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Ben Matthews
Managing Director
Ben.Matthews@bcsc consulting.com



Gavin Berry
Director
Gavin.Berry@bcsc consulting.com



Peter Young
Principal Consultant
Peter.Young@bcsc consulting.com

MiFID II

Keep on track for
3rd January 2018



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MiFID II introduces a major overhaul of financial standards in Europe and will cover everything from how market research is funded to the transparency of debt and equity markets. Everyone breathed a sigh of relief when the one year delay was announced, but firms will need to continue at pace to ensure compliance with the multitude of MiFID II obligations. It is crucial that firms take advantage of the delay to change their technology and processes rather than putting their plans on hold.



MiFID II, plenty to keep us busy for the next two years

Whilst the European Commission's extension of the application date of the MiFID II (The Markets in Financial Instruments Directive) package to 3rd January 2018 was no surprise, alarmingly, concerns were immediately raised that even a one year delay may not be enough.

The delay was driven by the European Securities and Markets Authority (ESMA) and the National Competent Authorities (NCA), who saw the timeframe to complete a full delivery of solutions to meet the MiFID II obligations, particularly across the most complex systems, as insufficient. The main challenges cited concerned instrument reference data, transaction reporting, transparency parameters and publication, position reporting and the need for a harmonised start date for each of these areas.

So how should industry participants make use of the extended timelines?

Firstly, there is no let-up in things to do. ESMA published a further consultation paper running to 270 pages, which covers guidelines on transaction reporting, reference data, order record keeping and clock synchronisation. In addition to forming a key part of the consultation process across the industry, this informs the way that firms develop core business requirements as it elaborates on what had been published previously with far more detail. Firms will need to participate in many industry discussions to ensure their requirements are aligned to the outcome of the consultations.

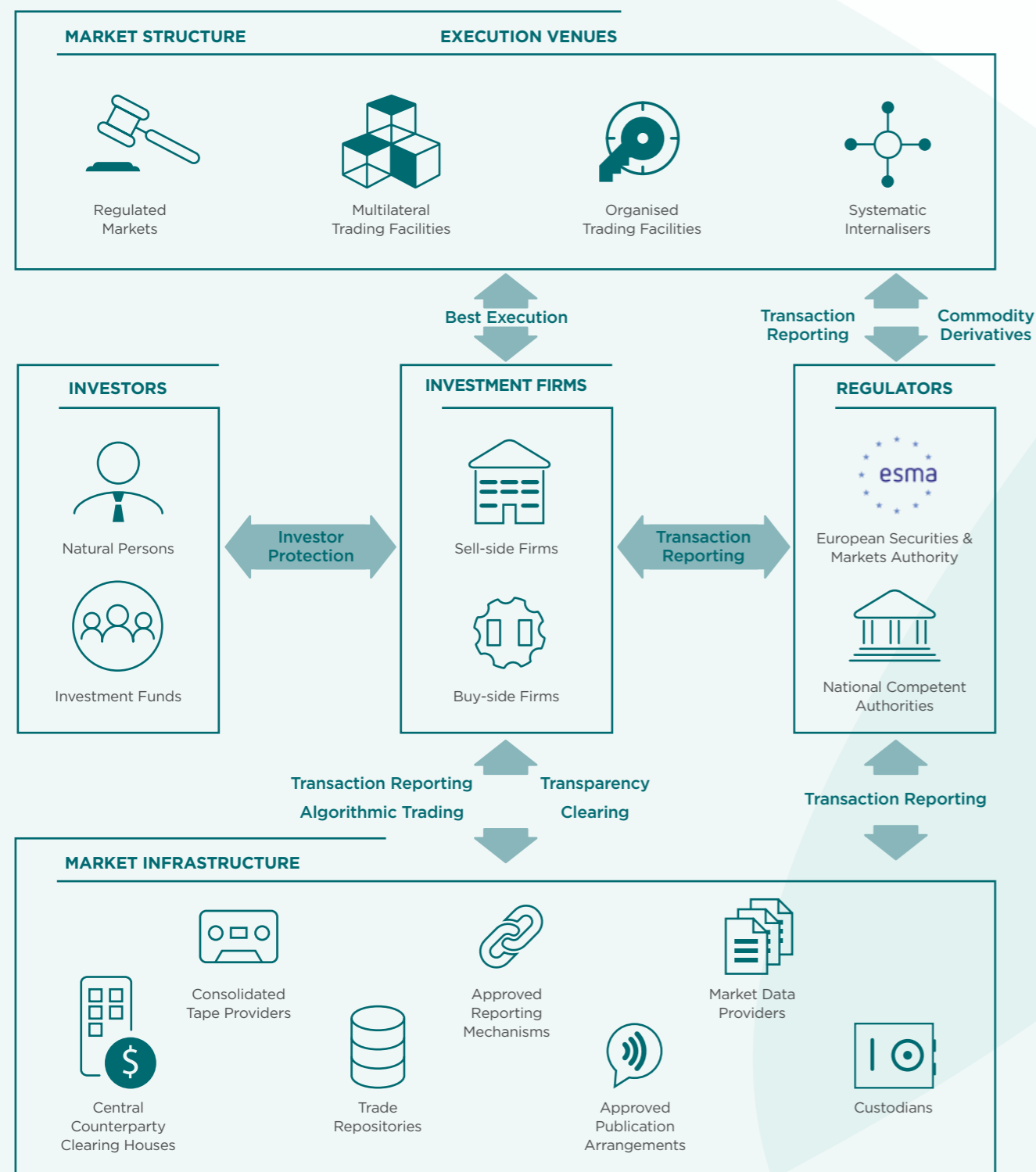
The overriding message has to be to keep up the momentum that has been established. Many contacts that we spoke to before the news of a likely delay talked of a "fat-tail" of MiFID II activity following the regulatory live date, perhaps mirroring what we've seen for EMIR. The industry now has an opportunity to ensure that this doesn't occur again and that the additional time is used to maximum effect.

