MiFID II: the transparency imperative

Transparency. Transparency. Transparency. These are the most frequently recurring words in any discussion of MiFID II, an important part of the wave of regulation that has been imposed upon the international financial industry since the onset of the global financial crisis. If the objectives set for the new directive are in fact achieved, the results will be transformational.

But the doubts that have been expressed about the feasibility of meeting the target implementation date are beginning to translate into a broad acceptance that more time will be needed to prepare. Martin Merlin, a director in the department, told European Union lawmakers on the morning of November 10 that the institution's "preliminary view at technical level is indeed that a delay is needed'' to the planned January 3 2017 start date.

"Maybe the simplest and most legally sound approach would be to delay the whole package for one year,'' Mr. Merlin said at a hearing of the EU parliament's economic and monetary affairs committee.

In response to Mr. Merlin's comments, a Financial Conduct Authority spokesman said it was for the Commission, the Council and European Parliament to make a decision on delaying implementation, not national competent authorities, on all or part of the texts.

Before this exchange, it had become increasingly clear that the industry feels more time will be needed. Many vital points of detail remain undefined and unresolved, and the industry cannot build effective solutions based on hypotheticals. The industry needs hard facts if it is to develop successfully and cost-effectively the new infrastructure that MiFID will demand.

It is almost impossible to overestimate the breadth and depth of MiFID II, which is intended to extend the provisions and protections of the original MiFID to asset classes other than equities. MiFID II runs to thousands upon thousands of densely packed pages that stretch the capacity of the human brain to breaking point and beyond.

A recent regulation-ready client study carried out by SGSS, which works with many European asset managers, identified MiFID II as the dominant change agenda item on clients' minds and the dominant spend driver for 2016, followed distantly by UCITS V. Trading venues will need to implement invasive new systems and controls to comply with the transparency requirements. Members of trading venues will have to consider the impact the revised transparency regime will have on their trading activities.

This short paper is an attempt to achieve to cut through the Gordian Knot that is MiFID II. It aims to summarise and explain the Directive's main impacts on the industry, to highlight the problems created by the uncertainty it creates and to argue the case for postponing implementation.

There is one underlying simple reason why MiFID II is so far-reaching and difficult to penetrate: its very diverse patchwork nature. While the original directive covered only equities, the upgraded version brings bonds, derivatives, commodities and structured products into scope whereas regulators push for more asset classes to be traded on formal recognised venues. The all-encompassing attempt to cover so many aspects of so many topics in a single piece of regulation means that it is complicated and cumbersome.

Who does it affect on the buy-side?

MiFID II affects fund sellers. It affects fund managers. It affects investment advisers. It affects private banks. And it also affects investors.

The key elements relating to transparency include provisions for the extended reporting of, and stricter controls on, trading. For marketing and distribution, a major change in the way that financial advisers and portfolio managers are paid will dictate that changes be made to established distribution models.

For product governance there will be increased emphasis on the suitability of individual products for individual investors, matching not only their current needs but also their evolving needs. Increased requirement for record-keeping threatens to be a logistical nightmare requiring extensive IT investment.

Best execution extension

MiFID II reinforces the best execution requirements of the original directive and enlarges its scope well beyond equities and bonds. In MiFID I it was "the best outcome for the client". MiFID II extends the concept to include price, total transaction cost, transaction speed (as the time elapsed between the execution venues receiving the order to execute and the actual execution of the order) and likelihood of a transaction taking place within the parameter of the order.

The new rules on best execution include an execution quality report where orders need to be grouped by financial instrument, execution venue and order type. Any reason that might have influenced the financial institution to execute the order in a specific venue should also be included, such as inducements, common shareholder(s), parent company-subsidiary relations, discounts, etc. Here as for most measures within MiFID II, all must be transparent, justified and disclosed.

Distribution disruption

One of the most significant changes will likely take place in marketing and distribution, because of the proposed new rules on remuneration. Members of distribution networks who have traditionally received financial inducements from fund managers and other financial instruments manufacturers will have to be remunerated in some other way. They will have to decide whether to be independent, or tied to named fund promoters. This will change the distribution model completely, affecting both structure and fees.

In this new environment, the pricing and cost allocation of research could also become complicated on both the sell-side and the buy-side; if so, many contracts might have to be revised. Research will have to be paid for somehow, and this will increase the total costs of investment. If the amount of research available to investors is reduced, if the quality of what research they have is reduced, if competition to provide research is reduced, this could increase investment risk.

Such potential constraints favour the development of new distribution models for research. One emerging model is the RSRCHX platform. This online marketplace, launched in late September 2015, says it now hosts research from firms specialising in topics as diverse as commodities, European online retail, global shipping, mergers & acquisitions insights, video gaming, China macro, wireless home technology, global liquidity flows and the fintech sector. RSRCHX change claims that it now offers thousands of research notes that are transparently priced and available for individual purchase or via subscriptions.

Data proliferation

Transaction reporting too is going to be much more demanding. MiFID II requires more than four times the amount of information in different fields than the directive it develops, throughout the chain. The information required to fill these new fields is very granular, including for example clear identification of the named individuals and computer algorithms within the investment firm responsible for any investment decision. MiFID II also imposes an obligation on firms that receive and transmit orders, but do not execute them.

Increased transparency can be positive for investors, but one potential downside from this proposed increase in transparency is that in less liquid markets this may negatively impact liquidity.

Reporting will become more expensive and not everyone will be able to cope with the heightened demands. Investment firms will need to record telephone, electronic communications and minute face to face meetings relating to the reception and transmission of orders, execution of orders on behalf of clients, and dealing on own account.

Records will need to be kept for five years instead of the current six months, and potentially up to seven years if requested by National Competent authorities. The storing of millions of notes of meetings and phone call recordings for five years is a big, big task. For any fund seller distributing across Europe, keeping track of thousands transactions and data for clients disseminated in different countries is not going to be easy.

Blurring the lines

MiFID II will blur of the lines between institutional investors and retail investors and the protection they will be afforded. In the new landscape, a retail investor will be anyone who is not a professional investor; this revised definition of the word retail can include local government pension funds, private clients with significant amounts of money to invest but also the famous “municipalities”.

In conclusion: What happens next?
MiFID II is coming and it is very different to MiFID I. It is broader in its coverage and challenges the ability of the industry to create and deploy in time workable solutions to the many of the implementation challenges. Those affected face a Herculean task to prepare for it.

But the industry will not, contrary to some doomsday predictions, be overwhelmed. Key asset managers will already have carried out impact assessment and will have gained an understanding of what they need to do. The next step is to advance from that starting point and towards devising and launching a proper project plan as relevant technical specifications are published.

Progress will not be made in isolation. The industry needs to work together to be ready to deliver the market structure, transparency, and investor protection that is being targeted. Regulators and investors, for their part, need to recognise that every improvement in transparency brings greater complexity, which means greater cost, including that of reduced liquidity.

But, as noted earlier, the industry cannot be expected to build solutions based on hypotheticals. The industry needs greater clarity in order to deliver MiFID II's key objectives.