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MiFID II: Why Compliance Should be an Ongoing Exercise for Firms

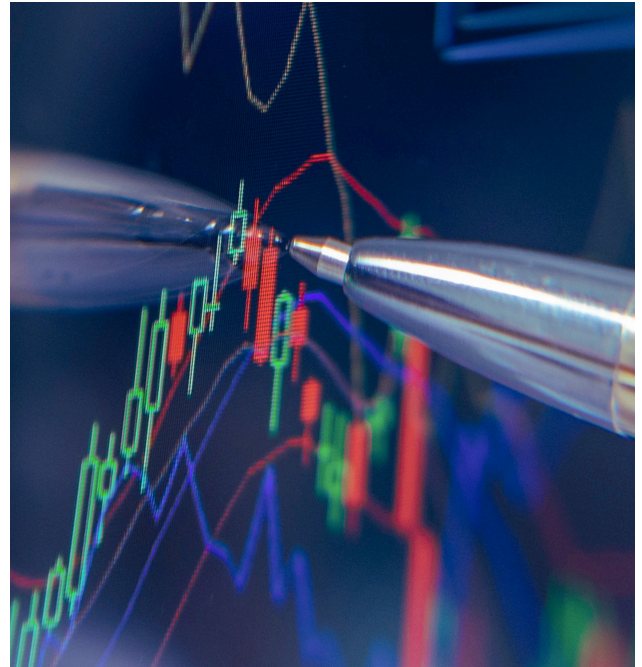
Some of MiFID II's changes might be about to bite, with regulatory enforcement ratcheting up.

Enforcement of the revised Markets in Financial Instruments Directive (MiFID II) could increase considerably in 2019. And with some of MiFID II's rules open to interpretation, inadvertent non-compliance is a real risk for some firms.

If found to be non-compliant with MiFID II, a firm could face strict liability in some cases, such as transaction reporting – meaning it could be liable regardless of the reason for its non-compliance. This could result in considerable fines, as well as reputational damage and possible knock-on third party claims.

In 2018, the Financial Conduct Authority (FCA) defended its initial lack of action over firms breaching MiFID II, arguing that enforcement was not the only regulatory tool at its disposal. In June 2018, however, the FCA's CEO told the Treasury select committee that the FCA will start holding firms to account for MiFID II non-compliance.

With 2018 in many respects having been a "grace period" for MiFID II, it might be hard for any firm to formulate a regulatory defence for non-compliance in 2019. Moreover, disgruntled investors may use non-compliance as part of the benchmark against which a firm's client service should be judged in any negligence claim.



Headwinds

MiFID II's aim is commendable: to offer greater protection for investors and inject more transparency. It covers virtually all aspects of trading within the EU, from banks to institutional investors, exchanges, brokers, hedge funds, and high-frequency traders.

It encompasses algorithmic trading; best execution and reporting to clients; conflicts of interest; governance and internal organisation; investment advice; explain derivatives and commodities; product governance; remuneration requirements; transaction reporting; and client categorisation. It applies equally to non-EU-based firms marketing products in the EU.

Given the complexity and technical elements of MiFID II, there have been some unintended consequences, which could cause firms to trip up – with potentially severe consequences.

1. Unbundling

MiFID II's so-called "unbundling" requires that fund managers budget separately for research and trading costs rather than funding research from commissions retained. This has strained some individual relationships between analysts and fund managers, forcing both sides to track meetings, calls, and emails. Having to add research costs as a separate charge can also lead to difficult questions from clients, both about why they should be funding research and what has happened in the past. This is compounded by the very broad definition of research under MiFID II, which may even encompass what would have previously been seen solely as informed market commentary.

As a result, many asset managers are paying for research themselves, resulting in less research being used: total industry spend on research has declined by about 30%, according to data from Greenwich Associates. Asset managers have cut their budgets by an average of about 20% in 2018, with a reduction of another 5% to 6% expected in 2019, according to Greenwich Associates. This trend raises the question of whether firms might consequently become de-skilled and start to lose their expertise, and the consequences this could have for client advice and attached liabilities.

2. Reporting to clients

There are indications that MiFID II has lengthened the process of reporting to clients, with advisers and asset managers required to provide more information to customers. Take, for example, MiFID II's requirement to provide an annual suitability review for every client; including updating a client's circumstances, reassessing attitude to risk and capacity for loss, and providing a report to each client demonstrating their products are still suitable for meeting their objectives. It would be easy to treat the provision of this information as a "tick box" exercise, but it is essential that firms keep sight of the importance of changing client circumstances and ensuring that products remain appropriate.

3. Regulatory reporting

MiFID II brought in a raft of rules and technical standards on reporting, from trade reporting through to transactional reporting. Transaction reporting requirements now mean that firms have to report transactions to the regulator as quickly as possible and, at the latest, by close of the following working day. This reporting must be complete and extremely detailed – there are 65 data fields required in the reports, as opposed to 23 under MiFID I. The increased level of reporting required may place a strain on some firms' systems and controls and, with so many different data requirements, it is easy to see how a firm could overlook some information. Such oversight could create exposures for firms regardless of whether there is a negative effect from the data not being provided, due to the strict liability regime.

Looking ahead

Revisions to MiFID II have been touted, along with rumours of a MiFID III. In September 2018, MiFID II author and MEP Kay Swinburne said firms should not fear MiFID III, adding that the regulation is further away than many believe. Swinburne said that any updates will be more about refinement and realignment, and concerned with removing inconsistencies, rather than a re-write.

The UK's prospective exit of the European Union is unlikely to result in a regulatory backslide on MiFID II. MiFID II equivalence is the most likely arrangement, at least in the short and medium term. This in itself could cause issues: the running of two regimes will inhibit cross-border activity, given that each counterparty will need to view the other as a "third-country entity", which may cause a duplication or even conflict of obligations. In addition, by untethering the UK from Europe, at least to some extent, Brexit might increase the possibility of MiFID II being subject to further change and influences outside of Europe in the years to come.

Although it is still unclear exactly how MiFID II will be enforced, there is no room for complacency. Compliance is not just about technology, but also about people and controls. Penalties may apply not only to firms but also to their management bodies and relevant individuals, which, together with the Senior Managers and Certification Regime, gives the regulator significant powers of enforcement. Firms should continue to be conservative in their interpretation and application of MiFID II. They should continue to review their compliance, and try to get a better understanding of industry standards and what is considered best in class.

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