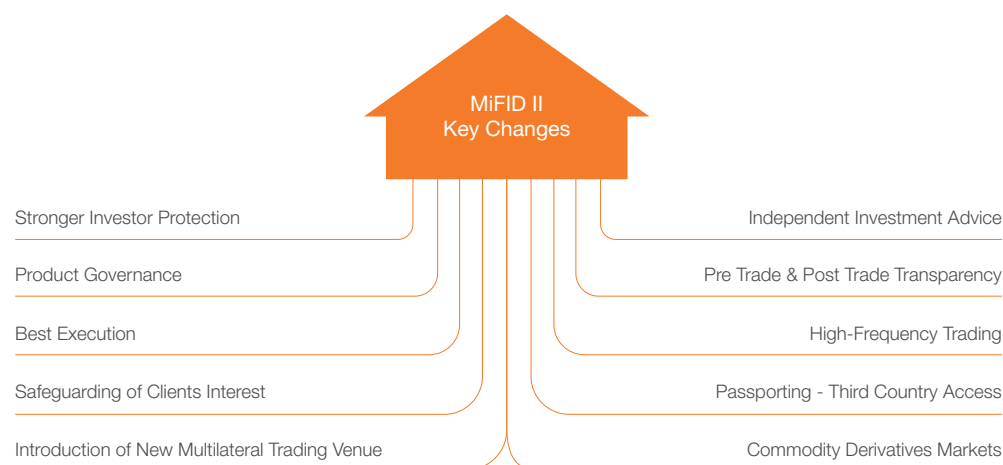
The clock is now ticking for Europe's financial institutions to get their IT and operational systems into compliance with the new Markets in Financial Instruments Directive II (MiFID II) regulations. As we approach the revised compliance date, January 3, 2018, we are discovering that many financial institutions are not yet ready for the new regulatory regime.

To meet the aftermath of the 2008 financial crisis, governments around the world launched a wave of new financial sector regulations. The impact of these regulatory frameworks has been significant on all the participants, both in terms of the resources needed to monitor and assess new regulatory developments and in the costs of adapting these changes and enhancing business models accordingly.

The original directive, MiFID I, came into force on April 30, 2004, and it became effective on November 1, 2007. Because it is a directive, it was up to the individual countries to implement it. Its main objective was to promote integration, competitiveness, and efficiency in financial markets in the European Union (EU).

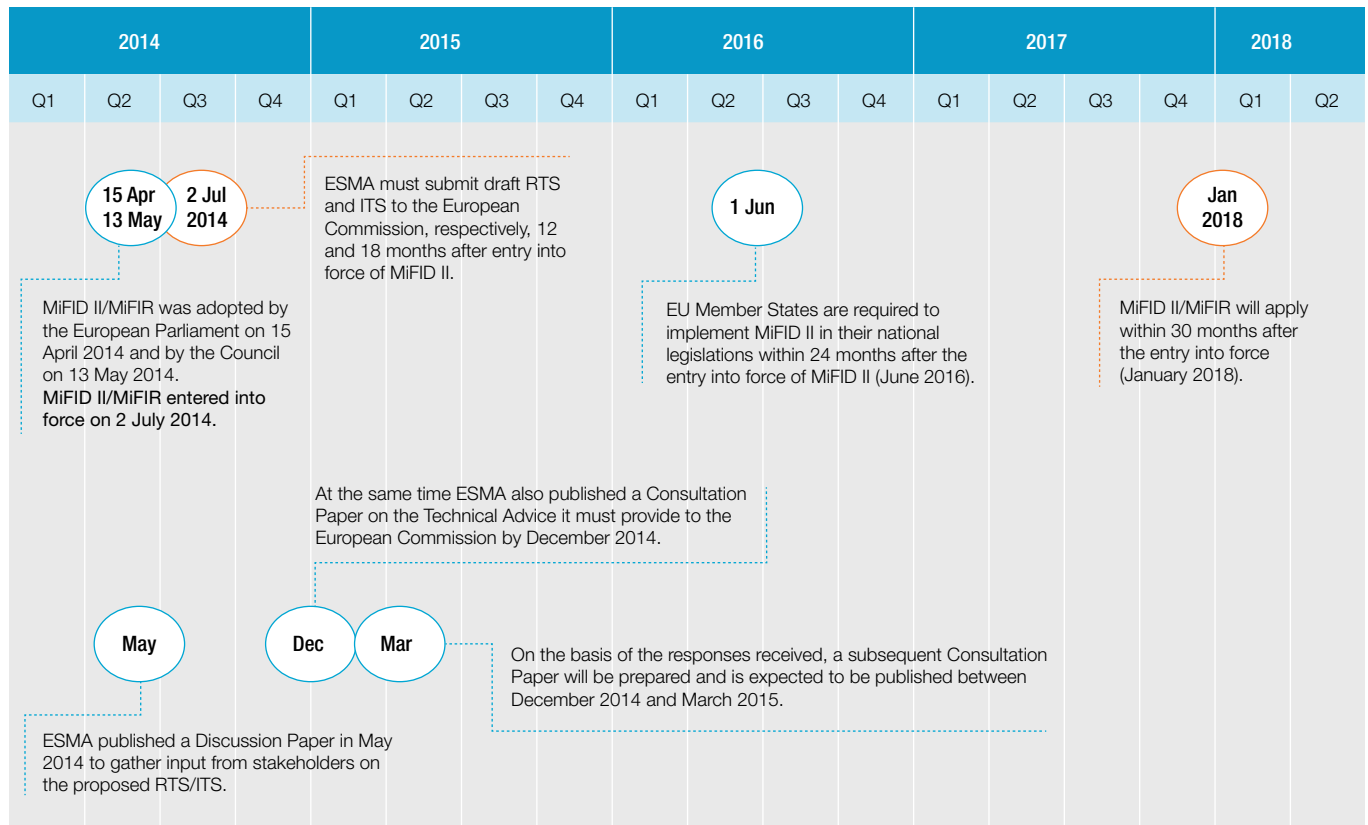
However, after nearly four years of MiFID I application, not all the objectives were achieved, so the European Commission launched the reform of the MiFID in 2010 as Markets in Financial Instruments Directive and Reporting II. MiFID II has a broader scope in terms of instruments and coverage. It will change the way investment managers work, making them more accountable than ever before. The primary objective behind the MiFID II is to protect investors and strengthen the regulatory and compliance industry.

