Intelligent Trading Technology

FROM A-TEAMGROUP

MIFID II: WHAT'S NEXT?

Commissioned by

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INTRODUCTION

Although the big 3 January 2018 deadline for implementation of MiFID II – all 30,000 pages of it – has come and gone, it is not yet time for MiFID II implementation teams to rest. There is still much work to do.

Many aspects of MiFID II are being rolled out during the remainder of this year – including key tenets relating to Systematic Internalisers (SIs), the use of the Legal Entity Identifiers (LEIs), and market reports.

What's more, the last-minute 20-month reprieve given to the commodities and derivatives markets by regulators means that an entire swathe of the marketplace, including the key London Metal Exchange (LME), Eurex and ICE Futures (the former Liffe) markets, won't go live with the new rules until 2020 – creating additional complexity down the road.

Even in the areas where there was reasonable certainty in the run-up to the deadline, firms need to review the work they've completed to date. Many firms' efforts at compliance don't represent the finished article. The jury is still out on what a final design will look like with many regulated firms still attempting to finesse and/or industrialise their response to MiFID II in order to comply for the long term, efficiently and effectively. In addition, most firms have not yet really considered how compliance with MiFID II could be pivoted into business benefit – even though there is a general consensus that substantial business value could be achieved.

The January launch day went more smoothly for some than for others. According to a poll of financial trading technology professionals attending A-Team Group's ITS MiFID II Briefing conference in London in February, some 60% of audience respondents said implementation day went generally fine, with a few niggles but no major issues. A third of respondents described the experience as 'a bit hairy' and have some mopping up to do. Just 5% said it was a walk in the park with everything going according to plan. No-one reported 'a complete nightmare', one of the options on the poll. A small group – 2% of respondents – selected the 'What's MiFID II?' option.

Joking aside, consensus seems to be that the majority of regulated firms achieved compliance with the bulk of MiFID II in time for the deadline – but concede that their solutions may not be optimal or final. For many, that means there could be quite a lot of additional work to be done.

UK regulators have indicated general satisfaction with the market's attempts at compliance thus far, while acknowledging that they

believe firms' efforts around MiFID II are far from complete. How long the regulators will give the marketplace to come up with final solutions that are defensible and will withstand any kind of market test remains to be seen. But it's clear that regulators will start to look at enforcing MiFID II sometime in the second half of 2018. At this point, firms will discover just how robust their response has been.

Meanwhile, a second A-Team Group poll questioned whether there is a silver lining in the cloud of MiFID II. Just over half of respondents (56%) said MiFID II provides some benefit for handling other regulations; 37% said they are seeing significant benefits in addressing other regulations and improving business processes. A small minority (5%) suggested there would be little opportunity to recycle their MiFID II solution, and 2% said there was zero chance of putting all the time and effort expended on MiFID II to other uses.

This paper explores how work on MiFID II is continuing through 2018 for firms – and regulators. It will look at some of the key areas of ongoing roll out of the regulation, including the postponement of the go-live of commodities and derivatives marketplaces. It will also discuss how firms are reviewing the work they completed under pressure for the 3 January deadline, with an eye towards improving and industrialising those processes.

2018: ONGOING ROLLOUT OF MIFID II

While Christmas was cancelled for some implementation and operations teams at firms, Day 1 of MiFID II generally went well. Low trading volumes gave the market some breathing space to adjust to the new regime. The absence of disaster was a real relief to many – some in the industry had been predicting there could be serious issues because some firms had said they could not complete testing with venues and lock down their technology by mid-December.

But if the MiFID II implementation day went better than expected, it was wholly due to the fact that practitioners spent an extraordinary amount of time and effort understanding the requirements of the regulation and putting in place a solid plan for execution. Indeed, according to another A-Team poll, this time of financial data professionals attending its Data Management Summit event in mid-March, 57% of respondents cited the challenges around interpreting and baselining the regulatory requirements as the most complex aspect of MiFID II delivery, indicating how much of a challenge getting one's head around the requirement represented. Some 41% of respondents to the same poll, meanwhile, said that the sourcing, mapping and integrating of the required data was their firm's most complex challenge in meeting MiFID II's requirements, and a lot more work needs to be done.

