Julia: **Hello everyone and welcome to this DerivSource podcast.**

I'm Julia Schieffer, the editor and founder of DerivSource.com

Many of you may have been relieved when the decision to delay for MiFID II implementation was announced recently.

In this DerivSource podcast, I speak to Jeremy Taylor, Strategy Owner, Capital Markets, at GFT about what constitutes an effective MiFID II programme and where firms really should be in terms of preparing for this very significant new piece of regulation.

If you're new to MiFID II or perhaps need a refresher since MiFID I, we do offer a quick overview and update of this regulation at the very beginning.

Julia: Welcome to this DerivSource podcast, with me today I have Jeremy Taylor, Strategy Owner, Capital Markets, at GFT in London.

Welcome to the podcast, Jeremy.

Jeremy: Thank you, Julia. It's good to be here.

Julia: **Jeremy, can you give us a little bit of background into yourself for our audience before we get into the questions?**

Jeremy: Sure. I'm a senior consultant here with GFT in London. I've been with GFT four years. I was responsible for the business consulting practice prior to my current role which is heading up the capital markets strategy for GFT.

Julia: Great. Today we're talking about MiFID II. So, starting from the top for some of our readers who may need a bit of a refresher about MiFID II, can you briefly state the core pillars of the regulation and the work streams that are really emerging from the directive?

Jeremy: Certainly. MiFID II builds on its predecessor, MiFID I, which was brought out in 2007. It also fulfils the requirement of the G20 meeting in 2009, known as the Pittsburg Meeting. And the three pillars really are aimed at investors, and basically the first one is to provide fairer, safer and more efficient markets. The second one is to provide a stronger investment protection. Thirdly, greater transparency, as well.

The other big feature of MiFID II is that whereas its predecessor was focused on the equity markets, what makes MiFID II big and challenging is that it actually encompasses a very broad range of products including fixed income, bonds, derivatives and certain commodity types.

It's a very, very large piece of regulation. In fact, I'd go as far to say it's probably one of the single biggest pieces of regulation in Europe that we've seen since the financial crisis. Given that, it's certainly a big challenge for all market participants, but especially those large financial institutions such as global investment banks that have a lot of asset classes and businesses that will all be impacted by this regulation.

Julia: I know that this specific regulation is quite large, but zeroing in on trading facilities, Jeremy can you first clarify the differences between the trading facilities under MiFID II and then also tell us a little bit about how they will impact financial organisations?

Jeremy: MiFID II, which as I say builds on MiFID I, introduces a number of trading venues. This is partly fulfilling a requirement of the G20 meeting in 2009 which in order to bring greater transparency and more efficient markets, mandated that liquid products need to be traded on central trading execution facilities. In Europe, they've introduced these as OTFs. Now, OTFs were introduced alongside some existing trading venues such as the traditional regulated markets, which are effectively exchanges like the LSE and Eurex. It also sits alongside MTFs, which were borne out of MiFID I. And, finally, if you don't want to be running an OTF or MTF or regulated market you can become what's called systemic internaliser, which means you can actually act as principal to your trading activity.

The MiFID I introduced MTFs really as an alternative to regulated markets and to allow a central venue for non-listed products to be traded. It's essentially an auto-matching quote-driven market. OTF is designed similarly but for the products in addition to equities, but it retained some discretion around its operation in as much as people running OTFs can actually decide whether or not they want to match, or partially match trades.

So there is a difference between MTFs and OTFs. What's interesting is that over time since the introduction of MTF since MiFID I in 2007, many of the MTFs are now operated by the same owners that operate regulated markets, so we're seeing a certain coming together of those two venue types, but OTFs we believe will continue to be operated by possibly some of the large banks, but indeed by some new entrants into the market.

Just to complete that picture, those venues are very much designed for the liquid products that are clearable, but of course you get the rump of the market which is still the bilateral OTC market. That will still exist and will be able to be traded on a bilateral basis outside of these new venues that have been introduced by MiFID II.

