MiFID II: Meeting the compliance challenge

Approaching MiFID II as a business risk exercise
Choosing the right vendors is mission-critical
Compliance issues ahead of January 2018 deadline
In this issue...

03 Choosing the right MiFID II vendors is mission-critical
By James Williams

06 Approach MiFID II as a business risk exercise
Interview with George Ralph, RFA

08 Setting out a compliance roadmap
Interview with Julian Korek & Nick Bayley, Duff & Phelps

12 Colt offers substantial infrastructure ecosystem
Interview with Ralph Achkar, Colt Capital Markets

14 Centralise your data management to cope with transaction reporting
Interview with Paul Yau, Advise Technologies

16 Compliance considerations ahead of January deadline
By James Williams

19 MiFID II could accelerate buy-side control of execution intelligence
Interview with Allan Goldstein, Trade Informatics

23 Product governance considerations under MiFID II
Interview with Mario Mantrisi, Gary Janaway & Raymond Groen in’t Woud, KNEIP

26 Unlocking the research market
Interview with Jeremy Davies & Vicky Sanders, RSRCHXchange
Choosing the right MiFID II vendors is mission-critical

By James Williams

The introduction of MiFID II and MiFIR on 3rd January 2018 will impact every aspect of how financial institutions do business. The scale of the task cannot be underestimated. For buy-side firms, getting the right vendor relationships in place will be vital to ensuring that they operate under the regulations in as efficient and compliant a way as possible.

To help frame this vendor selection exercise, in March 2017 the Alternative Investment Management Association (AIMA) compiled a report, detailing the most effective third party vendor solutions. These span: transaction reporting; post-trade reporting; best execution/transaction cost analysis; telephone recording and surveillance; research budgeting, and commodities position monitoring.

Most buy-side firms will need to make some level of adjustment to their internal IT systems to ensure the above areas of MiFID II can be handled.

“MiFID II is significant, more so than a lot of firms realise; particularly smaller asset managers,” asserts Leonard Ng, Partner at Sidley Austin LLP. “As it touches every part of operations, trading and governance, the buy-side can’t treat it just as a compliance disclosure issue.

“It will impact the way asset managers do business and large financial institutions understand that this requires changing their business model. If you are a hedge fund and you haven’t done anything to prepare for MiFID II, you’re going to find yourself in a difficult situation because you’ll have to make a lot of changes to your internal processes, not just from a compliance perspective but from a business, strategic and commercial perspective.”
Transaction reporting
Arguably one of the biggest challenges facing fund managers is T+1 transaction reporting. Managers will have the option of either handling this function internally and build the necessary systems to capture the data, cleanse it and report to the regulator, or, which is more likely to happen, appoint a third party vendor known as an Approved Reporting Mechanism (ARM). A third option is to use a vendor such as IHS Markit.

“We are not an ARM, we sit above that,” explains Kirston Winters, Managing Director at IHS Markit. “We provide the business logic and a data management system with all the mapping in place to disseminate data to the various ARMs, National Competent Authorities and APAs. We work with our clients to plumb in the data from all of their existing sources and then we run it through our validation models, so that when the client submits the transaction report T+1 they already know there are no issues.”

Getting the data right up front, at the pre-validation phase, identifying any gaps, etc, will require a change in mindset. Once the transaction report is populated, and the file is completed, IHS Markit’s clients send the validated report to the ARM to file on their behalf, or file it themselves.

The problem with MiFID II is that it is a real data challenge. MiFID firms were required to transaction report on equities, previously, but most buy-side firms could simply delegate this to their broker(s). That is not likely to happen under MiFID II, which will require information not only on equities, but OTC derivatives, exchange-traded derivatives, FX, bonds and commodities.

“Uniquely, the regulator will not just want information about the transaction, but also on the entity and the individual making the decision.”

Kirston Winters, IHS Markit

universe of data. For example, a broker’s reporting requirements in addition to transaction reporting e.g. trade reporting to an Approved Publication Arrangement, Annex IV reporting, EMIR reporting.

There’s no point building bespoke solutions for each regulatory demand as this replicates the cost base.

“Given its breadth, our clients are looking to put a comprehensive solution in place to replace some of their legacy systems. A future proof solution that not only handles MiFID II but also takes out some of these legacy system approaches that were used previously,” adds Winters.

Alejandro Perez is Global Head of Post-Trade Solutions at Bloomberg, which offers a complete suite of solutions under MiFID II from pre-trade workflows (pre-trade analytics, order management), execution workflows (routing and execution) to post-trade workflows (transaction reporting, best execution). He explains that under MiFID II, the handling of personally identifiable information means that the buy-side will likely minimise the amount of reporting it outsources to its trading counterparties.

“We believe most institutions will choose to do the transaction report themselves, either through a third party ARM or by submitting it on their own, if they have the capabilities,” he says.

Bloomberg is currently building a personal information database to house all the PII data from its clients, which can then be appended to a transaction report and submitted to the regulators.

“It is important for clients to understand how much data they will need to submit to their appointed third party. They should ensure that the third party can evaluate it in good time and provide the appropriate dashboard capabilities to ensure that clients are aware of what’s rejected, what’s accepted, and what needs to be...
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Approach MiFID II as a business risk exercise

Interview with George Ralph

MiFID II comes into effect on 3rd January 2018 and will likely require fund managers to make significant changes to their systems, governance and controls & procedures.

One of the first preparatory steps to take is for fund managers to gain a clear understanding of exactly how the regulation will impact them through an impact assessment and gap analysis.

Developing an implementation project plan is not an easy task and will require a joined up analysis across the various functions of the firm. Some key areas of focus will centre around commissions, the use of research and how it is paid for going forward; obligations around best execution; transaction reporting and record keeping; as well as regulatory reporting, data management and phone recording.

According to George Ralph, Managing Director of RFA, whose fully managed IT offering gives alternative fund managers complete technology infrastructure support, the reporting and the recording of information is going to be the biggest challenge to most fund managers. “Our approach is to help clients prepare for MiFID II from a technical perspective. In addition to working out the scope of work, it is necessary to identify the gaps in the client’s current communications and data management infrastructure; identifying data retention requirements, working out the data lifecycle to determine where and how they will need to store the data. And finally, identifying a trusted partner who can manage their infrastructure in compliance with the new regulation.”