The bad news for firms is that both of these challenges are set to continue, as regulators continue to release new or revised guidance around specific aspects of MiFID II, as well as work with firms around specific areas that have been postponed. Unsurprisingly, many of these aspects are heavily data-centric. A few key areas remain unresolved, in part because the marketplace is awaiting new deadlines or new requirements or some other regulatory edict before their ultimate solution is finally put in place. Here are a few:

Legal Entity Identifier (LEI) Mandate

For many firms, the vast data collection and record keeping requirements of MiFID II is a work in progress. In the run-up to the MiFID II deadline, many in the industry voiced concern about the January 'no LEI, no trade' problem.

There was considerable confusion about who was required to have an LEI to trade, particularly at investment firms. Additionally, many overseas organizations were either unaware of the LEI requirement or resistant to acquiring one. Predictions that this implementation deadline would have to be postponed proved to be correct, with ESMA pushing back enforcement of its LEI policy by six months.

The LEI is a free-to-use standard entity identifier that uniquely identifies parties to financial transactions. Its development, and that of the global LEI system that supports its widespread use, was set in motion in 2011 by the Group of 20 developed nations (G20) in an attempt to avoid a repetition of the 2008 financial crisis, whose cause was attributed in part to firms' ignorance of the identities of their counterparties and issuers whose securities they held.

The identifier is intended to help regulators measure and monitor systemic risk by identifying parties to financial transactions quickly and consistently, and obtain an accurate view of their global exposures. Many market participants are also using the LEI to improve risk management within their own organisations. The mandated use of the LEI in MiFID II transaction reporting is expected to increase adoption of the identifier and further improve industry understanding of legal entities operating in financial services markets.

The six-month delay has specific terms; ESMA has permitted:

- Investment firms to transact for a non-LEI-holding client on the basis that before they execute they receive the necessary LEI application documentation from the client, so the firm can apply on the client's behalf.
- Trading venues to report their own LEI codes instead of LEI codes of non-EU issuers which do not have their own LEI codes.

ESMA's six-month delay of the MiFID II requirement for every party to have an LEI in order to trade has given the market some extra breathing room. However, despite a significant uptick in the number of LEI registrations, many firms are still struggling to entice clients to get LEIs in place. For example, firms which have a lot of smaller, non-EU clients are experiencing issues communicating the need for an LEI to these entities. Also, sometimes there can be an issue in identifying the correct entity LEI for a counterparty, for a wide variety of operational reasons, making it practically complicated under some circumstances.

It's unlikely that the LEI will receive another delay beyond the new July 3 deadline, so firms should be prepared for the go-live for this to be final. Firms should:

- Ensure they have an accurate view of the LEI status of their entire client base, and review this LEI status regularly.
- LEI requirements have been embedded correctly in the client onboarding process.

- Communicate proactively with all clients who do not have an LEI.
- Apply for LEIs on behalf of clients, if it is corporate policy to do so.
- Check that LEIs are appearing correctly in all MiFID II reporting – regulatory as well as internal.

Provision of fair and non-discriminatory co-location services

Lots of work is going on at trading venues, too. Under MiFID II's Article 2, trading venues are required to provide fair and non-discriminatory co-location services. Another term that has come into use for this issue is 'latency equalization'. These co-location services have to be provided on the 'basis of objective, transparent and non-discriminatory criteria to the different types of users of the venue within the limits of the space, power, cooling or similar facilities available.'

The trading venues have to provide all users that have subscribed to the same co-location services with equivalent conditions – including space, power, cooling, cable length, access to data, market connectivity, technology, technical support and messaging types. In other words, access to a platform, from 'tick to trade' needs to be equal.

In addition, trading venues have to monitor all connections and latency measurements within the co-location services they offer, to ensure the non-discriminatory treatment of all users of each type of service offered. As well, the Trading venues must also be sure that users of co-location services are able to subscribe to only certain co-location services, and are not required to purchase bundled services.

Transparency is a significant component of this requirement too. Trading venues need to publish the details of these arrangements – including details about the co-location services they offer, the price of the services, the conditions for accessing the services, the different types of latency access that are available, procedures for the allocation of co-location space, and the requirements that third-party providers of co-location services must meet.

