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MiFID II: Its Impact on Retail Financial Services, and How to Comply

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Ovum view

Summary

MiFID II is a piece of European Union (EU) regulation that was implemented in January 2018. In this white paper, Ovum analyzes some of the key implications for retail financial services, looking particularly at enhanced requirements around record-keeping and how technology can help firms achieve compliance in this respect.

What is MiFID II?

From a retail perspective, MiFID II seeks to further ensure firms always act in the best interest of their clients

In terms of its focus on the retail side, MiFID (Markets in Financial Instruments Directive) at its core is an investor protection framework designed to ensure that investment firms act in the best interest of their clients. While it does include a number of technical requirements, its measures are aimed at ensuring that the industry's culture is directed toward serving the clients' interests, with clients treated fairly and given suitable advice and appropriate services, and with conflicts of interests managed (such as those arising around hard or soft industry inducements between providers and distributors, remuneration, or performance assessment).

This comprises a number of different approaches, including enhanced governance and organization requirements, and stronger business conduct obligations. Key aspects include

- improvements in product governance and design
- more complete and clear information about investments (particularly around costs and charges)
- better assessment of suitability of products recommended to clients
- an improved framework to achieve best execution
- strengthened protection of investment assets
- fair and efficient treatment of investment complaints.

Of course, while the underlying intent is to drive a client-orientated culture, it does have significant implications for compliance management. Firms have to implement appropriate governance structures, enforce required conduct policies, and, importantly, ensure that such conduct is both adhered to and evidenced. Firms need to be able to demonstrate to supervisory bodies that respective implementation measures have been achieved, with record-keeping of transactions and client communications a key compliance requirement.

The background to MiFID II

MiFID I was adopted in 2004, with implementation coming into effect across the EU in November 2007. With significant developments in the trading environment since then, particularly following the financial crisis of 2008–09, a review of MiFID was proposed by the European Commission in October 2011 to establish "a safer, sounder, more transparent, and more responsible financial system." This led to a revised set of proposals, agreed in April 2014, comprising a new EU regulation, MiFIR (Market in Financial Instruments Regulation), as well as a new directive, MiFID II. (The difference with the latter being that requirements needed transposition into law at a national level across the EU, while MiFIR is passed by the European Council and Parliament). MiFID II and MiFIR were initially due to come into force in January 2017. However, because of delays in finalizing the required technical standards by the European Securities and Markets Authority (ESMA), this was deferred in April 2016 by a year.

MiFID II broadens record-keeping requirements

In terms of the new MiFID, Articles 16(6) and 16(7) are the main demands relating to record-keeping. Article 16(6) is a general record-keeping requirement around all services, activities, and transactions to allow regulatory authorities (referred to as national competent authorities, or NCAs) to carry out their own supervisory functions, which include ascertaining that a firm has complied with all obligations relating to its clients and ensuring market integrity. Article 16(7) relates specifically to the recording of telephone conversations and electronic communications between a firm and a client, with firms required to notify the client that such recording will occur and ensure that records are kept (in at least some form) across all communication channels, including telephone, fax, mail, digital channels, as well as face-to-face.

Data requirements for order and processing record-keeping have been extended

Key changes with Article 16(6) relate to the need to provide additional information to NCAs, specifically around market abuse regulations relating to insider trading/market manipulation. More importantly, there is perhaps a clearer intention that transaction records will be used to ensure that market integrity obligations are complied with. However, in many respects, the changes are not substantial in principle compared with existing record-keeping requirements of MiFID I. The MiFID Implementing Regulation already sets out the following:

- Article 7 – Firms must keep records of every order received by the client, and every decision to deal taken in the course of providing a portfolio management service.
- Article 8 – Firms must keep records of transactions relating to client order execution, order transmission, and order confirmation.
- Article 51(1) – Records must be retained for a minimum five years, with any records relating to agreements between an investment firm and its clients retained for at least the duration of the client relationship.
- Article 51(2) – Records must be kept in an accessible form for the relevant NCA, so that the NCA can readily use the data to reconstitute each key stage of the transaction process.
- Article 51(2) – Records must not be alterable or manipulated, with any amendments made to correct data easily ascertained.
- Article 51(3) – Each NCA should draw up and maintain a list of minimum record requirements.

However, the breadth has increased significantly. With MiFID II, the ESMA's clarification in its technical advice extended the breadth of data that is required under Articles 7 and 8 around recording client orders and transaction/order processing details (the latter extending from six to 40 data items). The ESMA has also significantly revised Article 51(3) to provide a comprehensive list of records required across client assessment, order handling, transaction processing, client reporting, asset safeguarding, client communications, and organization requirements. Importantly, the extended list of minimum records in each respect is non-exhaustive, and can be extended by NCAs if desired.