Gap analysis will typically involve identifying gaps in a manager’s existing workflow and business process, or in the solutions being provided by their vendors. Take data categorisation, for example. Ralph says that working out how to classify data sets and ensuring the categorisation is accurate and complete is going to be critical, “And I don't think many fund managers have yet established a clear roadmap that sets forth how and where to begin this.”

“The data categorisation exercise overlaps somewhat with GDPR, which already presents challenges. We have one client who buys and sells pension debt. That data is going to contain people’s health records because of their due diligence process. Even if the fund manager adequately stores and protects their data, their data processor could still be on the hook under GDPR if they do not do the same and would face a potential 4% penalty.

“There is more focus on the service provider now, and a move under GDPR towards more of a shared risk model, which is how we have been working as a firm for years.”

Ralph notes that taking a partnership approach is important and needs to be led in conjunction with the CCO or COO. “The CCO/COO will know, from a compliance perspective, what to look for and our role, effectively, is to help them put the pieces of the puzzle together. If you get into the weeds of MiFID II, even the communications recording – i.e. video conferences, face-to-face meetings, phone conferences – will create three different sets of data.”

“There are lots of questions that relate to how you read metadata in different data formats to create the necessary output in one place,” says Ralph, adding that firms will be required to store voice data for five to seven years.

For smaller fund managers, this could prove prohibitively expensive. “What I advise our clients is to plan for seven years,” concludes Ralph.
managed from an exception perspective,” comments Perez.

As well as providing transaction reporting capabilities, Bloomberg can give its clients transparency reporting capabilities, record keeping, trade surveillance, best execution capabilities as well as research evaluation tools.

“Over the last six to nine months we’ve worked on consolidating those products so that if a client is ticketing in Bloomberg, using one of our order management systems or our MTF, there should be a seamless integration of data within the Bloomberg infrastructure, which can then be passed to record keeping, to best execution, to our Approved Reporting Mechanism for transaction reporting, and so on,” explains Mark Croxon, Head of Regulatory and Market Strategy EMEA at Bloomberg.

Role of the ARM

Firms will not be able to merely pull raw data from a core system and push it out to the regulator. The transaction report will require far more in terms of data contextualisation, such as matching ISIN codes against OTC trades, making sure they have Legal Entity Identifier (LEI) data properly tagged and accounted for; issues that are likely to prove quite challenging for smaller fund managers.

“Contextualising data and populating certain pieces of information that in the past there was no need to source, will not be straightforward,” explains Geraldine Gibson, CEO of AQMetrics, which operates an Irish-authorised ARM. “It’s not the number of fields in the transaction report but the sourcing of the data, for a small sub-set of those fields, that will cause the main challenge. If an LEI is missing for an OTC position, for example, how will that get managed?”

Ultimately, MiFID II is all about data handling. “We look at whether you can get the data that you require for MiFID II from your source systems – internal IR systems, CRM systems, etc - which can then be pulled together and staged, contextualised and prepared for transaction reporting. This process enables us to identify which data is missing in clients’ source systems that will need to be handled by AQMetrics.

“If the manager doesn’t have an in-house repository for LEI data, which a lot of small managers lack, as their appointed ARM we will pull all that data together from the necessary external sources. It’s a very controlled exercise. It has to be because if we miss any of the data for transaction reporting, it becomes problematic,” outlines Gibson.

Research unbundling

One entirely new market that is springing up as a result of MiFID II is research. Buy-side firms will now be required to unbundlere investment research and separate what they receive from their trade commissioning. The objective to this is to enhance investor protection and to ensure that the investment manager consistently acts in his clients’ best interests. This means operating a dedicated research budget where the efficacy and value of that research must be continuously assessed.

There are various implications to this. Some fear that the volume of research will subside and put smaller independent research providers out of business. Others argue that it could in fact give independent providers access to a wider audience of clients as research platforms emerge to disintermediate the process, effectively sitting between the manager and the sell-side research desk.

One such platform is London-based RSRCHXchange. As co-founder Jeremy Davies explains, the platform was initially built with the buy-side community firmly in mind but a couple of recent developments have lead to them to more actively support the sell-side; the aim is to have 300 research providers on the platform by year-end.

“Firstly, we’ve taken on Alan McDonald who was formerly head of research at Nomura and UBS, to help answer problems faced by the sell-side and provide an effective solution.

“It is important for clients to understand how much data they will need to submit to their appointed third party.”

Alejandro Perez, Bloomberg
At the last count, there were approximately 1,384 pieces of information to look through under MiFID II. For Chief Compliance Officers, that is an awful lot of work to get on top of, which is why implementing a compliance roadmap as early as possible is so important.

To help with this, Duff & Phelps, one of the industry’s leading regulatory compliance firms, has produced a solution named MAST: MiFID Analyser Solution & Tracker. This enables people to fast track in and identify, according to the permissions they have, what rules are likely to hit them and identify a ‘To do’ list for the areas that will require amending.

They can then track the progress of those amendments by using the tracker component of MAST. It’s a sophisticated tool that has taken Duff & Phelps nine months to build. “Given the need for MiFID firms to start transaction reporting, the sooner they think about it the better because it is likely going to require new systems, implementation of those systems, testing and so on,” explains Julian Korek, Global Head of Compliance and Regulatory Consultancy.

Putting a compliance ‘to do’ list together certainly has its merits, although it is predicated on the assumption that CCOs can prioritise elements of MiFID II. While taking practical steps to identify key areas such as transaction reporting, is a sensible approach, buy-side firms should not fall into the trap of relegating other areas in the hope that the FCA will take a compassionate view.

“People are very stretched,” says Nick Bayley, Managing Director in Duff & Phelps’ Compliance and Regulatory Consulting Practice. “I doubt that the FCA would pay someone a visit and interrogate every single aspect of their MiFID II preparation but, having worked there and knowing how they operate, they will likely be more worried about some aspects of MiFID II than others.”

Cutting corners is not advised although Bayley believes there are some changes that firms should be focusing on now, and quite a few that they could leave until later in the year.

Clearly, a firm that needs to change its permissions or apply for new waivers will need to act fast and anything system or data related like transaction reporting or transparency needs early focus.

Korek’s point about IT systems is important as part of the roadmap exercise. Speak to most people and the common consensus with MiFID II is that it is a data management challenge, over and above anything else. If the internal systems are not up to task, this could present serious challenges moving forward.

