



MiFID II

The time to act is now

Regulatory

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Background



The second Markets in Financial Instruments Directive (MiFID II), which comes into effect on 3 January 2018, is widely regarded as one of – if not the – single largest and most significant regulatory initiatives undertaken by the European Union since 2008. As a result, it is likely to reshape the face of European capital markets and will have a major impact on investment firms from both a commercial and operational perspective.

MiFID II, when combined with the European Market Infrastructure Regulation (EMIR) completes the European response to the G20 commitment made in Pittsburgh in 2009 to manage the risks associated with over the counter (OTC) derivatives trades.

Additionally, MiFID II updates the existing MiFID framework and addresses issues in relation to transparency, investor protection and market infrastructure. It comprises two key components; the Directive and Regulation, known as the Market in Financial Instruments Regulation or MiFIR.

In this note we will highlight the key aspects of these requirements and provide an overview of the common challenges investment firms are facing ahead of and during implementation. We will also discuss the key risks involved in MiFID II implementation and how they can be addressed.

With less than one year to go until the requirements come into force, each investment firm should by now have a good understanding of how it is impacted by MiFID II and – if necessary – have initiated projects to ensure that they will be compliant by the implementation date.

One important issue that cannot be over-emphasised is that, unlike other regulatory developments, there is no phase-in period with MiFID II and firms will have to be ready for its immediate implementation on 3 January 2018.

Where MiFID II will impact

Given the importance of MiFID II, it is not surprising that investment firms throughout the EU have been preparing for the new directive since 2014. At this stage, it is felt that the new directive will have its biggest impact on:



TRANSACTION
REPORTING



PRODUCT
GOVERNANCE



THE GENERAL
INDUCEMENT RULE
AND UNBUNDLING
OF RESEARCH



BEST
EXECUTION



MARKET
INFRASTRUCTURE

“There are less than 220 days until the implementation date of MiFID II, the time to act is now!”

Niamh Mulholland





Transaction Reporting

Transaction reporting is an important part of the existing MiFID framework and is also integral to regulators' ability to monitor market abuse in capital markets. In essence, transaction reporting is the mechanism by which investment firms provide reports to regulators, containing trade details of each transaction they execute, no later than close of business the following day. Transaction reporting under MiFID I was primarily an issue for sell-side firms, such as brokers and dealers, who report transactions for their clients.

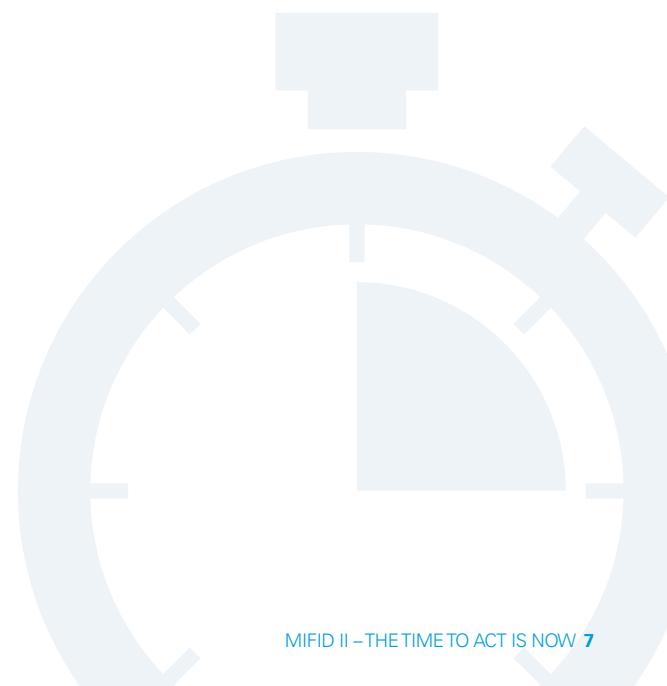
Regulators across Europe have focused on the quality of transaction reporting to varying degrees with both the Central Bank of Ireland and the UK's Financial Conduct Authority, being among the most active in this regard. This is evidenced by the substantial number of enforcement actions that have been taken for transaction reporting infringements. The significance of these fines and the number of entities sanctioned for erroneous or incomplete transaction reports, demonstrates both the complexity and the regulatory risk associated with transaction reporting.

Under the new framework, the scope of transaction reporting has broadened considerably. There are four main reasons for this:

- Reportable products – scope extended to virtually all instruments traded on European venues, including non-EU derivative instruments that relate to an EU security or index
- Venues – include all products traded on European RMIs, OTFs and multilateral trading facilities (MTFs)
- Data fields – extended to 65 data fields
- Reportable transactions – now include increases and decreases of notional amounts and the exercise of options, warrants or convertibles.