Figure 1: MiFID II – Broad Focus Areas



The implementation of MiFID II aims to establish a safer, sounder, and more transparent and responsible financial system in the EU that works in the interest of society as a whole. This paper presents our point of view on the impacts and challenges of MiFID II regulation faced by the investment firms. It also provides some high-level guiding principles for coping with the new regulatory environment.

Figure 2: MiFID II Regulation Timeline



2 Summary of Key Changes

The MiFID II regulation affects a broad range of functional areas, makes changes to existing rules set out in MiFID, I and introduces new changes in some areas.

Figure 3: Key Changes of MiFID II



2.1. Transparency

The Pre- and Post-Trade (Equity and Non-Equity) Requirement

- The transparency requirements need the following to be made public: details of bid and offer prices; depth of trading (pre-trade); and price, volume, and time of trade (post-trade). With MiFID II, the scope of current pre- and post-trade transparency requirements have been widened to encompass not only shares but also other equity-like instruments, such as depository receipts, ETFs, and certificates, as well as non-equity instruments such as bonds, structured finance products, emission allowances, and derivatives traded on a trading venue.
- The requirement will also be applicable to actionable indication of interests.
- The pre- and post-trade requirements will be applicable impartially to multilateral trading facilities (MTFs), systematic internalizers (SIs), and organized trading facilities (OTFs) to ensure that organized trading is conducted on all regulated trading venues.

Publishing Market Data

- MiFID II requires market operators and firms operating trading venues to make public the range of bid and offer prices and the depth of trading interest at those prices.
- Market operators and investment firms operating a trading venue and Investment Firms trading outside the rules of a trading venue are also required to make public the details of the transactions executed (price, volume, time of trade). The details should be made available using Approved Publication Arrangement (APA) on a reasonable commercial and on a non-discriminatory basis. The information must be made available free of charge post 15 minutes of such publication.
- The Consolidated Tape Providers (CTPs) also has been introduced as a new category of data service provider which will consolidate post-trade information into a continuous electronic data stream for real time publication.

2.2. Advisory and Investment Protection

MiFID II regulations have primarily focused on providing greater protection to the investors by putting in place sets of rules for investment firms in the areas of design, marketing, sales and distribution, and trade execution.





Investment Advisory

- Investment firms must follow fair, transparent practices while marketing products or services and ensure that they act professionally and in the best interest of their clients. The firms are required to provide information on:
 - Investment advice: Whether advice given is on an independent basis and whether it is based on a broad or more restricted analysis of different financial instruments
 - Suitability and appropriateness: Advisors are to recommend products or services based on the knowledge, experience, investment objective, and risk profile of the client. Investment Management/advisory firms are required to disclose whether they will provide the client with an ongoing assessment of the suitability of the product.
 - Costs and charges: The overall cost and charges of products or services provided and the cumulative impact on the returns.