Take transaction reporting as an example. If the FCA comes knocking and asks for full details on a specific transaction, the manager had best be able to supply it quickly. Taking a ham-fisted approach by submitting a batch file and asking the market abuse team at the FCA to find it themselves, will not endear the manager to them.

“If the market abuse team sends you an information request you’ve got to be able to retrieve that information quickly. Spending weeks looking for it is not going to be acceptable. Rather, the FCA will start asking serious questions as to whether your record keeping is of a high enough standard.

“Under MiFID II, firms will need to be able to pinpoint data in a more organised way than they currently do. They are going to have to provide more granular data to clients, more information on things such as costs and charges, more information on the quality of trade execution. This is not necessarily something they’ve needed to do in such
expect firms to be able to look right across their records and link them to transaction activity. Any records that inform the decision to trade are potentially relevant. The MiFID II 5-year record keeping obligation includes a wider information set and with respect to unstructured data like voice communications, it's pretty hard to link to transactions and retrieve,” asserts Bayley.

“If you are a CCO and one of your traders does something strange, if you can’t access the relevant communications data that contributed to why a trade or set of trades was made, your life could become extremely difficult,” suggests Bayley.

Given the scale of the challenge, what can be left for later? Internal matters that do not involve significant IT or business process changes may have to take a back seat for now. Compliance procedures will need to be updated and there will need to be additional compliance monitoring but this is perhaps less important, at this point in the lifecycle, than the matter above.

Bayley is hopeful the FCA will signal what its MiFID II supervisory priorities will be later this year. He says managers must read the signals – research unbundling has long been an FCA hobby-horse, poor transaction reporting has led to lots of enforcement action over the years “and the quality of best execution by asset managers has been clearly signalled as being of concern to the FCA”.

Above all, don’t be an outlier – find out what others are doing and play catch-up if needs be.

**External intelligence**

It’s important to undertake an external intelligence gathering exercise. Engage in discussions with all relevant counterparties. For research unbundling, look at what research you receive, who is comes from, and crucially what value the front office places on it.

Look at your IT vendors, those providing market connectivity, market data, best execution tools, phone recording, data management systems and the like – and ask them how their products are going to be enhanced to be ready for MiFID II, says Bayley.

Find out if their systems are going to include the additional data fields, whether they will cover the new requirements for non-equity and whether they have a solution to your particular challenge.

“There are lots of areas where early discussions should be initiated and I am seeing a widespread exercise of request information about MiFID II kicking off in the marketplace,” confirms Bayley.

**Internal assessment**

At the same time firms should conduct a review of internal readiness. Managers should assess their IT and record-keeping infrastructure and understand where all the required data is stored. This is going to be especially important for transaction reporting. Across those 65 fields, where is the data, who owns it and how is it going to be retrieved and organised?

Moreover, for those who have a transparency (trade reporting) obligation, they will face the pressure of handling information (albeit a smaller data set) that will need to be reported in near real-time; within one minute in the case of equity trading.

Part of this exercise should involve gap analysis on the client’s existing internal IT systems to ascertain whether they will be able to access data and monitor it effectively.

“For fund managers, it is also the MAR obligations to detect market abuse and market manipulation that they should have in minds when looking at how the manage their MiFID II record-keeping. Regulators
“Secondly, there has been an epiphany among sell-side firms that technology can really solve something. As they go through the process of understanding who their research clients are, what research they consume and how they value their content (aside from being linked to trading commissions), by using a research platform like ours they can more effectively manage those relationships. Ultimately, they can distribute their research to clients who might not necessarily be core clients,” explains Davies.

Uber ratings
One unique aspect of research platforms like RSRCHXchange is the ability for the buy-side to track their research consumption. “We can show you what you’ve read and only we can show you how that research has been consumed and rated. It is simple, effective and done in real-time with no need for reconciliation. It’s like rating an Uber driver.

“Other people can provide you with files to reconcile against, but they cannot necessarily provide evidence of consumption. The platform lets you rate the research as you read it, rather than have to wait till the end of the week,” adds co-founder Vicky Sanders.

There is no doubt that unbundling research from trade commissions puts a significant burden on the buy-side. For the sell-side, there’s really only one requirement, which is to price and separately supply their research.

But that has many potential consequences if one thinks about why a research department exists.

“They will need to adapt,” states Sanders.

“Some institutions who perhaps feel they have been underpaid for producing research are excited by the opportunity to sell it separately. Others are looking to understand how to drive their research department, going forward, and determine what will be their main revenue drivers. What do they do best and what do clients really value?”

One of the ongoing debates is how the payments for research should be funded and what the price level should be, particularly for non-equity research. Croxon thinks that while most firms will likely be compliant in terms of paying for research, by January 2018, it might take time to determine what the pricing schedules and arrangements will be.

Whatever the accepted model becomes, Bloomberg has focused on two areas for the buy-side, from a product development perspective.

“The first is to take our entitlements database, which has traditionally been used by the sell-side for the provision of research, and retool it so that the buy-side can also use it to entitle what research they wish to receive at fund and firm level, and implement controls to prevent inducement.

“The second area relates to demonstrating both the value and the price of the research you receive. We have evaluation tools that allow managers to create customisable scales of up to seven or eight levels of evaluation on research. They can manage entitlements such that they only receive research for those they want to receive it from, and then evaluate the quality of that research in all of its various forms,” explains Croxon.

Best execution and TCA
Aside from transaction reporting and research unbundling, a third important area relates to best execution/transaction cost analysis.

Under MiFID II investment firms will be required to:

• Monitor the effectiveness of their order execution arrangements and execution policy in order to identify and, where appropriate, correct any deficiencies.
• Publish a summary of the analysis and conclusions it draws for each class of financial instruments from its detailed monitoring.
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Colt offers substantial infrastructure ecosystem

Interview with Ralph Achkar

Colt Technologies is a private telecoms company owned by Fidelity. It delivers secure, on-demand services designed to meet the stringent requirements and speed of the financial markets. Among the more than 400 capital markets firms it supports worldwide includes 18 of the 25 largest global banks and 13 European central banks. With both sell-side and buy-side firms looking for reliable access to market data under MiFID II, having the requisite market infrastructure in place is a potentially daunting task.

This is where Colt Technologies – specifically its Colt Capital Markets division – comes in. Using Colt PrizmNet, a fully managed financial extranet that connects to over 10,000 capital markets organisations, MiFID firms can leverage Colt’s low-latency infrastructure without the stress of trying to build their own infrastructure and connectivity solutions.