For example, if firms continue to proceed at pace:

- There should be more opportunity to test reporting earlier and more thoroughly. The fact that the industry requires reference data for 15 million instruments should not prevent firms from proving their solutions for a subset in advance.
- The delay may provide time to explore alternative options for delivery, including outsourcing of reporting, rather than developing in house.
- They may see early feedback from best execution reporting that can in turn inform best execution policy.
- Critical paths that would have been affected by capacity and resource constraints for large system changes could be unblocked.
- There may be more opportunity to strategically review processes end to end, with a broader scope than just the new regulations. With additional time, the architecture required to support MiFID II could be better aligned with other regulatory requirements.

A new industry landscape

To better understand the implications for different types of firms, it is important to look at how MiFID II impacts the industry as a whole.



Although the impacts vary greatly for different types of firms, be they investment firms, execution venues, or market infrastructure, there are many interdependencies that need to be considered:

- Broker-dealer firms will have to decide whether they operate as a Systematic Internaliser, Multilateral Trading Facility or Organised Trading Facility depending on their mix of trading on an agency or principal basis.
- Buy-side firms that haven't previously undertaken transaction reporting may be looking to their sell-side counterparts and third parties for support with this new reporting challenge.
- Asset servicing firms will have to respond to the demands of providing new data to support the MiFID II programmes of all of their clients, becoming involved in a large number of simultaneous external MiFID II programmes.
- Technology suppliers will have to introduce new attributes at a trade capture level, having to provide new technology for a vast number of clients.
- Industry testing is dependent on the readiness of the different firms, market infrastructure and execution venues being aligned in approach.