While many of the larger exchanges have already implemented Article 2, financial services firms that are operating trading venues need to be sure they are complying with these requirements. A first step is to be sure that the firm is working with a data centre operator that understands these specific requirements and is able to partner with the firm towards complete compliance.

September's Introduction of the Full Systematic Internaliser Regime

The industry is still waiting to see what the full impact of the MiFID II systematic internaliser (SI) regime will be as the requirement shifts from voluntary to mandatory registration for those breaching certain volume thresholds. Other firms that do not meet the mandatory thresholds are deciding whether to opt in to the SI regime. In the run-up to the January 3 implementation date, the SI regime presented a number of structural and technological challenges. Buy-side firms needed to understand which SIs to trade with and establish connections to them. Meanwhile, sell-side firms needed to decide whether to become an SI and establish appropriate reporting mechanisms to Approved Publication Arrangements (APAs).

So far, the MiFID II environment is evolving in interesting ways – SI registrations surged from around 20, before MiFID II, to more than 100 and rising, during the first quarter of 2018, even as registration remained voluntary. Fascinatingly, bonds and derivatives are now the top SI types.

This is just the beginning – the SI environment is set to change much more as the year progresses. On August 20, ESMA is scheduled to publish the official mandatory thresholds for SI registration, so firms can begin preparation for formal SI declaration on September 1. Sell-side firms should:

- Be registered as an SI as soon as possible, if the firm has not done so and it believes this is a path it would like to, or must, go down.
- Communicate the firm's SI status to clients clearly and rapidly. Get marketing involved. Help buy-side firms understand why they should use the firm's SI.
- Obtain intelligence about other, competitive SIs.
- Ensure that their SI program is fully compliant – with all processes and controls documented. This includes ensuring all Know Your Customer (KYC) processes for OTC counterparties – required for compliance with anti-money laundering as well as bribery and corruption rules – are being adhered to.
- Have a strategy in place for decision-making once the denominators are announced in September.

Availability of Market Reports for Best Execution and Other Considerations

Best execution reporting for MiFID II is designed to fundamentally alter the competitive landscape, but its full impact will take some time to be felt. For the sell-side, MiFID II adds work with the introduction of more venues and SIs offering bilateral liquidity. On best execution, the firms quoting bilateral liquidity must provide pre-trade transparency to support best execution. Post-trade, firms must supply a range of reporting to their regulator as well as the public on how well they execute transactions.

Firms on both the buy-side and sell-side are now implementing systems to look at the quality of execution to decide if they should continue trading on a venue – they also employ algorithms to work out in real time which venues to target. Yet it's early days, most firms are scrambling to achieve compliance and understand what kind of new data is available. Adding to the task is the fact that the actual new data available so far is patchy. As a result, most firms are some way off from actually using MiFID II data to drive business decisions.

The pressures to reduce the cost of trading while improving performance are increasing. While MiFID II offers more trading venues and unbundles research and execution fees to improve transparency and investor protection, changes like these are pushing up the cost of trading.

There are other issues, too. Buy-side firms did not have to capture and manage data in the same way as sell-side firms, until the advent of MiFID II – so today they are also facing big compliance bills. They are expanding solutions, investing in record keeping, extending analytics and hiring compliance officers, but not always reaching the level of data required. Many organizations are complaining that MiFID II has not solidified what firms must do, and has instead raised many unanswered questions. Key challenges for firms have included and include:

- Publishing the first RTS 28 report by April 30 – Firms must publish their five largest destinations for order flow, across the 22 different asset classes they are active in. While this can be done on a 'best effort' basis this year, regulators have indicated their expectations are high.
- Creating a governance process around RTS 28 data – Firms are meant to be reviewing this data regularly, not just once a year when they publish it.

- Preparing for June's RTS 27 reporting – Execution venues will have to publish data on the quality of their trade execution, and buy-side firms will need to demonstrate to regulators that they are actively using this data.
- Ensuring all best execution reporting is correct – Regulators are complaining that the data they are receiving from firms is not up to the required standard. Firms need to be sure that all trade reporting is accurate and all fields are completed – otherwise even their own best execution reporting and analysis will be very difficult.
- Double checking compliance – Ensuring all the required best execution policies are in place, and that they are up to date. It may be a good idea to review these policies, and related processes and controls, regularly to ensure they stay current – a firm's own internal systems may change as compliance with MiFID II evolves, for example, with the adoption of new technology systems.