Colt PrizmNet is helping to create a rich ecosystem that aims to facilitate the cost and complexity of operating under MiFID II.

“We leverage Colt’s assets: the network, the reach, the distribution capabilities,” says Ralph Achkar, Strategic Alliances Director, Colt Capital Markets. “We have approximately 500 clients globally, supporting everybody from pension funds, Tier 1 banks, long-only mutual fund houses, high frequency traders and agency brokers, as well as exchanges and clearing houses.

“We are building out these services to provide managed services to capital market clients that combine the network with the ability to locate, host and operate infrastructure in third party data centres or exchange data centres, as well as provide them with connectivity to the exchanges and market data.”

Colt has identified several core areas where they are able to support capital markets clients with their MiFID II requirements by leveraging Colt PrizmNet for network access, time stamping, algorithmic testing and market data. These include: organisational requirements, trading mechanisms, financial instruments, market structure, and, with respect to transparency, transaction reporting, trade reporting and investor protection.

“If you have software that meets a MiFID II requirement, for example algorithmic testing, we can host the solution and offer it to the market as a managed service. We work with a partner called TraderServe in this capacity. One of our approaches, therefore, is to look at different providers that offer deployed solutions and offer them the ability to enrich those solutions by using our network infrastructure and all the market data, providing a complete end-to-end solution,” explains Achkar.

The second approach is to build on the Colt PrizmNet extranet to leverage Colt’s connectivity reach. Given that in Europe alone it reaches into more than 10,000 commercial buildings, Achkar said it might make sense to extend that connectivity to a wider range of service providers, in effect building an ecosystem that connects vendors with consumers.

“One specific area we are targeting is to attract vendors offering MiFID II solutions. For example, ARMs or APAs for transaction and trade reporting, so that they don’t have to build connectivity and lines to different parts of the market. They can access one connection using Colt PrizmNet, which customers can then directly interact with in the ecosystem,” explains Achkar.

“With the infrastructure and the market data that enables any solution to run optimally under MiFID II. For investment firms who need to reach a destination such as a transaction reporting facility, we want to make reaching such a destination on Colt PrizmNet as simple as possible,” concludes Achkar.
Report on the top five entities used for transmission/placing of client orders for each class of financial instruments and provide information on the quality of execution obtained by those entities who executed the orders.

"We’ve been running a TCA, best execution solution for a number of years, where the primary objective of the tool was to provide actionable insight to help equity clients adapt their trading styles. With the expansion into non-equities, we’ve adapted the solution into a multi-asset class environment to meet the best execution requirement," confirms Michael Richter, Director of Markit Trading Analytics at IHS Markit.

This will enable institutions to run TCA and best execution on instruments such as CDS and IRS, which up until now have mainly traded OTC.

How one can determine best execution on an OTC derivative raises an interesting question. These instruments are not freely traded like equities, they are far more institutional and bilateral in nature.

"Using an evaluated price based on a number of different inputs, at this stage, is the best way forwards in these asset classes where execution data is not plentiful. The regulators understand there are pitfalls to this. What they will want to see is that firms can demonstrate a process for best execution and our offering on a T+1 basis allows firms to do just that.

“This process also has to be in line with an organisation’s best execution policy, which needs to be constantly updated. The regulator wants it to be a living, breathing document," explains Richter.

**Leveraging existing infrastructure**

In conclusion, Ralph Achkar, Strategic Alliances Director, Colt Capital Markets, believes it is important to select a vendor who is open to a partnership approach where they work with other best-of-breed vendors to offer the end client a functioning solution.

“We realised that no matter how much we do, no one vendor is capable of implementing everything. That’s why we started reaching out to different vendors to ask them to join our Colt PrizmNet ecosystem.

“For an ARM, rather than having to build out their own infrastructure, they can use Colt’s infrastructure, which has connectivity to over 10,000 capital markets locations. It becomes much easier and quicker for customers to reach ARM services, rather than having to build their own connectivity.”

This ability to provide access to best-of-breed vendor solutions enabled with market data, from trade surveillance to transaction reporting, is a novel way to supporting vendors under MiFID II.

“It avoids having to incur the cost of running multiple components in an infrastructure with lots of systems and equipment. With such an ecosystem approach, you use one set of physical connections to reach a whole range of services,” concludes Achkar.
Centralise your data management to cope with transaction reporting

**Interview with Paul Yau**

MiFID II aims to increase the accountability and transparency of the financial services industry and represents the latest in a long line of regulatory developments since the '08 global financial crash.

Both buy-side and sell-side MiFID regulated firms are busy focusing on exactly how reporting obligations will impact their existing IT system configurations. According to Paul Yau, Senior Regulatory Counsel at Advise Technologies, whose Consensus Regulatory Management System is used by investment managers for a repeatable, reliable, and automated filing process, the current environment reminds him of when firms were preparing for Annex IV reporting under AIFMD a few years ago.

“This was a substantial regulatory hurdle faced by alternative fund managers. There were a lot of questions being asked, people attended industry events and working groups and I feel the environment is similar with MiFID II, specifically as it relates to transaction reporting.

“One manager I spoke to recently was discussing transaction reporting and working on an implementation roadmap, ahead of Q3, but had not yet decided whether to develop a reporting solution in-house or use an outsourced provider,” says Yau.

This ultimately depends on figuring out what transactions need to be reported and the amount of work that will be involved sourcing and managing that data.

One big issue that both the buy-side and sell-side are trying to figure out is the extent to which managers can delegate transaction reporting under MiFID II. The increase in data that will need to be reported will be substantial.

By the time buy-side organisations go through the exercise of collating all that data, submitting it to their broker(s) to delegate the reporting, which leads to an additional layer of data reconciliation, they might as well just report themselves. Delegated reporting may end up being more operationally burdensome, according to Yau.

That said, there might be a bit of a complication in that while some brokers might offer a delegated reporting system, other brokers may choose not to. As firms have a best execution obligation to act most favourably in how they execute trades for their clients, choosing a particular broker just because they offer delegated reporting will not necessarily mean the client is also getting best execution services.

“This is something managers need to think about. They shouldn’t just select a broker because they can do delegated reporting. The amount of personally identifiable information that a manager has to provide in a transaction report, means that some brokers are going to be reluctant to offer that service. One manager I spoke to recently feels that they will not be able to rely on their broker for transaction reporting given the complexity of the data involved and are looking instead to use an Approved Reporting Mechanism,” confirms Yau.