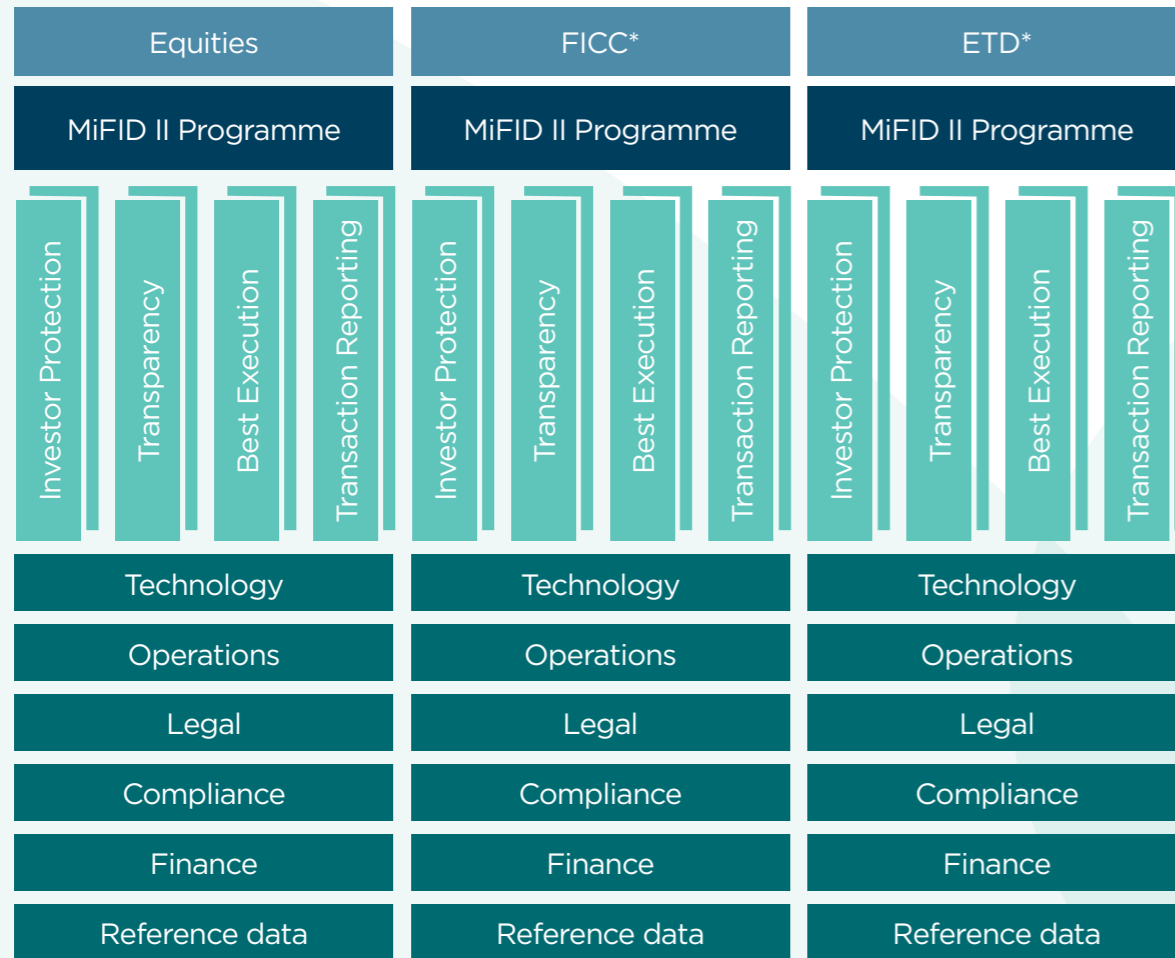
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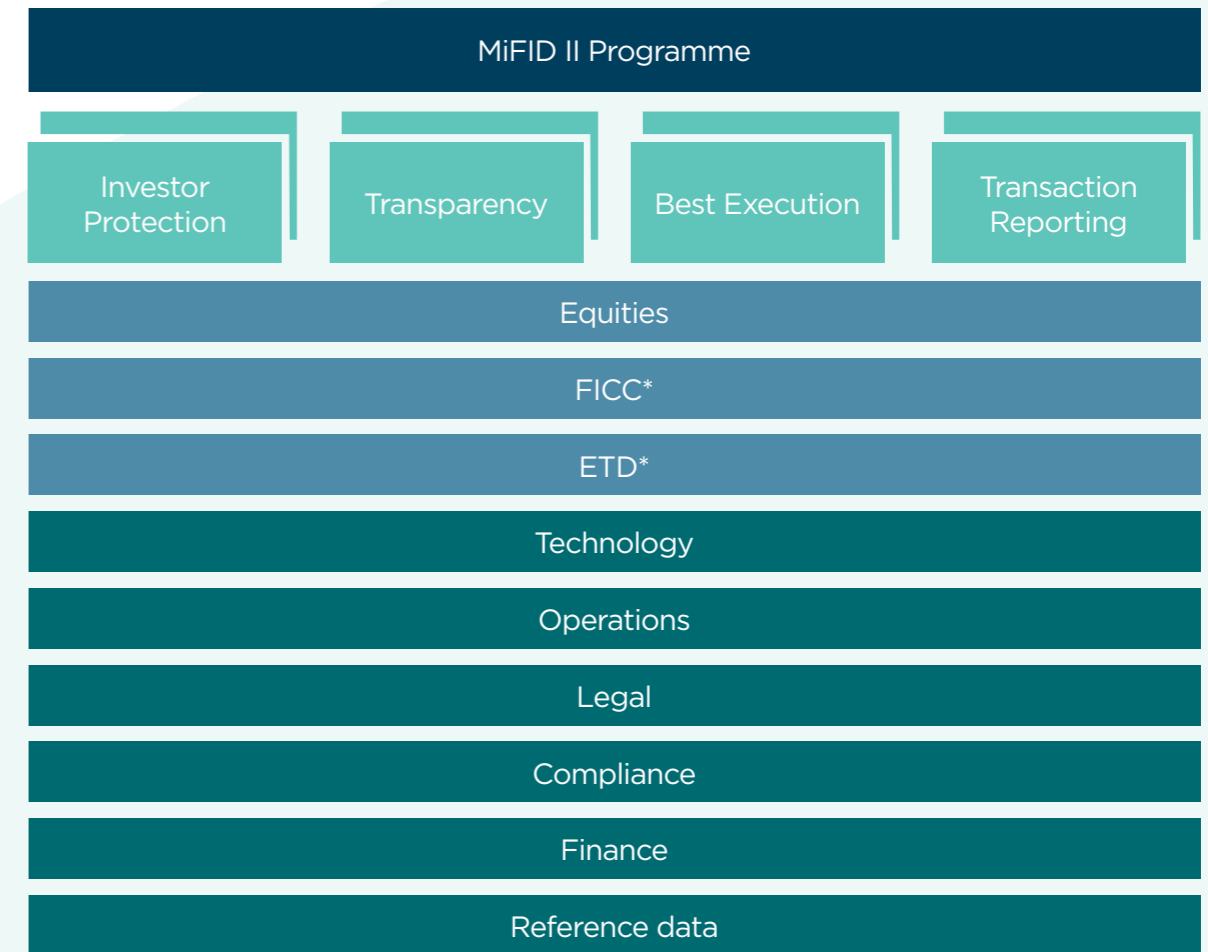
Getting governance right