Recording of client communications is mandatory across all channels in MiFID II

In contrast, Article 16(7) is a more significant change in terms of requirements, as MiFID I effectively deferred the setting of requirements around telephone and electronic communications recording to the discretion of each member state. While some regulators, such as the FCA in UK, had introduced call recording requirements, this was often limited to individuals directly involved in trading and initially focused on fixed-line recording (although this was later extended to include mobile recording as technology capabilities evolved).

MiFID II removes any such discretion, with the recording obligation now a mandatory one across all EU states. This is driven by a desire to

- ensure there is evidence to resolve disputes between a client and an investment firm over terms of a transaction
- assist NCAs and firms in their own supervisory work in ensuring conduct of business rules
- act as a deterrent against, and improve detection of, market abuse.

MiFID II imposes a broader minimum requirement on recording of conversations that may result in a trade (even if communications do not result in the actual provision of services). This covers conversations across telephone and electronic channels of dealings for anyone involved in the advice chain if there is potential for an order. This effectively extends the scope to all intermediaries, including independent financial advisors and wealth managers, as well as to staff within a firm for internal calls related to transactions. Any communications made in "durable" medium such as mails, faxes, emails, and documentation of client orders must be maintained, and records must be also kept of face-to-face meetings, although written minutes/notes are allowed for this at present. Similarly, all call-based conversations require recording across fixed line, mobile-based devices, softphones, and so on. Firms need to take reasonable steps to prevent employees or contractors from taking order via personal equipment outside the firm's recording setup.

A key point to note here is that conversations relating to the provision of investment advice do not need to be explicitly recorded (although record-keeping of the advisory process is required under Article 16(6)). However, firms do need to record conversations that may result in the provision of services/orders. Given the high potential overlap in conversations across the advice and order process, this does make the requirement quite broad regardless, unless firms unequivocally separate the two – for example, by explicitly preventing orders from being accepted over the phone. Even in this case, firms need to ensure that they have systems and processes in place to ensure any communications/conversations that are subject to recording requirements are captured.

Firms need to use communication recordings to ensure compliance and retain retrievable records for at least five years

As with general record-keeping requirements from Article 16(6), communication records have to be kept for at least five years, although this can be extended up to seven years if desired by a member state's NCA. This is a significantly longer period than many NCAs currently enforce – by comparison, the UK's FCA Conduct of Business Sourcebook 11.8 requires only six months of call record retention. Again, as with Article 16(6), such records need to be durable, stored in a medium that allows them to be replayed or copied, but in a format that does not allow the original record to be altered or deleted.

Importantly, a key challenge is that such records are retrievable, either to NCAs or to service clients' requests. Clients have to be notified that such records are available for at least five years, with information stored in a medium that is "readily accessible and available to clients on request." This means that call/communication records need to be associated with relevant information, such as caller or order details, so that firms can rapidly and efficiently locate records.

Firms also require such recorded information for supervisory process to ensure compliance with both recording and wider regulatory requirements. Therefore, firms have to periodically monitor all transactions, although firms are allowed to take a risk-based approach to managing process, which means they do not necessarily have to physically review all records, but must ensure that all conversations are being recorded.

How can technology help firms achieve MiFID II compliance?

Clearly, given the extent of recording requirements, scale and efficiency demands mean that creating appropriate technology systems and processes is essential to allow firms to achieve regulatory compliance. Many areas, such as email retention, are longstanding requirements, and as such also relatively technology mature. However, for many firms, it is the new broad conversation recording requirements that present the greatest challenge.

From a regulatory perspective, the main stipulation is that firms have to comply on a "technology-neutral" basis – the key point being that processes and systems require periodic re-evaluation to assess their effectiveness, so that procedures can be updated to reflect new technologies. This is particularly the case when a new medium of communication is accepted/permitted for use by a firm.

From a technology perspective, key considerations include assessment of the ability of systems to support call recording across all devices, including fixed line, IP phones, softphones, mobile devices, and new communication channels. Fragmentation of call recording systems by device/channel will increase system costs and, more importantly, impede the ability to retrieve records effectively across to service client or regulatory requests, or a firm's own supervisory processes.

Another key capability to consider is the ability to link call records with other record-keeping requirements (such as client order and trade execution, transmission, and confirmation records). Firms need the ability to replicate the transaction process across the whole process chain, and as such call recording under Article 16(7) should not be treated in isolation with Article 16(6) requirements. Systems will ideally need the ability to enrich call recording with relevant metadata, such as unique client and trade IDs, so that records can be linked.

Finally, while this is regulatory driven, firms obviously will want to the minimize cost and process disruption impacts of compliance here. Most firms will already have some processes in place from MiFID I, and while the breadth of coverage has increased with MiFID II, systems that offer high flexibility to adapt to, and work with, existing customer processes should be considered at a premium. While technology investment can be significant, it is generally far less than costs associated with major process transformation.

Appendix

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Ovum Consulting

We hope that this analysis will help you make informed and imaginative business decisions. If you have further requirements, Ovum's consulting team may be able to help you. For more information about Ovum's consulting capabilities, please contact us directly at consulting@ovum.com.

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