He confirms that Advise Technologies intends to provide a solution offering to help with transaction reporting by becoming a registered ARM with the FCA. This is currently going through the authorisation process.

If one compares it to Annex IV, ultimately transaction reporting is a data gathering exercise.
Advise Technologies

Asset managers need to do a gap analysis on what they need to report and then pull together all the necessary counterparty data, trade data, risk data, investor data, and so on, from different sources, including static fund data.

“It is important to put all of the data from these different sources in a central place, given the volume of data that will be reported under MiFID II. It is increasing from 23 data fields under MiFID I to 65 data fields for transaction reporting under MiFID II. My advice to clients is, ‘Get your data organised, clean it and make sure it is accurate, so that you can report directly or pipe it directly to an ARM’, says Yau.

This ability to leverage data from a centralised hub is something that alternative fund managers have been increasingly doing with their fund administrators in response to greater regulatory and investor reporting demands.

By working in tandem with IT vendors, those buy-side firms who build their own internal (or hosted) centralised hub are going to have far easier lives. If they can avoid having to reinvent the wheel every time a new regulation is introduced, that is going to help improve their business efficiency.

“I do think a side benefit to all of this regulation is that it can lead to improved operational efficiencies. If they can get their data more organised it will help managers to deal with the deluge of regulation they face and handle obligations like transaction reporting more smoothly,” says Yau.

Another element of the reporting obligation under MiFID II, is near real-time trade reporting, compared to T+1 for transaction reporting. Trade data will need to be disseminated in a machine-readable format and made available to the public using an Approved Publication Arrangement.

This was already required under MiFID I for all equity trades. Now, the responsibility extends to report on all financial instruments, including OTC derivatives and FX, under MiFID II. Another important difference is that, whereas under MiFID I the requirement for reporting equities was within three minutes, under MiFID II, reporting must be done within one minute.

“Granted, technology is highly advanced but still, that will present quite a task for a lot of firms,” comments Yau. “For the first three years of the regulation trades must be published within 15 minutes, and thereafter it will be reduced to within five minutes after trade execution. It’s not going to get any easier.

“I think that most firms who trade derivatives will need time to adjust to these demands. For equities, the requirement has long been in place under MiFID I. For those who have not previously reported non-equities, they are going to have to figure out how to get on top of this.

“In terms of the post-trade report itself, there are 18 fields for non-equity instruments compared to nine reporting fields for equities. The amount of post-trade information will be substantial but nowhere near as granular as the 65 fields of information required for transaction reporting.”

Pre-trade transparency is not a reporting requirement. Rather, firms will need to provide market data on bid and offer quotes to facilitate price discovery. Under the non-equity requirements for pre-trade information, firms will need to be prompted by a client to provide that information and will need to agree to provide the quotes.

“Such quotes must also be made available to other clients in a non-discriminatory manner,” adds Yau.

Currently, there is still a lot of detailed discussions between fund managers and their counterparties as they roadmap their obligations and understand exactly how, where, and to what extent, MiFID II will impact their day-to-day business operations.

“The buy-side needs to work out the necessary contractual agreements to move forward in line with the requirements, especially for things like research. This is something that legal and compliance will need to focus on and potentially redraft contracts. With all of these new requirements, my advice to clients is to start the conversations now,” concludes Yau.

“My advice to clients is, ‘Get your data organised, clean it and make sure it is accurate, so that you can report directly or pipe it directly to an ARM’.”

Paul Yau, Advise Technologies
On forecasting the likely actions of Russia during the Second World War, UK Prime Minister, Sir Winston Churchill, spoke of it as a ‘riddle wrapped in a mystery inside an enigma’.

Alternative asset managers might be forgiven for thinking the same about the devilish complexity of MiFID II. But rather than get bogged down and concerned about the vicissitudes of regulation, managers should focus on the aspects they can control and take practical steps towards becoming compliant.

The first point to make is that MiFID II should not be thought about as merely a compliance exercise.

“The buy-side should think more about the major strategic implications to this, which could create new marketing opportunities and a competitive advantage. If I knew there was a challenge on the horizon, from a regulatory standpoint, I would use the ability to demonstrate more transparency to investors as an opportunity and would look to do it as early as possible, and market the fact that I was already MiFID II compliant.”

“That’s my advice to clients. Don’t put it off. Be an early adopter and you’ll potentially bring more business in,” says George Ralph, Managing Director of RFA.

Collective buy-in

Given that MiFID II will touch every aspect of a fund management business, the worst thing to do is treat it merely as a compliance issue and dump it on the Chief Compliance
To get all the data in place for reporting under MiFID II is likely to be a significant data management exercise across the various front to back office teams. As such, they will need to understand what is involved and when to engage with the right people: with respect to legal and compliance, risk, the Investor Relations team, etc. Some will have to re-evaluate their whole IT framework.

"It’s important to be able to put appropriate monitoring in place for best execution and to be able to demonstrate it, and that you are properly considering the results of best execution," says Robinson. "It’s much the same on the research side; sitting down with portfolio managers to understand how they assess the quality of research and how they use it, and where they are getting it from. These are all aspects around which MiFID firms need to build a robust monitoring solution."

The sooner fund managers have gone through the data mapping exercise and worked out the extent to which their IT systems will be up to the task, the better they can identify gaps and engage with the right vendors.

"Now is the optimum time to be getting data handling processes and procedures covered off and documented," says Geraldine Gibson, CEO of AQMetrics. "Simulated testing for transaction reporting takes places over the summer and then moves on to the regulators’ systems towards the end of the year."

As part of the transaction report, a legal entity identifier (LEI) has to be provided for security. Every service provider and fund manager will have its own LEI, which is held in an LEI reference database. It’s no different to financial instruments having their own ISIN code. As new companies and service providers come on board, they will need to..."
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Do you know where your alpha went?
MiFID II could accelerate buy-side control of execution intelligence

Interview with Allan Goldstein

Anyone who has bought or sold a home knows that, prior to closing, an inspector usually verifies the property’s condition. The buyer doesn’t simply accept the seller’s representation that the home is sturdy and unlikely to collapse. An inspection lays bare the houses faults, giving the buyer comfort in the home’s condition and absolving the seller of ongoing responsibility. While such a careful examination might not be typical of most markets, the European financial markets are not most markets, and regulators are imposing a type of inspection requirement under MiFID II Article 17.