Firms will find it challenging to deliver MiFID II consistently across their organisation if they do not have the appropriate governance and programme structures in place.



A common way for firms to structure their MiFID II programme is by business lines. This can be problematic as, left to their own devices, business lines can come up with different approaches to achieving MiFID II compliance, which can lead to issues such as overly complex technology architecture, lack of centralised control, operational support headaches and over-reporting. It can also be costly for firms to have multiple functional teams. For example, firms may establish separate technology, operations and legal teams to support each business line.

* Foreign Exchange, Interest Rates, Credit and Commodities (FICC)
* Exchange Traded Derivatives (ETD)



A preferable programme structure would be one aligned with the key components of the regulation. For example, Transaction Reporting will require SME input from each business line but ideally one technology solution would be developed to meet the requirements of all business lines. This approach minimises duplication of effort across the firm and minimises the risk of MiFID II solutions diverging by business line.



A programme structure aligned to the key themes of the regulation helps minimise the risk of MiFID II solutions diverging across the firm.

Covering all bases

MiFID II has a vast number of complex and interconnected components. To ensure full compliance, maintain a traceability matrix that will stand the test of time.

MiFID II is an extensive regulation that affects almost every part of the organisation, from front office to back office. How do firms ensure that they are making the necessary changes to be compliant?

A traceability matrix is a simple idea that enables tracking of a complex regulation. Done correctly, the relationship between business requirements and the specific part of the regulation from which they derived will be clear.

1. Start with the regulatory text

There are hundreds of pages of MiFID II text. Create a library, starting with MiFID II and MiFIR articles and linking them to the related level 2 and 3 text as additional guidance is released.

2. Determine what is in or out of scope

By article, determine what is in scope. The best way to do this is by creating a matrix that shows all MiFID II and MiFIR articles on one dimension and the programme workstreams on the other. This can be further broken down by paragraph of each article and by sub-workstream.