There's some controversy around this aspect of MiFID II inasmuch that ESMA have been tasked with coming up with a definition for a liquid product, and that threshold of liquidity will be used to determine whether or not a particular product or instrument has to be centrally traded on an MTF, OTF or RM (regulated market), or whether indeed it is illiquid and can therefore fall into the OTC bilateral market.

So quite a complicated task and really a thankless task for the regulator, because in order to determine that liquidity threshold they're going to have to look at a lot of data and make some calculations on which products are in and which products are out, so to speak, and it's fairly dynamic, so it could be that some products for a certain period are deemed to be liquid and then as volumes drop and the liquidity drops, they're deemed to be illiquid and therefore become bilateral OTC products again.

That is something that everybody has to stay on top of, not least the regulators. So, yes, there's some controversy around that; there's certainly some difficulty on the part of the regulators to determine that, and also difficulty for market participants to stay on top of it as well.

Julia: **Jeremy, speaking of staying on top of it, and MiFID II implementation specifically, how would you advise firms to start preparing for this, because it is so large and complicated; as you pointed out, there are various different moving parts and areas that are still very controversial. When you speak to clients, how do you advise that they start getting prepared?**

Jeremy: Yes, you're absolutely right, Julia, it is a huge task and of course we've recently written a paper that we titled "How to Eat the Elephant" because it can, on the face of it when you first read the regulation, seem very daunting. I think the first thing to do is to try and put some structure around the regulation and try and categorise it into the different parts of the regulation.

We mentioned the 3 pillars earlier, and what we've done at GFT is we've looked at the regulation and we've identified 27 sub-themes within those 3 pillars that the regulation sets out. Already, you can start to decompose the regulation into certain types of functions and processes that will be impacted.

I think the first step… And I suspect a lot of people who are having to comply with the regulation, although it's not finalised, the technical standards are at a very mature stage. So people are able to interpret what they need to now to do an impact assessment.

I think doing the interpretation is key; doing what we call the codification of the regulation to try and put some structure around it and start to map the regulation versus the businesses and functions that one has within one's organisation, and then to start to do a proper impact assessment and start to construct a programme of change around that structure that you've started to develop.

So I think Step 1 would be do some interpretations and get those agreed by Legal & Compliance, then using those interpretations, perform an impact assessment against your functional model and your process model, or any other architectural model within your organisation. And then you can move into actually writing the requirements, which would drive any system changes, any organisational changes, and any process changes that need to happen in order for you to be compliant with the regulation.

I think there's another very difficult aspect to this regulation which I think financial institutions are becoming used to now, and that is data, because of its breadth and its depth inevitably this will come down to data. Large pieces of the regulation require financial institutions and investment firms to provide reporting around trades and transactions. That's not new in terms of post-crises; we've seen that in Dodd-Frank in the US and we've seen that already in EMIR through Europe, but the bar is now being set higher. More fields now need to be reported. There are differing requirements across different products and markets, so all of that needs to be codified and determined when writing the requirements for any changes to systems and the like.

So we would recommend those steps, and obviously once you've done the requirements you can then move into the build and execution phase, and the testing phase.

There is one final aspect to all of this, which is once you've completed the work necessary for compliance and generating all of the reporting required, you need to have a mechanism in place to monitor on an ongoing basis the accuracy of your processes and to ensure that you are compliant on a daily basis. This is particularly important when looking at the trade and transaction reporting aspect of the regulation because you need to ensure that any trades that are falling through the cracks. Trades that, for whatever reason, are not reaching the reporting repository, you can get fined.

Whatever you're building, you need to keep the end in mind and you need to think about once you're live with this, is this sustainable, is this scalable, and is it transparent? Can senior management, at a glance, see on day-to-day basis whether they're fully complying with all the regulations that MiFID II brings to bear?

This is not just true of MiFID II, of course. This is true of a whole raft of other regulations that we're seeing concurrently at the moment.

