Preparing your operation for MiFIR and MiFID II

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Acknowledgements

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Executive summary

This report aims to set out the key operational effect that MiFIR and MiFID II plan to influence. Whilst at the time of writing the exact details are unknown, we are aware that the regulatory changes will require firms to consider their systems and controls from an operational perspective to determine the practical impact of MiFID II. However, we are aware of the intent that the regulatory change plan to have and how this intent would effect a current operational performance.

Introduction

European fund and investment managers are currently in the shadow of further overriding regulatory change in the form of MiFIR the compliance guidelines associated with MiFID II which is due for implementation in each member state in January 2017.

The Directive (MiFID II) must be transposed into national law before it becomes binding in the UK, whereas the Regulations (MiFIR) have direct effect. As MiFIR contains the practicalities behind the transparency and transaction reporting regime, it is important to begin considering its impact on your firm’s operational, IT and compliance capabilities.

Whilst MiFIR regulations are currently being finalised there seems to be a degree of uncertainty about the long term implications for fund and investment.

If you’re thinking that January 2017 is a long way away it might be time to think again. The MiFID II compliance legislation promises to encompass more types of companies and individuals that previous financial trading legislation.

As one of the UK’s leading IT infrastructure service providers to the financial trading industries, we joined forces with Portman Compliance a Specialist FCA Compliance Consultancy to share our opinion on what action to take.

Recording client communications will require greater storage and security capability

One of the protections MiFID II will introduce is the implementation of stringent terms around client communications, disclosures and transparency. For many this will include the recording of telephone and electronic communications. Whilst many institutions are already covered by this legislation, MiFID II will encompass small organisations and individuals who have previously been exempt from this form of reporting.

The current rules exempt discretionary investment managers[1] from the requirement to record telephone conversations/electronic communications if these are made with, sent to or received from:

- A firm which is, itself, subject to the recording obligation.
  Or
- A person who is not, themselves, subject to the recording obligation and such communications or conversations are a small and infrequent proportion of the total communications/conversations occurring during in the course of business.

Under MiFID II, this exemption is likely to fall away. In its discussion paper (DP15/3: Developing our approach to implementing MiFID II conduct of business and organisational requirements), the FCA proposes to remove this exemption (to avoid inconsistencies with the application of the recording rule to other previously exempt firms – 'Art 3 firms'). Given that the FCA argue that recording will aid them in detecting and deterring market abuse and dispute resolution (both the subject of recent enforcement actions and hefty fines[2]), it is likely that this proposal will be adopted.

For many smaller financial trading entities this change in regulation will have a dramatic effect, forcing smaller operators to invest in recording, IP telephony and scalable storage. It will also impact on smaller firms with flexible/remote working arrangements as dealing and arranging may not be performed verbally on an unrecorded, privately owned mobile phone. This change in operational capability could clearly have a dramatic effect on how many (currently unaffected) investment managers operate. However, Portman's Senior Consultant, Hannah Spencer commented "with scalable and adaptable IT solutions which allow discretionary fund managers to perform key front office tasks on software which facilitates recordings/copies, this potential stumbling block is not insurmountable".

[1]'Discretionary Investment Manager' is a person who acts on behalf of clients and manages designated investments in an account or portfolio on a discretionary basis under the terms of a discretionary management agreement.[2] Lloyds Group £117m fine for failing to handle PPI complaints fairly, 'Operation Tabernula'is the FCA's largest and most complex insider dealing case.

Total transparency, audit trail and reporting will drive big data BI for smaller financial traders

The key regulatory change with regard to transparency is the requirement for trading venues to publish pre- and post- trade data on non-equity and 'equity-like' instruments traded on a trading venue including Multi-lateral Trading Facilities ('MTFs') and the newly introduced Organised Trading Facilities ('OTFs'). This extends the reporting obligation beyond purely instruments admitted to trading on regulated markets.

New post-trade time limits will apply: for equity trades details must be published within 1 minute (reduced from the current 3 minutes), for non-equity trades details must be published within 15 minutes for the first 3 years after MiFID II comes into force, then 5 minutes thereafter.

Ultimately this level of transparency will be delivered by reporting on key trading and business critical systems. Perhaps, more critically, organisations need to make provision for workers who access these systems from outside office walls or regions to ensure all trades and interactions are captured and can be reported. For smaller financial traders this level of reporting transparency does not necessarily require investment into enterprise systems. Public data storage provides 100% scalability and secure access. Commensus CTO Alex Parker comments "Cloud storage and encrypted security provide the smaller financial trading organisation with the assurance of scale and the ability to mine the transactional data for the reports that any future regulatory change could bring."