Best Execution

An investment firm's execution policy must be simple, detailed, and clear to understand. Investment firms are required to provide clients with best execution in terms of total cost. In accordance with MiFID II norms, investment firms may not be entitled to any remuneration for routing orders to a particular venue that would lead to conflict of interests or inducements. Investment firms are bound to publish public data related to the class of financial instruments and the top five venues where they executed client orders in the preceding year.

Client Categorization

MiFID norms emphasize client categorization, which includes retail clients, professional clients, or eligible counterparties. This classification was proposed in order to determine treatment in terms of information disclosure, reporting and suitability, and appropriateness assessment.

Product Intervention

- The regulations empower the EU and national regulators to monitor the market for financial instruments and structured deposits that are marketed, distributed, or sold in or from their member states. For orderly functioning of the markets and better investor protection, the Regulators have the power to prohibit or restrict marketing, sales or distribution of certain financial instruments or structured deposits with certain features.
- The firms that manufacture products must have a comprehensive product approval process in place and identify the appropriate target market for those products before they are marketed or distributed to clients.

Client Assets

Investment firms are required to safeguard client assets, and MiFID II regulations have mandated enhanced accountability. Investment firms are prohibited from the reuse of assets in the case of title transfer collateral agreements for retail clients. Client consent and disclosure will be required before assets are reused. This is likely to have an impact on stock lending, borrowing, and repo activity.

2.3. Trading

New Trading Venue

MiFID II introduces a new multilateral trading venue, the Organised Trading Facility (OTF), for non-equity instruments to trade on organized multilateral trading platforms. This is a significant step toward improving the transparency of the trading activity currently taking place in the dark.

HFT/Algo Trading

To minimize the risks arising from high-frequency and algorithmic trading activities, MiFID II has imposed stricter rules on the investment firms. It also requires all the high frequency traders to be registered as investment firms and be obligated to sign the market-making agreement.

Commodity Derivatives

- MiFID II has imposed comprehensive disclosure and reporting requirements in order to curb speculative trading and promote transparency. It has proposed position limits per trading venue on not only securities trading but extending to equivalent OTC transactions.
- Firms are also obligated to provide daily position reports to venues and regulators.

2.4. Compliance and Governance

Transaction and Regulatory Reporting

- Investment firms that execute transactions in financial instruments must report complete and accurate details of such transactions to the competent authority as quickly as possible. While MiFID II introduces APA & CTP as data providers to public it also introduces Approved Reporting Mechanism (ARM) as a data provider to the regulators. These are third parties that provide reporting services to investment firms. The ARMs need to monitor that the data published or submitted is accurate and complete and are required to ensure that it has mechanisms for detecting errors or omissions caused by the client or itself.
- The reports must, in particular, include details on:
 - The names and numbers of the financial instruments bought or sold
 - The quantity, the dates and times of execution, and the transaction prices
 - Code to identify the client on whose behalf the investment firm has executed that transaction
 - Code used to identify the person or the algorithm within the member or participant of the trading venue who is responsible for the investment decision

Record Retention

- Investment firms are required to maintain records of all their transactions for a period of five years.
- Trading venues are required to keep records of all orders submitted to their systems to enable competent authorities to have access to records at all stages at any time.
- Investment firms must keep recordings of telephone conversations, meetings, and all electronic conversations related to their own accounts and their clients' accounts, which must be presented on client demand.

Remuneration Structure

- For enhancing investor protection and curtailing potential conflicts of interests, the MiFID II norms have also laid out certain provisions on the management bodies of investment firms to define, approve, and oversee the remuneration policy of the individuals responsible for providing services to clients.
- The remuneration structure and sales targets of staff should be designed in such a way that it does not give incentives to prioritize own interests over clients.

Passporting—Third Country Statutory Norms

MiFID II allows third-country firms without a place of business in the EU to provide investment services and activities to professional and eligible counterparties across the EU.



Figure 4: High-Level Impacted Entities



3 Challenges

The major challenges for investment firms in complying with the new MiFID II regulations are listed in the table below.

