MiFID II: Bringing Significant Volume of Change

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MiFID II builds on the principles of original MiFID and extends the scope to cover more asset classes, financial market participants and activities. Given significant volume of change, firms need to initiate assessment of potential impact on their businesses now and start scheduling work required to comply with the regulation.

Background

Markets in Financial Instruments Directive (MiFID) revision is aiming to make financial markets more efficient, resilient, transparent and safer for investors. Proposed revisions consist of a Directive (MiFID) and a Regulation (MiFIR) that will provide more supervisory powers to regulators and clear operating rules for all trading activities and new trading venues to the markets.

The objective of MiFID has always been a transparent and integrated EU financial market for the protection of investors. However, the financial crisis demonstrated that the coverage of MiFID was not sufficient despite underlying principles being sound. Furthermore, technological advancements and market innovation have outpaced the regulation and altered the way markets operate. These developments called for enhanced scope of the regulation leading to arrival of MiFID II.

European Commission, Parliament and Council agreed MiFID II texts in February 2014. However, these level 1 texts will need to be supplemented by delegated and implementing acts and technical standards as required under the Directive and Regulation which will set out the detailed rules in a number of areas.

Key Changes under MiFID II

The key changes with the largest impact on the market structure and business model have been highlighted below:

Market Structure

- Introduction of new trading venues - organised trading facilities (OTF) - for non-equity derivatives
- New restrictions on high frequency trading and algorithmic trading firms and activities
- Compulsory authorisation by competent authority of all members of regulated markets and multilateral trading facilities (MTF)
- Tightening of the exemptions regarding commodity traders

Investors Protection

- Ban on independent advisers receiving/giving third party fees, commissions or other monetary benefits
- Meaning of 'complex' has been redefined to include all products with embedded derivatives, and some Structured UCITS
- Firms to publish top five trading venues for executing orders

Transparency

- Pre- and post-trade transparency requirements extended to non-equity instruments and all trading venues
- Moving Broker Crossing Networks to MTF or systematic internalisers (SI)

Third Country

- Third country firms who wish to provide Investment services to retail clients will be required to establish an authorised branch in the member state

What Happens Next?

The main requirements and obligations being placed upon in-scope entities have already been agreed. However, key technical details on the precise meaning and implementation of these requirements have yet to be provided.

There are more than 75 topics for which industry is awaiting technical guidance from European Securities

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and Markets Authority (ESMA). Level 2 consultation process was launched by ESMA on 22 May 2014 with the publication of two documents:

- Consultation Paper on ESMA's technical advice on MiFID II/ MiFIR delegated acts that it must provide to the European Commission by December 2014; and

- Discussion Paper on draft Regulatory/Implementing Technical Standards, the responses to which are intended to provide the basis for a further consultation paper to be issued in late 2014/early 2015.

The deadline for responses to ESMA by the industry to questions in both Discussion and Consultation Papers was 1 August 2014. ESMA has now to submit its advice and technical standards to the Commission, the Commission will then publish its final Level 2 delegated and implementing regulations for MiFID II/ MiFIR.

Timeline for Implementation

Q2/Q3 2014	Entry into force. Member states will have 24 months to transpose the directive
Q2 2015	ESMA to deliver draft technical standards (RTS+ITS) to EC. EC to deliver draft implementing and delegating acts
Q4 2015	Publication of the implementation and delegated actis in OJ EU
Q2 2016	Transposition in Luxemborg Law
Q1 2017	MiFID II Application Date

OJ EU = Official Journal EU; RTS = Regulatory Technical Standards; ITS = Implementing Technical Standards; EC = European Commission

Likely Impact on the Markets

After the introduction of MiFID I, regulators expected that market would become more consolidated and transparent. Instead, the regulation changed the way shares were traded through wider use of “Dark Pools” and automated trading firms leading to less transparency and more fragmentation. It is therefore hard to predict the unintended consequences of MiFID II. What could be expected with a degree of certainty is that MiFID II impact will be significant as it affects less transparent markets such as bonds and commodities. Furthermore, many of the requirements are challenging the way business is carried out at present thus potentially leading to changes in market structure.

While implementing MiFID II and wider changes introduced through other regulations such as EMIR, CRD 4, Dodd Frank, MAD and REMIT, the focus is on identifying profitable opportunities across the board and divesting from activities with higher burden on capital and costs. Therefore the key questions to be considered are:

- How are the new regulations affecting the current business proposition and model?
- What products to continue to trade? Where the firm adds most value to clients?
- What is the likely cost base after all the regulatory change?
- How the cost will be shared between firm and client?
- What are the key market opportunities presenting themselves as a result of regulatory change?

Potential Implementation Approach

At Avantage Reply, we constantly monitor regulatory changes and assess their effect on risk and return of the industry. We are helping our clients understand and implement the changes in a cost effective and structured way. One of the potential approaches to implement changes required under MiFID II is:

Step 1 Gap Analysis

(1) Compare MiFID I and MiFID II / MiFIR line by line
(2) Map all the gaps between the two
(3) Conduct detailed impact study of the regulation on an institution

Step 2 Business Model Assessment

(1) Understand client offering at a product, market and business model levels
(2) Assess and prioritise the relevant changes required per business model
(3) Determine available options and communicate best possible scenario to senior management (including expected value added, implementation time, cost and resources required)

Step 3 Implementation Plan

(1) Draft detailed implementation plan (cost, time)
(2) Agree programme of work with senior management

Step 4 Value Addition

(1) Implement agreed plan using tailored structured approach
(2) Communicate progress consistently and tailor approach where needed
(3) Measure value added

Holistic Approach in Implementing Regulatory Change

Since the financial crisis in 2008, at least 70 regulations have been overhauled with the objective of reducing systemic risk and enhancing investor protection and transparency. This large scale rapidly changing regulatory landscape requires firms to constantly review their business models to remain compliant and profitable.

Firms are under constant time and cost pressure to navigate through large regulatory changes and make early assessments to prioritise, plan and implement key changes.

We believe, and our clients agree, that with all the regulatory change work needed, there is a case for a holistic approach to regulatory change management, whereby all the various regulations are themed together and impact on each of the process, system and department is considered.

This approach is likely to save cost and time of regulatory change implementation to the financial institutions willing to employ it. Whereas preliminary JWG research (based on experience of MiFID I) suggests that implementation of MiFID II in isolation will cost around £10 million for a large institution in the UK, we believe that holistic approach could significantly bring these costs down.

More Publications on MiFID II

This is the first paper in our series of MiFID II publications. Our upcoming papers are:

- Transaction Reporting under MiFID II
- What Trade Transparency means under MiFID II

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