3. Understand impact

SMEs for each area of the MiFID II programme will need to conduct an impact analysis for all of the articles that are in scope. For their respective areas, a detailed description of the impact is required. When compared against the current state systems and process, this will highlight the key gaps that need to be addressed.

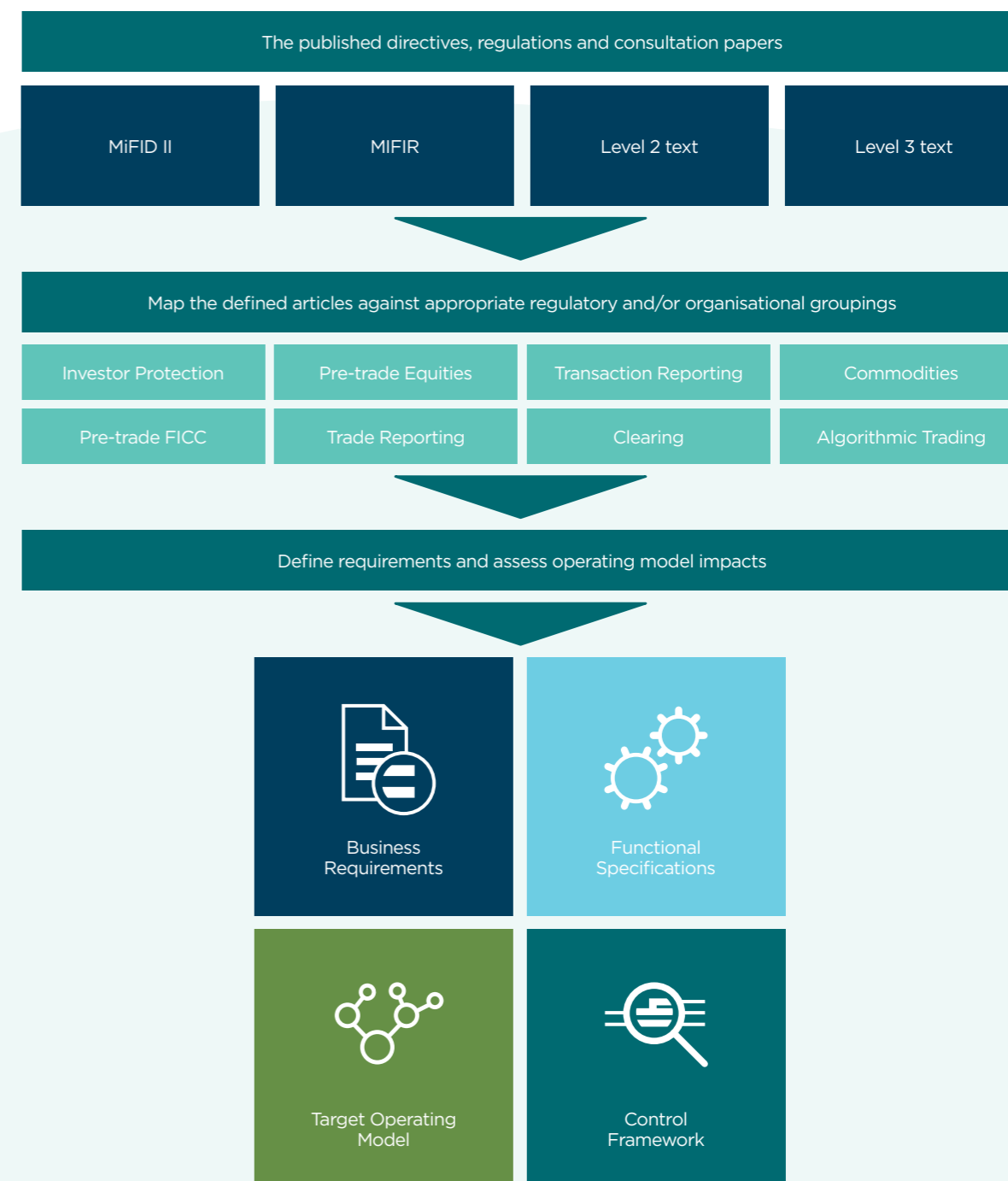
4. Define requirements that will enable compliance with this text

A set of business requirements should be documented for each impacted area. These will naturally start as high-level requirements and progress to detailed requirements which include all inbound and outbound dependencies.