Transaction reporting will now also become the responsibility of the counterparty who initiates the transaction, typically buy-side firms, as under MiFIR all investment firms have responsibility for ensuring transaction reporting information for their firm is accurate. Firms can no longer simply rely on a broker or trading venue to complete transaction reporting on their behalf without having adequate oversight of these arrangements. Also branches of third country firms will have to submit transaction reports to the regulator which authorised the branch.

The fundamental challenge of transaction reporting is data management. Data management, including the handling of sensitive data, and having IT systems that are "fit for purpose" are key to ensuring compliance with these new requirements from the outset. The first transaction report must be submitted to national regulators on 4 January 2018 by close of business – one working day after MiFID II comes into effect.



Product Governance



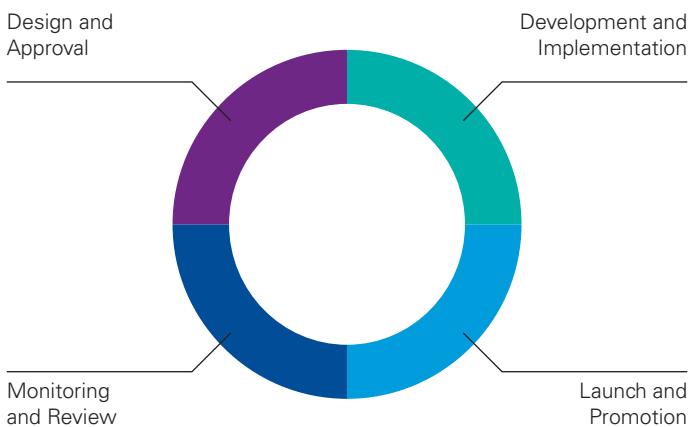
Product governance is one of the most fundamental changes to European financial product distribution since the inception of the MiFID passport. This area of MiFID II is often seen as extra-territorial and is one of the most challenging to implement for many firms. It obviously has an impact on MiFID investment firms, but it also indirectly impacts non-MiFID entities, such as UCITS management companies and AIFMs.

Manufacturers v Distributors

For the purpose of product governance requirements, investment firms that create, develop, issue and/or design financial instruments, including when advising corporate issuers on the launch of new financial instruments, are considered to be *manufacturers* while investment firms that offer or sell financial instruments and services to clients are considered *distributors*.

Manufacturers will need to identify, and take reasonable steps to distribute to a target market of end clients. They will need a product approval process and to periodically review the target market and performance of the investment products they offer. Distributors will need sufficient understanding of manufacturers' products and product approval processes to identify and sell to their own identified target market.

The product governance requirements impact both manufacturers and distributors (as well as sub-distributors) equally and define a number of obligations along the four distinct segments of the product governance cycle:



In identifying the target market firms will need to assess all of the following criteria:

- The type of clients to whom the product is targeted
- Knowledge and experience
- Financial situations with a focus on the ability to bear loss
- Risk tolerance and compatibility of the risk/reward profile of the product with the target market
- Clients' objectives
- Clients' needs.

Implementing all of the processes required for product governance will require significant interaction between manufacturers and distributors. In order to satisfy all of the information flows distributors will have to obtain, verify and send data that is currently not collected.

Firms should not underestimate the complexity of implementing product governance properly especially in the context of operating on a cross-border basis and across-entities.

They should also bear in mind that MiFIR sees the introduction of formal product intervention powers at an EU level to complement this new product governance regime. Under these powers, the national regulator of a Member State or ESMA and the EBA may, on reasonable grounds, prohibit or restrict: (1) marketing or distribution of a particular instrument (including structured deposits); or (2) any type of financial practice, in or from that Member State.

These product intervention powers represent a new departure in EU financial services regulation and confer Member State national regulators and the EU regulatory authorities with a relatively powerful tool to supplement their enforcement regimes. It remains to be seen how these powers will be used in practice and to that end the regulatory authorities have been consulting on how best to use them.



“Product Governance requirements are: complex, extra-territorial and potentially vast. Industry practice will continue to change until a market standard has evolved”

Frank Gannon

The General Inducement Rule and Unbundling of Research

General inducement rule

The general inducement rule states that investment firms must not accept and must not retain third party payments or non-monetary benefits, other than where the payment or benefit:

- is designed to enhance the quality of the relevant service to the client and
- does not impair compliance with the investment firm's duty to act honestly, fairly and professionally in accordance with the best interest of its clients.

The general inducement rule has changed as a direct result of repeated cases of poor practice in client service that is rooted in conflicts of interest between investment managers or advisors and their clients. The FCA in the UK has already addressed these market failures with its own set of rules (the Retail Distribution Review ("RDR") in 2013), the core features of which are reflected in MiFID II.