Article 17 and Regulatory Technical Standard 6 require that buy-side firms annually assess and validate the integrity of trading systems and maintain detailed records of such checks. Any firm that accesses broker algos directly from their O/EMS is likely to be affected and will need to have in place systems, governance and risk controls that affirm system integrity and prevent exceeding trading thresholds and the sending of erroneous orders, potentially disrupting the market. This is a high bar.

Whereas today it might be acceptable to lean on brokers for the evaluation of their own algos, the new regulatory regime wants the buy-side to more equally share this responsibility. The buy-side now enjoys the ability to contract out for best execution and trading strategies with minimal regulatory scrutiny and accountability. As of 3 January, the regulatory pressure will spread more equally to the buy-side, and it will be in their best interest to be in full control of the tools used for trading and trade analysis.

This is important as MiFID II could, in the opinion of Allan Goldstein, CFO, COO and CCO of New York-based Trade Informatics, create an environment where the buy-side reduce their reliance on traditional broker execution services, instead taking trading intelligence and best execution obligations into their own hands.

"Under Article 17, buy-side firms will be required to perform a series of pre-game checks on the algorithmic trading systems they use and will ultimately need to validate the integrity of those systems,” says Goldstein. “How can this effectively be achieved if they rely on outsourced broker-sponsored algorithms? How will managers properly validate the integrity of a trading system and the results of sell-side trade analysis if they don’t have full access to, and knowledge of, the underlying technology? Recent ESMA Q&A clarified that RTS 6 requirements will not apply when a firm transmits an order to another, who in turn uses an algorithm. Will traders resort to this antiquated workflow simply to avoid RTS 6? I think not."

But that’s exactly the position managers may find themselves in when engaging directly with broker algorithms under MiFID II. While they might have a vague idea of how orders are being routed and filled, they almost certainly have no way of looking under the hood and often don’t have complete control over routing preferences. And, they can’t send the equivalent of a home inspector to evaluate and validate the technology they are using.

“I believe that in the long run, MiFID II obligations will compel the buy-side to disintermediate aspects of traditional sell-side execution services, and accelerate the trend towards the buy-side taking more control over their trade implementation process.”
In January 2014, the Hong Kong Securities and Futures Commission ("SFC") issued rules requiring the sell-side to provide "training materials" to the buy-side in an effort to educate users about their strategies including details of testing and development details. However, in the MiFID II regime, will this suffice and is it really worth the effort to source, review and rely on sell-side provided documentation? As unbundling of research and execution becomes a reality, the current practice of spreading orders out to multiple broker-sponsored algorithms will quickly reveal that commoditisation of execution strategies is prevalent, even among those offered as "customised". So will the buy-side choose to skirt broker algorithms completely? Is this even a viable option?

"There exist today broker-neutral trading platforms that make use of historical trading data to create a truly customised systematic execution solution. By using these platforms, the buy-side can regain control of and transparency into their own trading strategies. They’ll be able to understand, document and participate in every aspect of how execution strategies are built, tested and customised. By matching each alpha source to an appropriate execution strategy, the implementation of a portfolio idea is never separated from the idea itself. This approach is truly customised algorithmic trading informed by the alpha profile of the manager and is the best way to bring realised returns in line with expected returns."

So where does the sell-side fit into this scenario? Goldstein suggests: "In this scenario, the buy-side would continue to use brokers for market access, liquidity sourcing and market microstructure expertise optimising their experience at the point of sale. The sell-side smart order routers (SORs) are quite sophisticated today as they allow for child order placement optimisation. Parent orders should reside in the buy-side’s system, brokers should only see child orders thereby minimising information leakage. So the buy-side can lean on their brokers to help them understand and direct where child orders should be going supported by 3rd party post trade venue analysis via TCA (Transaction Cost Analysis)."

On the market microstructure point, sell-side firms and market makers have been investing a significant amount over the last 12 months in smart order routers. In a deal worth USD 1.5 billion, high speed trading firm Virtu recently agreed to acquire KCG, which has built out a significant market access technology infrastructure, including sophisticated SORs, microwave transmitters and co-located servers.

"Microstructure detail deals with child order placement. Once the child orders are parcelled out by the buy-side, the sell-side knows what to do with them. The point I’m making is that the buy-side is going to become the owner of how and when those child orders are parcelled out," states Goldstein.

The upshot to this is that the buy-side will likely require better performing systems and a more robust approach to trading when they truly own the trading expertise with respect to parent orders and the sell-side takes on a specialised role as market microstructure experts.

"I think there will be a push by the buy-side. There should be a push in this direction. If not, and managers take a business as usual approach, using their brokers’ commoditised algorithms is not likely to lead to performance gains. It will limit the amount of customisation and actual transparency to achieve sufficient steps toward best execution leaving a regulatory vulnerability," concludes Goldstein.
The problem is that for some managers, their databases aren’t configured to automatically tag every LEI. “If someone doesn’t have a repository for LEI data in-house, which a lot of small managers don’t, we will pull all that data together as the appointed ARM. Then we sign off the interface with the client and from that point forward, if there are any changes to the way we source data, we just run through structured change management. It’s a very controlled exercise,” comments Gibson.

The data lifecycle
With respect to the data lifecycle, as part of a compliance ‘to do’ list there are two components worth considering.

The first is to make sure that fund data is stored in an efficient way that makes it easily retrievable for transaction and transparency reports. Ralph says that fund managers should investigate storage management software in order to automate the movement of data through the lifecycle.

Secondly, fund managers will need to be surgical with their reporting, and ensure that their IT systems act like a scalpel not a sledgehammer.

Enterprise data management
With increased regulation such as MiFID II facing fund managers, many will need to strengthen and invest increasingly in their regulatory reporting function and associated technology. Key to this, in Ralph’s view, will be enterprise data management.

“Historically, fund managers have been large consumers of market data from vendors, which is structured, validated and easy to manage. However, fund managers also create their own data sets, such as who made the decision to place a trade, who executed it and which algorithm was chosen. New regulations such as MiFID II are increasingly asking managers to report on these internal data sets too.

“The challenge many will experience is that internal data can often be held in different systems across the firm and is typically less structured yet will need validation before reporting to regulators. Therefore, I believe we’ll see a growing focus on enterprise data management and investment in those technologies, which will make that process less onerous and more secure.”