Clearly, the technology platform used to support the traceability matrix tool will be an important consideration. An automated solution (versus a spreadsheet alternative) could provide a more effective 'slice and dice' functionality - for instance, allowing requirements to be viewed by article, by asset class or by impacted system. It would also support the automation of reporting - often an area where valuable time and effort is wasted on a programme. Regardless of the technology behind it, a traceability matrix will prove essential as both a project management tool and an audit history for regulators.

A traceability matrix is a simple idea that enables tracking of a complex regulation.

Understanding the link between regulation and requirements.



A comprehensive traceability matrix will map the regulatory requirements to chosen organisational groupings and specific business processes or applications. This will highlight any and all impacts by business division and allow for easy maintenance as the text evolves.

Take control

Focus on designing and building a robust reporting control framework now to avoid pain later.

The FCA alone has issued over £30 million in fines related to transaction reporting breaches since the launch of MiFID I. Regulators expect reports to be complete, accurate and on time, but they also want to see that banks have control of the reporting landscape, even when something does go wrong. With extensive requirements for pre and post trade, best execution, reference data, and transaction reporting, here's how to avoid such fines for MiFID II.

Front to Back (and everything in between)

Start by documenting the entire reporting system architecture including all interfaces in the system flow. This will vary by asset class, but transaction data naturally spawns from front office order management systems and passes through various risk management, confirmation and settlement systems before being prepared for life in the outside world. Along this journey, basic trade economics are enriched with reference data and it will be crucial for any MiFID II solution to ensure that client, product and instrument data sources are considered alongside any system changes. In addition, the understanding of where eligibility and reportability decision-making occurs will be extremely important and so should be reflected in the end-to-end architectural view.

Correct problems at the source

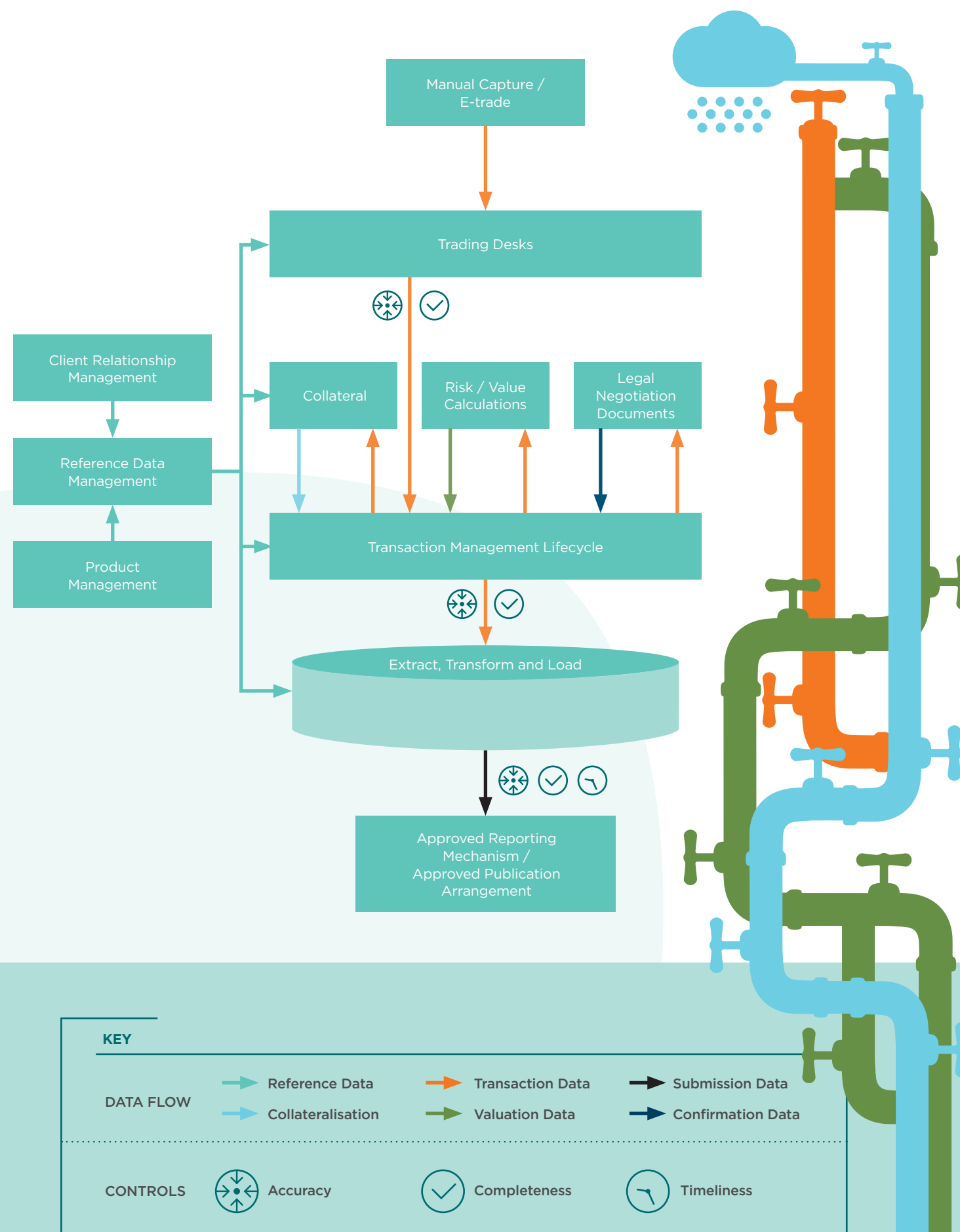
Armed with the full visibility of reporting system architecture, firms can plan for how controls will be embedded. A robust control framework is one where incorrect data is fixed at the source, so firms need to understand the potential causes of any misreporting. It is also important to understand the data specification requirements of the downstream system in relation to the supplied data. MiFID II covers a vast array of asset classes, and as a consequence a huge number of systems will be impacted. Firms should consider an Extract, Transform and Load (ETL) layer within which heterogeneous data is captured and prepared for external distribution. Not only will this standardise processing, it will in turn simplify the control framework required.