The table below summarises the new requirements on the general inducement rule under MiFID II:

	Commissions	Non-monetary benefits	
("Independent") Investment advice	Prohibited	Generally prohibited	Minor non-monetary benefits possible under certain circumstances
Portfolio Management	Prohibited	Generally prohibited	Minor non-monetary benefits possible under certain circumstances
Non-independent advice (and other investment services)	Generally prohibited – only permissible under certain circumstances	Generally prohibited – only permissible under certain circumstances	
EU member states free to impose stricter requirements	UK, Netherlands or Belgium have banned commissions for retail clients	Stringency of expectations regarding benefits & hospitality differs across member states	



“The ban on inducement will reshape the European distribution landscape and have a commercial impact on firms”

Patrick Schmucki

Unbundling of investment research and execution

In the regulator's view, the choice of a broker should depend on nothing but the criteria described in the “best execution” section of this note. However, in reality the widespread practice of purchasing investment research from particular brokers using “soft commissions” ties the investment firm to that broker, thus giving rise to potential conflicts of interest.

MiFID II, in a delegated directive of 7 April 2016 introduced new requirements that seek to unbundle the purchase of research from execution services. Investment firms may choose between two methods to pay for investment research

- They can either fund the research themselves – the “P&L method” or
- They can set up a Research Payment Account (RPA), funded by the client, which can be managed in two ways;

The “Accounting Method”: This requires a strict separation between execution and research purchase where the RPA is funded with a separate charge to the client based on an annual budget. Any research used is paid out of the RPA.

The “Transactional Method”: In line with the current regime, the client keeps being charged bundled transaction costs but they are later unbundled on a transaction-by-transaction basis. The part of the costs that represents the research charge is credited to the RPA and used for the payment for research provided by the brokers.



Firms will have to assess very carefully which method they want to use for the purchase of research. Large firms with their own research department, or investment firms that rely only marginally on external research, may find the “P&L” method the best solution. Investment firms with large external research budgets will have to consider their individual needs when choosing the method for the operation of an RPA.

Best Execution

Best execution is the requirement under the current MiFID framework that requires investment firms to take “reasonable steps” to obtain the best possible results for their clients. MiFID II strengthens the governance aspect of the best execution requirement by replacing the term “reasonable steps” with “all sufficient steps” setting a higher bar for compliance than “reasonable steps.”

MiFID II also introduces two other changes aimed at increasing the scope and transparency of best execution:

- Best execution requirements are extended to include non-equity asset classes (including listed derivatives, fixed income assets such as corporate and government bonds, warrants or contracts for difference (CFDs)). Accordingly, it also includes asset classes where transaction costs are not disclosed separately but are expressed in the spread, such as fixed income, or “netted” such as in certain derivative instruments.
- Investment firms must publish their top five execution venues by trading volume for each class of financial instruments annually. This information needs to be extrapolated from a quarterly report published by execution venues on the quality of execution of transactions. Additionally, firms have to prepare an annual report describing the quality of execution of transactions.

The following are the key challenges that are anticipated:

- Adequacy of Systems and Controls
- Data challenge
- Evidence of optimal best execution arrangements
- Broker selection and monitoring
- Client documentation
- Product complexity
- Governance

As ESMA states in its “Q&A” on MiFID II and MiFIR investor protection topics, a firm is not expected to obtain the best possible results for its clients on every single occasion. Rather, a firm needs to verify on an on-going basis that its execution arrangements work well throughout the different stages of the order execution process. Putting in place a solid governance framework, complemented by a control system and powerful applications to analyse market data, provides the foundation for ongoing compliance with best execution requirements and evidences this to clients and regulators.

Seven factors are taken into account to ensure best execution for clients (the first two of the following being the most important):



COST



PRICE



SPEED



SIZE



EXECUTION



SETTLEMENT



NATURE OF THE ORDER

Market Infrastructure

Trading “venues” including existing trading venues such as Regulated Markets (RMs), Multilateral Trading Facilities (MTFs) and Systematic Internalisers (Sis) have proven to be among the most scrutinised technical topics of MiFID II/MiFIR.

In an effort to both enhance the transparency of EU Capital Markets as well as creating a more level-playing field, the forthcoming Directive and Regulation introduce a number of significant changes in the following areas;

- The **Organised Trading Facility** (“OTF”) has been introduced in MiFID II, to capture multilateral trading in non-equity instruments that does not currently take place on RMs or MTFs.
- MiFID II has developed the rules around **RMs and MTFs** by aligning the requirements for MTFs with those applicable to RM's and to some extent OTFs.
- **Pre and post trade transparency** requirements.
- MiFID II increases the requirements on **trading** in shares, and introduces a new trading obligation for derivatives.
- Under MiFID II, **SIs**, which are firms dealing on their own account by executing client orders outside a trading venue, have increased obligations.
- **High frequency trading and algorithmic trading** requirements.
- A number of the **organisational** requirements that currently apply to RMs and MTFs will now be extended to OTFs.