Research compliance
This is a new requirement for MiFID firms and will require them to demonstrate in detail how they are setting research budgets and delivering the best value to clients. In the eyes of the FCA, it will not be sufficient for the buy-side to simply say that this is what they pay for commission, therefore that is what next year’s budget will be based on. “That does not meet the requirements under MiFID II. Firms are going to need to figure out what they need and have a separate budget. Understand your needs now and go through that discovery process before you start to contract with different research providers.”

Vicky Sanders, RSRCHXchange

“Firms are going to need to figure out what they need and have a separate budget. Understand your needs now and go through that discovery process before you start to contract with different research providers.”

Vicky Sanders, RSRCHXchange

Towards the end of 2016, RSRCHXchange ran a survey, in which one of the questions asked: “When does your firm plan to be compliant with MiFID II rules on Research Unbundling?”
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Product governance considerations under MiFID II

Interview with Mario Mantrisi, Gary Janaway & Raymond Groen in’t Woud

Investment managers running UCITS funds or Alternative Investment Funds (AIFs) will not fall directly under MiFID II or have any legal obligation to comply with regulation or require a MiFID license. However, from a product governance perspective, they will be impacted indirectly. This is because their fund distribution partners, such as MiFID licensed bank platforms, will be required to define the investor target market for each product.

“Consequently, if Asset Managers want to stay in business it becomes essential for them to define the target market for all their funds at the share class level and communicate this to their distribution network,” explains Mario Mantrisi, CEO of InReg, a sister company of KNEIP, one of the fund industry’s foremost legal and regulatory report providers.

AIFMs or UCITS managers will be required to provide a sufficient level of product transparency in order for fund distributors to make a clear judgment on whether the fund is suitable to the clients that the fund sponsor wishes to sell it to.

Defining the target market

ESMA has come up with six categories to define the target market, however these need to be described at a more granular level on the manufacturer side. These categories will include the ability for the investor to bear losses and as Mantrisi explains: “We will probably end up classifying products in distinct categories, varying from cases where the investor can bear minimal losses of capital at the one extreme, to where the investor can bear losses beyond the investment amount at the other extreme.”

So far, the template for defining the target market has yet to be finalised by ESMA. In the opinion of Raymond Groen in’t Woud, Product Director, the AIFM can say that they have no view on this and that it is down to the distributor to redefine its own target market model.

He says that the main challenge to this is that individual EU countries will have their own definition of target market on the distributor side. “Consequently, products that are distributed cross-border need to be prepared to cope with slightly different definitions, and the product target market definition will need to be adapted for different markets.”

“I don’t think this will be the most complex piece under MiFID II nor, from what I am seeing in terms of the measures being taken in countries like Germany, will it be too problematic. However, the target market definition should have been finalised some time ago, to allow firms to make the necessary plans,” explains Gary Janaway, COO of KNEIP.

Just as the AIFM will have significant responsibilities in providing distributors with sufficient transparency and detail to meet the target market requirement, equally the distributor will have responsibility to ensure that the fund sponsor is made aware of what is referred to as a ‘Negative Target Market’.

“This is where a specific investor is deemed not to be suitable to invest in the fund. From a distribution chain perspective, there will be an obligation on MiFID II-regulated entities to relay that information back to the Management Company,” says Groen in’t Woud.
Mantrisi points out that whilst the understanding is that distributors will be required to report back on negative target market, where the product does not match the target market definition, not all distributors will necessarily be able to do this.

"Consequently, Asset Managers should define how much responsibility they are prepared to take when it comes to distribution oversight duties and decide what their policy shall be in cases of missing and incomplete reporting," advises Mantrisi.

Under MiFID I, fund sponsors could simply delegate the transparency requirements to the distributor. Under MiFID II, that responsibility moves up the chain from the distributor to the fund sponsor. If they aren’t receiving negative target market data, or some sort of confirmation from their distribution arm, the fund sponsor could be perceived as not being active enough, in terms of product compliance, and run the risk of being liable.

The Asset Manager must now be able to receive information about the entire fund distribution chain and gain a transparent view through platforms and nominee structures to ensure that the product governance rules are properly applied.

"Through obtaining a full transparent look through on investor positions and transactions, the Asset Manager can validate the product governance rules set," asserts Groen in’t Woud.

**Level of transparency facing fund sponsors**

In brief, Article 25 of MiFID classifies UCITS (except for structured and alternative UCITS) as non-complex and further states that shares admitted on a trading market should be classified as non-complex, except for shares in non-UCITS collective investment undertakings.

Therefore, all AIFs, no matter how straightforward their trading strategy, will be treated as complex, which will have implications in terms of how and to whom that fund can be sold.

"In principal, if it is classified as complex you are only allowed to sell it in execution only models but you need to make a suitability test before you sell the product. "Then you need to define what type of clients you are selling to; are they institutional investors or retail investors? Next, you need to define the risk appetite of investors as part of the target market exercise.

"Also, there is a disclosure of the costs. This needs to include ex-ante costs, which are estimations on the past, and ex-post costs on a yearly basis, which detail the actual costs incurred by the fund," outlines Mantrisi.

**A new family of fees**

UCITS funds, which have for some years been engaged in disclosing fund costs to investors in the Key Investor Information Document (KIID), including entry and exit charges, ongoing charges and performance fees, will now face even further cost transparency disclosure. This will largely be in relation to transaction costs.

This break down of transaction costs is a whole new area for the funds industry and will present a particular challenge, especially when it comes to implicit fees on instruments that are not traded like equities or bonds.

"A methodology for determining a mid-market rival price will be needed on which to base the implicit fees. This is new for UCITS and AIFs," says Mantrisi.

"Up front costs at the pre-sale stage (ex-ante costs) will need to be provided to distribution partners on a quarterly basis on every fund, down to the share class level. Then, on an actual (ex-post) basis, transaction costs and the total cost of the product will need to be disclosed to investors, on an annual basis, to show how much the fund product actually cost that year," explains Janaway.

Whichever way one looks at MiFID II, it is clear that AIFMs and UCITS managers will need to demonstrate clear and evidential product governance to meet the distribution requirements of the regulation.