Julia: **Jeremy, you brought up data, and this is something that we've covered quite extensively at DerivSource in terms of various different guises: reference data, market data, and of course data for trade recording. What is the biggest challenge for firms that you see or that you come across when you speak to investment banks in terms of managing data needed for MiFID II? As you said, it's quite complicated.**

Jeremy: I think the biggest challenge is the legacy that a lot of the bigger firms have, particularly the banks, around data existing in multiple locations, multiple databases, multiple venues, and it's a legacy of the way banks grew. I mean, they've grown up in a very siloed fashion, certainly in the UK and Europe. A lot of the investment banks have come into being through acquisition of smaller banks, and although these have been integrated at a sort of legal entity level, if you look beneath the covers a lot of the separate technology and even right down to general ledgers still exist separately because the old firms have not properly been integrated at that more 'atonic' level.

So there's definitely a challenge in terms of aggregating together information that is held on disparate databases. That's something we saw in BCBS 239; it's a huge challenge.

I think there's some very ambitious targets that MiFID II sets. I mentioned that the trade and transaction reporting number of fields is increasing, I think from 21 to up to 65, so there's a huge increase in the amount of data that one has to harvest from across your technology estate. Also the introduction of the rules around best execution means that firms have to develop a policy around best execution, then they need to be able to capture pricing to be able to evidence back to the regulators and to their client that they have been treated in a fair way.

It's not just about capturing a snapshot of information at the time the trade is done; you need to capture the market times either side of the time the transaction was done, but you also need to retain all of this information for a year so that you can report back to the regulators who might be able to spot-check this. And this is just an enormous challenge and a huge increase in the amount of data - gathering, aggregation and retention - that the regulation requires.

Julia: **Of course, making sense of all that data is often a challenge as well. Not to mention that you have to source it, as you pointed out, you have to store it and report it as well. Sounds like that's quite a big challenge for people to focus on for MiFID II implementation going forward.**

Jeremy, you work with various different types of clients, so I know this might be a bit of a difficult question, but in your view, what stage should firms really be at right now in terms of planning an effective program for MiFID II implementation?

Jeremy: I think the delay probably had a few people feeling very relieved on their return from Christmas vacation. We think it would be a mistake to take your foot off the gas completely, and I'm pleased to say that a lot of the firms that we're working with haven't done that. There may be some relief, but I think that the realisation is that actually having an extra year, although very helpful, doesn't necessarily make this a much easier task.

I think right now we would expect firms to have established a programme, and that means identifying an owner globally of the regulation. So it would be a hybrid program structure where you need strong command and control to set standards and to set an overall, what call a 'Level Zero' top level plan for the firm, but you also need to federate in a lot of the responsibility for building the requirement to the individual businesses and functional areas of your organisation, as they will be the people best placed to interpret the impact of the regulation on their particular business or function.

Where we would like to see people at the moment is having established that programme, identified some key owners of the programme, have set up a structure that makes sense, and there's a lot of lessons to be learned from BCBS 239 where I think people went for a more federated model and found that some of the consistency and quality of the responses, and the requirements, and the building that people were doing meant that people were coming up short and organisations found that out very late in the day.

So you need to build a very good structure, and you need to engage senior stakeholders very early on. We would expect right now a lot of engagement at a senior level and a mobilisation of resources. It's an old adage, but you can't beat planning, and upfront planning is very, very key, and if you plan properly now you're going to save yourself a lot of pain in the future.

Even though it looks like we've had an extra year to implement this, that's going to go very, very quickly and I think people will come back after their summer holidays and start really worrying about this. You can do yourself a favour and really start that process now, start to get the resources in and start to build up your program early.

Julia: **So the key message is plan and don't procrastinate then?**

Jeremy: Absolutely.

Julia: **Great. Thank you for joining us in this podcast, Jeremy, and for sharing your insight and your expertise with us. As you work with different firms, I know our audience will really appreciate your information today.**

Jeremy: My pleasure Julia, and thanks for inviting me.

Julia: **To find out more on this topic of MiFID II, please go to DerivSource.com. There you will also find the transcript for this interview via our Podcast Notes page. And you can keep an eye on this Podcast Notes page to really see the future podcasts as we publish twice a month, or of course you can always subscribe to iTunes or download the free DerivSource app to listen to our podcasts on your own time.**

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