The peculiar thing about the market infrastructure requirements is that they will fundamentally change the functioning of European capital markets. But as the changes are on an unprecedented scale, it is difficult to predict the practical implications of the new rules. One thing is clear and that is that transparency will be increased which will impact market liquidity, enhance competition and further accentuate the data management challenge for investment firms.



“It is clear that transparency will be increased which will impact market liquidity, enhance competition and further accentuate the data management challenge for investment firms”

Niamh Mulholland

Challenges to implementation



In summary, investment firms will face numerous challenges on the path to MiFID II compliance. However, consideration should also be given to the specific risks of these implementation projects. Because of the broad scope of MiFID II, the projects are likely to be larger, more complex and more interlinked than other regulatory change projects.

Depending on the size, scope and activities of an investment firm, the implementation of MiFID II can result in large and complex transformation projects consuming massive resources while daily operations still need to be maintained.

While MiFID II implementation programmes are not significantly different from any other project within an organisation, there are a number of key risks specific to MiFID II programmes that need to be addressed:

Description of risk	Risk mitigation
Inadequate evidence to trace compliance Inadequate evidence of completeness and appropriateness of the project design with regard to the requirements applicable to the firm carries the risk that the firm will not be compliant by the end of the project.	Monitoring traceability must be an integral part of the project design and clear ownership must be assigned. Regular reporting gives confidence and evidence of compliance over the course of the project.
Insufficient resources can lead to project failure Due to the scope and complexity of MiFID II implementation projects, the project can require massive resources and relies heavily on expert knowledge (not only regulatory experts but also in the areas of operations, IT or Compliance/Risk Management). Very often MiFID II implementation projects are running parallel with other projects and strain the availability of key personnel that remain in charge of running the daily business. Finally, there is often a lack of adequately skilled programme level managers that can coordinate and manage the project.	Experts should be pulled together in targeted work streams with assigned priorities and time plans. This ensures the appropriate mix of professionals and allows for the planning of their availability. The program should be led by a fully dedicated, experienced project manager who can be an internal resource or hired externally.
Organisational “silos” undermine cross-departmental work streams Larger organisations are particularly impacted by limited interaction between different departments although processes are similar and the same systems are used. The requirements of MiFID II often cut across departments which increases the effort to coordinate the project. Moreover, implementation of the new requirements often leads to the need to redefine core processes which reveals existing gaps, overlaps or conflicts.	The work stream leaders will have a crucial role in coordinating the overall operating model as well as defining and confirming core processes, appointing key owners and documenting business requirements. A key component to success is also the support and involvement of the key decision makers of the relevant departments through their involvement in a steering committee.
Compliance must be maintained on an ongoing basis once the project is complete It has often been observed that projects tend to focus on day one compliance and fail to address end-to end process definitions, data requirements or risk- and control frameworks in a day-to-day environment.	The analysis of “business as usual” processes must be an integral part of the implementation project. This requires enhanced involvement of the control functions (risk, internal audit and compliance) in reviewing process designs, and risk- and control assessments. Additionally, sufficient time has to be built in for building of awareness, communication of (new) roles and responsibilities, training and update of policies and procedure manuals.

Finally...

It is important to keep sight of the urgency and regulatory risk of the different parts of MiFID II. As mentioned earlier, transaction reports need to be submitted to the regulator, by close of business 4 January 2018, just one day after MiFID II comes into force, and these reports come with the potential of high fines if delayed or done incorrectly.

Updated cost disclosure documents will need to be issued to new clients from 3 January 2018. Customised breakdowns of effective costs incurred could theoretically be requested within the first month of that new client relationship. Other requirements, such as the top five venues for best execution reporting, do not need to be prepared until the end of 2018.

In summary, MiFID II implementation projects are atypical in that they are simultaneously introducing several new requirements that can be disruptive from a commercial perspective such as requirements for product governance, or the more stringent inducement rule. The new requirements can also be disruptive from an operational perspective, for example transaction reporting or best execution will require extensive IT-based capabilities for the recording, analysing and reporting of trading related information.

These aspects should be taken very seriously as they could jeopardise the success of any implementation project which could eventually damage the firm as a whole.

How KPMG can help

MiFID II will introduce radical changes to the way that investment markets function, with these changes aimed specifically at boosting protection for investors.

MiFID II undoubtedly presents major challenges to all those providing services and products for the investment industry. But for those who are prepared to put the resources and systems in place to ensure a smooth transition to the new MiFID II requirements, there are opportunities to grow their business and ensure compliance – and that is where KPMG can help.

At KPMG we have a multi-disciplinary team of professionals who have a deep understanding of MiFID and its looming successor MiFID II. Please contact us and we will demonstrate how your business can not just cope with MiFID II but can benefit from the opportunities it brings.

Contact us for more MiFID guidance

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