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ONE-ON-ONE INTERVIEW

DEVELOPING EFFECTIVE MIFID II CONTROLS AND COMPLIANCE PROGRAMMES



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R&C: How would you describe the impact that the Markets in Financial Instruments Directive II (MiFID II) is having on financial institutions (FIs)? In your view, where will the regulatory focus be in the future?

Taccogna: The Markets in Financial Instruments Directive II (MiFID II) has introduced a wide and diverse range of requirements, which have had, and will continue to have, a radical impact on FIs. To achieve compliance, firms have transformed their processes, documentation, governance and systems. The ‘real’ impact – the one on business models and profits – however, will only become fully apparent in the coming months. The industry’s attention is therefore likely to gradually switch from operational challenges to strategies, services, products and distribution channels. Furthermore, the industry expects UK and European regulators to engage with firms to assess impact, compliance and challenges. Clarification and even changes are not to be ruled out, especially with Brexit on the horizon, and FIs should continue to be alert to them.

R&C: What have been the main challenges faced by FIs in implementing business practices and systems from a product and client governance

perspective? How do you see the debate about governance evolving?

Taccogna: Some FIs reported challenges in interpreting and implementing rules that appear to have been designed with exclusively retail clients in mind, and were difficult to apply to products and services offered to professional clients. The European Securities and Markets Authority (ESMA) recently published clarification in regard to this, but debate on interpretation is likely to continue. Implementing changes has meant not just transforming product and pricing strategies but also delivering the cultural shift of having to more demonstrably balance commercial drivers and investors’ interests in the price formation process. From an operational point of view, client information and classification has been one of the more frequent challenges. For example, not all firms have developed system capabilities to apply multiple client classifications across products and this could make identification of best execution requirements more difficult. In general, to remain compliant, firms should continue to treat the product and governance lifecycles as closely aligned and invest in updating their legacy infrastructure. This will become increasingly relevant as rapid and fundamental technology developments continue to transform the industry. For example, the use of automation for investment advice provision and portfolio management is likely to pose further

challenges and lead to evolution and clarification of product and client governance obligations. Firms that have implemented more flexible and agile system solutions are likely to come out as the winners in the longer term, and those that have not should start to explore how they can obtain commercial benefit in a changing competitive landscape.

R&C: Could you outline the key issues surrounding inducements, conflicts of interest and cost and charges under MiFID II? What controls should FIs establish to ensure compliance?

Taccogna: MiFID II places emphasis on the need for firms to demonstrate that fees, charges and non-monetary benefits – both paid and received – demonstrably enhance their services and do not impair the firm’s ability to act in the best interests of its clients. One of the challenges faced by firms in implementing these requirements has been the identification and traceability of all such fees, historically ‘hidden’ within prices. Unbundling them has therefore often meant redesigning pricing strategies and has led to some players withdrawing from markets where they cannot be aggressively competitive. An early example being observed is the change occurring in the relationship between brokers and fund managers. Historically, brokers

have bundled into an overall charge services such as ‘corporate access’ – meaning the arrangement of meetings and introductions for fund managers with prospective investors. As MiFID II now requires them to price the service separately, fund managers are proving reluctant to absorb the charge and are seeking to bypass it, by arranging meetings

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directly. The impact of this development may not be insignificant for small brokers and may lead, once again, to a shift in business models. The specificity of newly-introduced requirements has also posed challenges for the compliance function. It has, for example, led to the need to design novel and more complex approaches to the monitoring of price formation, research frameworks and budget controls. This, in turn, has generated demand for resources which are equally versed in regulatory interpretation as they are in commercial practices and the use

of advanced technologies. Unsurprisingly, these resources are in short supply and firms with more effective resourcing approaches are likely to gain a competitive advantage over those which are slower to react, or reluctant to invest in this space.

R&C: How have FIs met best execution obligation? What challenges lie ahead?

Taccogna: The fundamental concept of ‘best execution’ has been slow to embed itself in the collective consciousness of FIs. Best execution does not mean obtaining the best price; rather it represents the duty to obtain the best compromise between multiple contradictory factors of execution, for the client. It has prompted a Financial Conduct Authority (FCA) Thematic Review on the subject, and with varying degrees of difficulty, firms have managed to implement the basic requirement – the enhancement of their order and best execution policies and procedures. Monitoring best execution and producing insightful management information on it, and being able to justify execution quality upon challenge and to report it, are heavily dependent on high-quality data, and the availability of enhanced transaction analytics. Technology capabilities are likely, therefore, to become a competitive differentiator, as MiFID II becomes truly embedded. Moreover, as a result of the structural market changes driven by the new requirements, participants now need to interact with a more

complex range of trading venues in addition to their traditional sources of liquidity to achieve best execution. This is an opportunity that some technology-centric firms have started to harness and is a trend which we believe will intensify.

R&C: What advice would you offer to FIs on meeting their transparency and reporting requirements under MiFID II?

Taccogna: From an operational perspective, the increased scope and variety of deferrals and waivers have made achieving compliance a challenging task. The obvious advice to firms is to treat this as an evolving endeavour and continue to validate assumptions, reporting scenarios and trading strategies, and implement, whenever possible, flexible analytical solutions that will withstand the test of time more easily. Firms should also consider developing a combined approach to reporting both within the boundaries of MiFID II and beyond it, to achieve efficiencies but also utilise data and insight to harness opportunities. Some areas of overlap between MiFID II and other data-related regulation, for example the General Data Protection Regulation (GDPR), will also continue to contribute to complexity and FIs will have to continue to interpret requirements and adapt systems accordingly. From a strategic point of view, numerous firms expressed concerns, during the implementation stages of new regulation, that transparency requirements – in

particular, the obligation to execute on indicative prices – would adversely affect liquidity. While it is possibly too early to make a conclusive assessment, this remains a crucial aspect of the debate and is likely to drive future changes.

R&C: What solutions are available to help FIs address the cost, complexity and risk management demands of MiFID II?

Taccogna: It is apparent that the new rules have led to a fundamental reshaping of the way in which FIs operate and position themselves.

Debate is very much alive, and the actual impact of changes will become fully evident over the coming months. Further evolution of the current standards, in the context of the wider regulatory and political landscape, is almost unavoidable. Technology and compliance expertise will, in our view, not only continue to enable compliance with complex requirements but also provide cost efficiencies and support strategic change. Firms that intelligently invest in these two areas, both from a human and a system resource point of view, are likely to better withstand the future challenges that MiFID II undoubtedly has in store. **RC**