KEY AREAS		CHALLENGES
Transparency	<ul style="list-style-type: none"> Pre & Post Trade Transparency (Equity, Non-Equity) Publishing Market Data 	<ul style="list-style-type: none"> Processes and applications must provide non-discriminatory quotes to clients. Publication costs must be minimized to ensure competitive operating costs, and new publication arrangements must be integrated with vendors. Changes that have been made will affect workflows related to sales/orders/trades. OTC markets with non-equity products will have greater impact
	<ul style="list-style-type: none"> Investment Advisory Best Execution Client Categorization Product Intervention Client Assets 	<ul style="list-style-type: none"> A substantial impact is expected, due to additional disclosures on a firm's infrastructure and costs: increased database storage capacity (products, clients data, advisor data, etc.) and governance overheads. A consistent distribution strategy to the identified target market must be ensured. A process for client profile analysis and an appropriateness assessment for complex products must be established. The scope of information available for access by clients, either through a mobile or a dedicated client portal, must be broadened. A robust technology platform to source, collect, and store benchmark data for comparing various execution venues must be developed. Integration of the best execution logic or smart order routing into existing trading systems must be executed. New systems are needed for client categorization to match clients them with appropriate products based on risk appetite, complexity, and compliance norms. Know Your Client (KYC) and front office process and procedures need significant changes in addition to meeting client data privacy needs. Appropriate, sufficient business continuity plans must be in place to address contingencies.
Compliance & Governance	<ul style="list-style-type: none"> Transaction & Regulatory Reporting Record Retention Remuneration structure Statutory Norms for 3rd Country firms 	<ul style="list-style-type: none"> Increased reporting parameters (static and trade data) put pressure on the existing technical infrastructure. Enhancement of current data infrastructure to handle increased coverage of financial instruments and other reference data, improved record keeping and audit trail functionalities. The following must be developed and implemented: New processes and systems for recording, storing, and retrieving telephone conversations with clients A process for monitoring the sales by advisors and alerting systems in case of mis-selling
	<ul style="list-style-type: none"> New trading venue HFT/Algo trading Commodity Derivatives 	<ul style="list-style-type: none"> Operators of trading venues and CCPs must revise their systems and assess their business models in light of the new rules. Firms need to maintain control over algorithms deployed in production environment. Comprehensive testing, monitoring of suitability checks needs to be in place. Monitoring system performance, capacity and resilience, systems and risk controls. Firms need to adjust methodologies for determining net positions make changes to internal processes to monitor aggregated positions (for position limits compliance)

4 Key Considerations—Scope of Work

4.1. Process Automation & Application Redesign

Investor protection has been the core of the MiFID II regulations. This area in our view will lead to a sea of changes, not only in terms of technology but also in terms of processes and controls. In our view, there is a strong need to automate the existing processes of client servicing, beginning from the onboarding, classification, product recommendation, and monitoring of performance. Process automation in this area will be of significant help to reduce the manual workload and channelize efforts to provide greater quality of service to clients.

A new system for capturing client data and all related communications (electronic and telephonic) must be designed, along with a transparent reporting interface. Changes to the existing process of product/service recommendation and maintaining advisor data (certifications, remuneration, etc.) will require significant effort and infrastructure.

There is strong need for a robust, dynamic internal control system to take care of anomalies in the area of investment advisory and to ensure no conflicts of interest among the firm, advisor, and its clients.

4.2. Data Strategy and Reporting Architecture

To tackle the problem of data inconsistency and publication, MiFID II has put in place several norms like standard formats for trade and transaction data and close to real-time publishing. This, in our view, will require firms to revisit their existing data architecture across asset classes and overhaul their existing systems to ensure that audit trail and various trade and transaction data identifiers are captured.

Since the additional data spans across various processes and business areas, it is recommended that firms implement strategies for centralized data capture, aggregation, Transformation, Governance and Distribution so that there are synergies with other reporting obligations that can be leveraged.



5 Structured Approach for MiFID II Implementation

To overcome the key challenges in MiFID II compliance, we follow a comprehensive, structured approach to deliver quick and measurable results.

The first step in this approach aims to identify an investment firm's level of compliance. Using the MiFID II Maturity Assessment Tool, our team of experts — who operate cross functionally and have deep knowledge of regulatory frameworks — would identify the gaps between the current and target state.

Steps 2 and 3 focus on creating a roadmap based on the inputs from gap analysis and taking accountability for execution, delivery, and driving the program forward. The roadmap would be consistent with the overall strategy of the organization taking into consideration the broader implications on business and processes and not restricting to IT impacts.

Step 4 aims to confirm that the program is functioning without any unwarranted challenges and monitoring the dynamic regulatory environment for any future impacts.

Figure 6: Proposed Approach



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