Take advantage of third party reports

Firms are recommended to submit transaction data to Approved Reporting Mechanisms (ARM) and, though the majority of reporting issues should be caught before going out the door, exception reports from the ARM itself should be used as an additional control. In order to do this, the receipt of exceptions from the ARM should be integrated into operational processes, to once again fix issues at the source. In addition, ARMs are offering a testing service before the MiFID II go-live in order to provide some assurance for transaction reporting. Firms should be taking advantage of these test environments to identify any fundamental issues before there are financial consequences for getting it wrong.

Do not wait until the end to think about controls

MiFID II introduces an explicit requirement for a robust control framework, and the most effective way of ensuring compliance is to consider controls at the same time that reporting requirements are being produced. Regulators are expected to crack down on over-reporting in addition to the misreporting and under-reporting breaches for which we've already seen fines. It won't be enough to fire off all available transaction data to the ARM and hope for the best. If system changes are designed with controls in mind from the start, this won't be necessary. Remediation will be costly.



Conclusion

MiFID II is one of the largest regulatory challenges the industry has faced, with its extended implementation timeline only serving to underline the scale and complexity of what is involved.

The industry as a whole must keep the momentum that is underway and firms need to ensure they have prioritised, planned, resourced and organised their programmes in a way that ensures successful delivery of strategic – rather than tactical – solutions.

Central to success will be collaboration with peers, counterparties and other market participants; strong and appropriate governance; clear traceability of delivery against the evolving regulations; and operating controls that are built into the design from the outset.

1. Industry collaboration to overcome challenges: An open approach with a high degree of co-ordination across the industry will help firms align their solutions to industry best practice.

2. Establish a programme that aligns to the regulation: This allows firms to deliver more with less and ensure that their solution is consistent across their organisation.

3. Maintain traceability: If effectively used, a traceability matrix will protect firms from the evolving regulation that is already more complex than anything firms have had to deal with in the past.

4. Controls to protect: Robust controls must be in place from the outset to avoid painful fines that are guaranteed if firms cannot get to grips with their reporting obligations.



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