Impact of Double Volume Caps

Under MiFID II's dark pools program, if more than 4% of stocks are traded in a dark pool on any trading venue, or 8% across all trading venues, over the previous 12 months, then dark pool trading in those stocks is suspended for six months. ESMA delayed publishing dark pool data for January and February 2018 until mid-March – the program was originally meant to be effective from January. It said the cause of the delay was poor quality data from the exchanges. In January 2018, 17 instruments passed the 4% cap and 10 in February 2018, while 727 instruments passed the 8% cap in January and 633 in February. Some significant companies have been caught up in this new regime, and will have their shares suspended from being traded in dark pools for a six-month period.

This approach is designed to boost growth in block trading, periodic auctions, and SIs, which are MiFID II compliant. Firms should:

- Review execution management systems to ensure they are compliant with dark pool trading caps.
- Update any compliance policies and processes that need tweaking in light of evolving approaches by the business units to meeting these requirements as they move to different trading venues and approaches.
- Consider how alternative trading practices for capped securities will be communicated to clients.

REVIEW OF WORK COMPLETED SO FAR

Regulators have not been shy about what they perceive the benefits of MiFID II to be for them. They plan to use the data to address market abuse, supervise individual firms, identify broad trends in financial markets, and run analytics to support policy. The FCA alone believes that it will capture 30-35 million transaction reports a day, up from 20 million before MiFID II – this is truly Big Data. It's expected that they will soon be using the information to accelerate examination and enforcement activities.

In the face of this coming enforcement focus, as well as the elements of MiFID II that are coming on line over the coming months, firms have a lot to do. If firms thought MiFID II was a sprint, they were wrong – it is a marathon.

A top priority must be industrialising MiFID II processes. While regulators have said they are willing to accept a certain amount of 'best effort' approaches in the first 12 months, over the medium-term they wish to see that firms are serious about sustainable MiFID II compliance. Regulators want to see robust approaches to processes like transaction reporting implemented – and the end of temporary work-arounds. Firms will benefit from industrializing their approach to compliance too – putting in place the right systems and processes will reduce costs, as well as risk.

Any MiFID II industrialization program must support the organization's overall business strategy – and here MiFID II will have enormous impact too. For example, when it comes to transaction reporting, there is much more to be done, not only to ensure compliant reporting, but also to gain value from the data and benefits to the business.

Another example is that best execution is more complex and more onerous under MiFID II than it was under MiFID I. Many of the new requirements relate to documenting and proving evidence of best execution. This involves significant records retention (5-7 years) and trade reconstruction obligations. It also involves time-stamping of key points along the order workflow. Physical proximity to a market's key matching engines remains of paramount importance if firms are serious about offering best execution to their clients. Yet, if firms are also beginning to sense a silver lining here, there could be particular business benefits resulting from the data management requirements of best execution.

In short, MiFID II will continue to be a compliance priority for much of 2018 – but smart firms will be looking beyond these short-term projects and finding ways to industrialize their processes, as well as use the quantities of MiFID II data to generate competitive edge and business value.

COMMODITIES & DERIVATIVES MARKETS

Maintaining market stability seems to have been the rationale behind the delay to introducing new freedoms around derivatives clearing – most of the exchanges, which own their own clearers, were just not ready.

MiFID II changes the rules around derivatives clearing, allowing open access for derivatives clearing. This permits investors to clear derivatives contracts via clearing houses that are not owned by the exchange on which the trades concerned took place. The original text of MiFID II permitted venues and clearing houses to petition regulators for a postponement until July 2020 to enforce the open access rules – and that is just what most of the EU-based exchanges have done.

Making the announcement on January 3, the UK FCA said: "Having taken into account the risks resulting from the application of the access rights under Article 36 as regards exchange-traded derivatives to the orderly functioning of the trading venues referred to above, as required by MiFIR [MiFID II's sister regulation, governing mostly transaction reporting], the FCA has decided to agree a transitional arrangement for those entities."