"It’s ultimately about having a responsible relationship and making sure the right clients are in the right products. If it doesn’t work well, and information is not being shared adequately when a negative target market is identified, it will negatively impact both the fund manager and distributor," concludes Janaway.
7 Steps to unbundling

Use RSRCHX to

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› Monitor consumption in real time to identify your research needs ahead of January 2018

Implement controls
› Centrally manage your firmwide research procurements and payments with granular controls and oversight

Identify ‘Research’
› Differentiate and only pay for content that meets the ESMA definition of ‘Research’

Block ‘free’ inducements
› Control research access, segmented to the strategy or individual user

Record consumption
› Generate rich, real-time audit trails of consumption and payments, avoiding lengthy data reconciliation

Evaluate quality
› Rate research as you use it, building an evidence-based assessment of providers and informing future purchases

Unlock research market
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Unlocking the research market

Interview with Jeremy Davies & Vicky Sanders

Research unbundling is creating a whole new marketplace model for research procurement and consumption.

One of the biggest changes that asset managers face under MiFID II will be the need to unbundle research payments from execution commissions and provide evidence on how they are paying for that research, to the optimal benefit of their investors.

This is likely to shake up sell-side research departments and those independent research providers with limited distribution capabilities, with some fearing that it could potentially reduce the quantity of research in the marketplace.

But with every challenge there is a new opportunity. Research platforms are now becoming a key part of the value chain, acting as a central hub for research providers to distribute their research; good news for any research outfit that wants to have the potential to reach the widest possible buy-side audience.

One of the leading platforms is London-based RSRCHXchange, co-founded by Jeremy Davies and Vicky Sanders. Their RSRCHX platform offers asset managers a single MiFID II compliant research solution, covering all functions from discovery to reading reports and including essential features like budgeting, consumption tracking and analysis.

“The average buy-side firm might have 80 to 100 research providers that include a mix of banks and independent firms,” says Sanders. “To comply with the incoming MiFID II regulations, asset managers will need to decide quickly who they want to enter into a contract with. It is highly unlikely that they would negotiate directly for research from all of their current providers.”

“Contracting with one research platform like RSRCHXchange, which currently has over 200 research providers on the platform, is an attractive proposition. The later into the year people leave this, the more attractive that proposition is likely to become,” suggests Davies.

He adds: “What our platform offers is aggregation, procurement and management of research. The cloud environment means we can bring all of that research into one secure place, making it accessible, fully searchable and customisable depending on the person’s role and position within the organisation and their area of interest. They can immediately start to monitor their consumption, rating a research report as soon as they’ve read it.”

Using a simple dashboard tool, clients can see research usage across different sub-asset classes, how it has been rated, and a breakdown of the dollar spend on each piece of research consumed within the organisation.

“All the content is securely hosted, so none of the research can be physically downloaded. What that does is mitigates the risk that the hedge fund manager is being induced by free research,” says Sanders.

One of the unintended consequences of MiFID II is the concept that if a buy-side firm only uses and pays for research from five research providers, for example, they will need a mechanism to discover and unlock research from other providers and have a simple way of paying for it.

From January 2018, all research has to be priced separately from dealing commissions and budgeted and paid for by the asset management firm. The regulation stipulates that ‘you shall not receive research that you have not paid for’.

“We are the only institutional platform that gets people from the discovery phase through to access, handling all the research payments automatically. We are unlocking the research market, both for the buy-side and sell-side,” concludes Davies.
With respect to hedge funds, the results were as follows:
- Q4 2016: 9.1%
- Early 2017: 2.5%
- Mid-2017: 18.2%
- End-2017: 18.2%
- Start of 2018: 13.6%

In brief, there are seven practical steps to research unbundling that fund managers can consider:
- Set a needs-based budget;
- Implement controls;
- Identify research (i.e. only pay for content that meets ESMA’s definition of research);
- Block free inducements;
- Record consumption;
- Evaluate quality;
- Unlock the research market.

Firms will also be required to demonstrate best execution, again to prove to the regulators that they are acting in the best interests of their clients.

However, in Article 27 of MiFID II there is no single way to determine best execution. “Even though they’ve strengthened the language from ‘reasonable’ to ‘sufficient’, investment firms must have a strong, demonstrable and documented process in place for measuring best execution, however, the regulation is not prescriptive and does not specify the steps needed to achieve the standard,” says Allan Goldstein, CFO, COO and CCO of New York-based Trade Informatics.

He advises fund managers to put in place a policy that allows them to measure their counterparties both qualitatively and quantitatively and review it periodically, making adjustments as they see fit.

“One once you have a process in place, you’ll then be able to marry the transparency that you’re gaining from research unbundling to your process for measuring the effectiveness of your counterparties. You’ll then start to better understand who, among your counterparties, is truly accretive to your overall investment process,” adds Goldstein.

**Watertight service contracts**

One final compliance consideration is to re-appraise one’s vendors and make sure that they understand MiFID II, such as the turnaround time on reporting, retention periods for data and so on.

“A lot of investment banks’ terms of business are based on what MiFID I required 10 years ago, so is going to be a huge amount of change given what MiFID II introduces, as well as new commercial realities of trading.”

Leonard Ng, Sidley Austin LLP

“If you think about the stringency increase under MiFID II on communication disclosure and transparency that firms are going to have to have with their clients, that same level of stringency equally needs to apply to the vendors they use,” says Ralph.

This is all about ownership. Under MiFID II, the buy-side will be required to take more detailed approaches to the way they manage their business processes; they can’t just rely on the sell-side.

“In Q3 and into Q4, I would expect the sell-side to deluge the buy-side with repaperings,” remarks Leonard Ng, Partner at Sidley Austin LLP. "Imagine if out of 100 brokers you use, 60 are based in the EU. That means 60 repapering exercises. A lot of investment banks’ terms of business are based on what MiFID I required 10 years ago, so is going to be a huge amount of change given what MiFID II introduces, as well as new commercial realities of trading.”

The good news is that plenty of service providers and vendors are working hard to support their clients through this difficult phase of readjustment.

Yau’s role as regulatory legal counsel at Advise Technologies is to help get the rules correct, in terms of the business intelligence then goes into the solutions it builds.

“I am part of the Best Practices group, composed of attorneys, fund accountants, etc. Based on conversations within our group, as well as with asset managers and regulators, we gather industry knowledge and share it with our clients. We aren’t just a vendor, we try to always provide practical industry insights where possible. And MiFID II is no exception,” concludes Yau.