Trading 'flags' will drive the need for real time reporting and monitoring

Under MiFID II, the transaction reporting requirements will be extended beyond instruments admitted to trading on regulated markets (as noted above for the general transparency obligations) to instruments traded on MTFs and OTFs, plus instruments where the underlying is traded on such trading venues (even where this is traded outside the trading venue). Correspondingly, this increase in scope will make reporting more onerous as the current 21 fields will grow to 93 fields under MiFID II and MiFIR (as this increase in stipulated in the regulation – MiFIR – this will be directly binding and may not be negotiated down by the FCA).

There are exceptions to the requirement to report for financial instruments:

- which are not admitted to trading or traded on an MTF or OTF;
- whose value does not depend on that of a financial instrument admitted to trading or traded on an MTF or OTF; or
- which do not or are not likely to have an effect on a financial instrument admitted to trading or traded on an MTF or OTF.

Hannah Spencer Commented "On a practical note, fund managers are likely to outsource to trade repositories such as UnaVista and DTCC who many use for EMIR reporting (who are already authorised as approved reporting mechanisms ('ARMs')) or to the trading venue whose system the transaction was completed upon".

MiFIR requires the inclusion of a number of new 'flags' such as commodity derivative flag and a short selling flag. Whilst the final details of these trading identifiers is unknown, Financial trading research group, Aite, suggest there could be up to 14 different kinds of flags that will be made public as part of European legislation. Transactions will need to be reported to the FCA (or appropriate 'national competent authority') on a T+1 basis.

Whilst the inclusion of these data identifiers presents a headache for most firms it will drive the need for real time monitoring of key reference data at the point of transaction, ultimately driving a need to capture and maintain databases for the long term life of an organisation.

High Frequency Algorithmic Trading

In keeping with MiFID II's aim of keeping pace with technological advancements, HFT falls within scope to ensure that it does not 'have an adverse effect on market quality or integrity'[3] . This would imply that the FCA considers HFT and algorithmic trading as posing a potential systematic risk to its single statutory objective of 'ensur[ing] that the relevant markets function well'.

MiFID II requires an HFT undertaking to seek authorisation as an investment firm and comply with the FCA rules on market making, the latter of which requires them to be in continuous operation during the trading hours of the trading venue to which they send orders. As HFT Firms must have a market making agreement in place with venues on which they use market making strategies, this will have the knock-on effect of requiring additional compliance monitoring to ensure that the terms continue to be met.

It is important to note the distinction between 'algorithmic trading' and 'high frequency algorithmic trading' ('HFT'). It is only HFT which requires authorisation as an investment firm as it is precisely the high speed, system-generated order initiation/routing/execution without human intervention which falls within scope (and concern). If you are unsure which category you fall within, you should seek advice and consult the ESMA guidance for the exact definitions[4] .

In addition to the requirement to obtain authorisation, HFT firms must also comply with certain on-going requirements with respect to: order to trade ratios, tick sizes and venue pricing – the details of which will be outlined in the Level 2 measures. This, of course, is in addition to the transparency reporting requirements (including the requirement to disclose which algorithms they use).

[3] http://www.fca.org.uk/firms/markets/international-markets/mifid-ii/what-is-changing
[4] P.318 of 'Final Report: ESMA's Technical Advice to the Commission on MiFID II and MiFIR', http://www.esma.europa.eu/system/files/2014-1569_final_report_-_esmas_technical_advice_to_the_commission_on_mifid_ii_and_mifir.pdf

High Frequency Algorithmic Trading

Many financial traders could benefit from the rise in reporting requirements. Mario Mantrisi CEO at regulatory reporting firm KNEIP suggests “...for some manufacturers it might make more sense to set up one – one reporting lines with key distributors where products are being sold.” This new environment of greater transparency could represent an opportunity to improve operational performance and provide clients with a higher level of information that could yield improved relationships for both the short and long term.

Summary

The European Commission's regulatory change is still in consultation but the drive to standardise across Europe reporting will not ease. EU legislation stands to override any local regulatory authority and as such many more organisations will be effected by this significant and impending change.

Severe penalties are expected to take place once legislation takes effect in 2017 and the FCA looks to take global supremacy as the local regulator eye's to stamp its authority on a few example traders who fail to comply. The FCA has (recent) past form in penalising firms for failing to report transactions properly, in fact there is a "hall of shame" section on its website listing those who have fallen foul of the reporting requirements (http://www.fca.org.uk/firms/systems-reporting/transaction-reporting/transaction-reporting-fines). Most notably Deutsche Bank was fined £4.7m last summer for failing to report 29,411,494 Equity Swap CFD transactions over a period of five and a half years.

Individual IT capability will be the limiting factor for a financial trader and their ability to comply with the impending reporting requirements that the change in regulation promises to bring.

With just 18 months to go before MiFID II becomes a reality, many in the EU financial trading market need to assess the capability and long term suitability of their current IT systems and infrastructure. Firms who follow the evolution of MiFID II from now (when the European Commission is nearing the end of its deliberation process) until 3rd July 2016 when the FCA will publish the final amendments to the rulebook, will be best placed to make unpressured and pragmatic decisions on how to comply with the new rules.

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