ESMA published a list of 12 venues that had received delays at the end of March. These include:

- Eurex Deutschland
- Eurex Clearing AG
- Euronext Amsterdam
- Euronext Brussels
- Euronext Lisbon
- Euronext Paris
- ICE Clear Europe
- ICE Endex Markets
- ICE Futures Europe
- LME Clear
- The London Metal Exchange
- Nasdaq Clearing.

(See link for more information: **https://www.esma.europa.eu/sites/default/files/library/esma70-155-4809_list_of_access_exemptions_art.54.pdf**.)

These changes were created with an eye to improving services and reducing fees in both trading and clearing. These new arrangements

could also reduce clearing costs thanks to benefits from the netting of off-setting margin payments. Financial services firms need to be ready to pivot to take advantage of changes here. If, for example, a firm wanted to clear derivatives transactions in France going forward, it would need to be working with a data centre operator that can could quickly deploy the transactions to a geographically close data centre.

On the other hand, trading venues, central clearing counterparties (CCPs) and regulators could deny access in particular conditions, as well as implement further transitional arrangements, undermining potential benefits.

These risks – and others – are heightened by the uncertainty around Brexit. It remains unclear as to what the transition and final regime for Brexit will be, and so firms should be ready to pivot their clearing operations in advance of the final Brexit withdrawal deadline in case of a 'hard' Brexit or other potential snafus. These issues should be addressed in any Brexit business continuity plan that a financial services firm puts in place.

However, if all goes well, the move creates the mouth-watering prospect of commodities and derivatives skipping a phase of development and moving directly to more final solutions with the benefit of lessons learned by practitioners in other asset markets from finessing their initial MiFID II approaches and the subsequent regulator response.

The move also puts the new implementation deadline after the initial deadline for the UK to leave the EU under Brexit – which may have also been a factor. Now, the industry will have a clearer understanding of the Brexit impact in this area before it decides its own course of action. Recommended actions include:

- Create a project group – The implementation of derivatives clearing freedoms has been delayed, but it's unlikely it will be delayed further. Having a team in place that can follow this important issue as it evolves is important.
- Target compliance carefully – For example, it is possible that CCPs based in the UK will be subject to additional supervision, thanks to a rule proposed by the European Commission in 2017. It will be important to get the detail right within the new regime, as it may be more subject to change than other areas of MiFID II that are less caught up in Brexit.
- Do due diligence – If the firm is considering working with new

clearing partners after July 2020, or consolidating clearing activity with just one or two, make sure due diligence is performed. Understand the strengths and weaknesses of the organisation, and how those align with the firm's own needs for support, and business drivers. Make sure that any cross border compliance issues are flagged from the start.

- Consider connectivity – If the firm plans to change its approach to clearing, make sure that the technology is there to support it, including the robustness of the connections between the trading venue, the clearer, and the firm.
- Communicate to clients – If the firm is substantially altering its approach to the clearing of these instruments, it should explain these changes to clients – including any benefits clients will see as a result.

MIFID II: WHAT NEXT?

It's clear that most firms will have quite a lot to do to ensure compliance with MiFID II, as elements of the directive come into force and delays to specific elements are resolved. As well, firms will have to consider how they industrialize their approach to MiFID II compliance, and leverage their investment to drive business value – from both the data and their engagement with clients. However, there are other key issues outstanding too:

How long before regulators test practitioners' solutions and/or impose penalties on substandard compliance? Sooner rather than later – ESMA has already started to crack down on the way firms are reporting trades. In another example, the FCA has indicated in various places that it will begin reviewing firms' approaches in the second half of 2018 in key areas, including trade reporting.

Firms can also expect Europe's regulators to begin to use the data generated by MiFID II for analysis around market abuse and other practices. It's expected that regulators will make examples of early firms they catch complying with MiFID II in a sub-optimal way.

What will be impact of Brexit on enforcement? Who will enforce? What does uncertainty mean for UK-based players/entities? Brexit negotiations continue to rumble on, with the financial services industry becoming a particularly sticky area of the negotiations. Overall, it's likely that the UK's regulators will continue to adhere to most EU rules post-Brexit, to ensure that the regulatory regimes remain aligned enough to ensure equivalence. However, EU countries may try to obtain elements of the financial services industry that currently sit in London – meaning there could be some fragmentation of some business. It's also likely that UK regulators will continue to have close working relationships with other supervisors when it comes to enforcement – particularly in areas such as anti-money laundering/ know your customer and market abuse. This means, for now, that firms should anticipate continued adherence to MiFID II rules for at least the next five years.

The impact of all this on choice of location: extends to the 'coal face' of data centre operations. MiFID II, as well as Brexit, make having the right access to key markets across the EU – as well as London – more important than ever. Financial services organizations must be nimble in this rapidly evolving environment – able to rapidly pivot to meet both regulatory and client needs quickly and in a compliant manner.

Firms need to ensure they are well-positioned to take advantage of the opportunities that MiFID II may present – across their entire field of trading operations.

HOW INTERXION CAN HELP

In the new world of MiFID II, geographical proximity is more important than ever – and Interxion's connections make it unequalled in terms of European trading venue access. Interxion's state-of-the-art LON-3 facility in London, complements its key LON-1 site with close proximity to all UK markets. These include Slough (Cboe Europe, EBS and others), City of London (London Stock Exchange), Docklands (Thomson Reuters Technical Centre), and Basildon (ICE Futures Europe/Liffe and Euronext markets). In addition, Interxion can offer microwave and other low-latency connectivity channels to Frankfurt/Eschborn for Deutsche Boerse's Xetra cash and Eurex derivatives markets.

This central location yields major speed advantages for multi-venue trading strategies and enables optimal order book aggregation/ consolidation under MiFID II. Interxion's London data centre houses all the major POPs for connectivity to all of Europe's major exchanges, multilateral trading facilities (MTFs) and broker routing systems. It also has a pan-European network of data centres for local access to markets in Germany, Netherlands, France, Italy, Spain, and others.

Interxion's pan-European geographic footprint of data centres will enable firms to nimbly capture potential benefits from the new, more flexible derivatives clearing environment, when it is finally launched in 2020. Interxion can also help firms be prepared for Brexit – and know that their ability to trade and their business processes are safe no matter what shape Brexit takes.

Interxion's experience in helping trading venues comply with MiFID II's Article 2 will provide reassurance to their compliance teams that clients are experiencing the organization's services as they should be. Regulators are clear that Article 2 is important – all clients using the same services should be on an equal footing – and so it's important for trading venues to be working with a data centre operator that can provide the right technology in the right location, as well as the expertise in understanding MiFID II's specific requirements in this area.

Interxion's community of independent software vendors (ISVs) – offering time-synchronisation, everything from time stamping and order aggregation, to pre-trade risk controls and more – provide on-site access to key value-added services to facilitate high-performance trading and regulatory compliance under MiFID II.

The Interxion London Financial Services hub is one of the most established data centre communities in Europe, enabling customers to effectively execute their European trading strategy and plan for future business growth.

ABOUT INTERXION

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Interxion (NYSE: INXN) is a leading provider of carrier and cloud-neutral colocation data centre services in Europe, serving a wide range of customers through 50 data centres in 11 European countries. Interxion's uniformly designed, energy efficient data centres offer customers extensive security and uptime for their mission-critical applications. With over 700 connectivity providers, 21 European Internet exchanges, and most leading cloud and digital media platforms across its footprint, Interxion has created connectivity, cloud, content and finance hubs that foster growing customer communities of interest.

For more information, please visit **www.interxion.com**.

ABOUT A-TEAM GROUP

A-TEAMGROUP

A-Team Group provides news and analysis, white papers, webinars, events and more through our two online communities:

- Intelligent Trading Technology
  www.intelligenttradingtechnology.com
- Data Management Review
  www.datamanagementreview.com

The A-Team Group also organise the RegTech Summit for Capital Markets 2018 taking place on October 4, 2018 in **London (http://bit.ly/RegtechCMLdn18)** and on November 15, 2018 in **New York (http://bit.ly/RegtechCMNYC18)**.

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