

How Charles River IMS Supports MiFID II Compliance

Slated for implementation on 3 January 2018, the revised Markets in Financial Instruments Directive (MiFID II) and the Regulation on Markets in Financial Instruments (MiFIR) will impact every stage of the buy-side investment process, and all asset classes aside from spot FX.

MiFID II provides some latitude for EU member states to amend and interpret requirements before codifying them into national law. In contrast, MiFIR allows no room for interpretation or amendment and will be implemented consistently across the EU.

The looming implementation deadline is forcing institutional investment managers, private banks and hedge funds to rethink their operating models and technology platforms. Firms also need to understand which aspects of the legislation fall under the directive versus the regulation. This brief discusses MiFIR and MiFID II's global impact on asset managers and how Charles River is helping firms streamline implementation and adapt their workflows to minimize business disruption.

MiFID II Objectives and Impact

The Financial Conduct Authority (FCA) published four primary objectives shared by MiFID II and MiFIR:

- Reduce system risk
- Increase the efficiency of financial markets and reduce unnecessary costs for participants
- Strengthen investor protection
- Reduce the risk of a disorderly market

These objectives will impact several key areas, including commission management for the payment of buy-side research, transaction and trade reporting, and ensuring best execution. MiFID II also mandates the migration of certain classes of OTC-traded derivatives onto Organized Trading Facilities (OTFs) with the goal of reducing counterparty risk exposures.

While MiFID II is driven by European regulators, asset managers globally will be subject to many aspects of the legislation, depending on their level of interaction with European clients, trading venues and securities. Tabb Group estimates that 66% of U.S. buy side firms will be directly affected.

The following table summarizes how a firm's domicile dictates which MiFID II obligations apply:

	Commission Handling (RPAs)	Transaction Reporting	Trade Reporting	Best Execution
EU Firm	Required	Required	Required	Required
Non-EU Firm with EU Branch	Required	Required	Required	Required
Non-EU Firm EU Domiciled Fund	Required	Not Required	Not Required	Required
Monetary Investment in EU Asset Manager	Approve RPA	Not Required	Not Required	Not Required
Non-EU Firm Executing in EU	Not Required	Not Required	Need to provide LEI	Not Required



Charles River's Approach

Making sense of MiFID II's numerous lengthy directives, discussion papers and delegated acts is an onerous task. Charles River has implemented a multi-pronged strategy to help buy-side clients expedite MiFID adoption:

- Analyze MiFIR/MiFID II analytical, reporting and data requirements across all impacted asset classes and instruments
- Communicate required changes to Charles River's clients via webinars, working groups, and advisory bulletins
- Implement technology enhancements with sufficient flexibility to accommodate changing requirements, automating procedures whenever possible, and minimizing changes in existing client workflows to maintain efficiency
- Establish partnerships with emerging MiFID-related service providers, including Approved Reporting Mechanisms (ARMs) and Approved Publication Arrangements (APAs), and trading venues to refine interfaces as requirements evolve

With the highest per-capita R&D spend among buy-side technology vendors, Charles River is uniquely suited to help clients navigate the rapidly changing global regulatory landscape. Charles River's considerable expertise in buy-side compliance, trading, and risk management solutions ensures institutional asset managers can leverage a single source of technology and domain knowledge as they begin to implement MiFID II requirements. Charles River's SaaS-based deployment model delivers frequent upgrades to ensure clients are always current with the latest functionality.

Partnering with a technology vendor capable of monitoring and rapidly implementing changes is especially critical with MiFID II, as some key aspects of the regulation remain unclear. For example, industry groups and institutional investors have pointed out the inadequacy of using the International Securities Identification Number (ISIN) standard for MiFID II reporting. Whether this standard will be replaced is currently unresolved, and technology platforms will have to adapt within a short time frame.

Transaction Reporting

To support new regulatory surveillance activities, MiFID II significantly expands on the original MiFID transaction reporting requirements. Firms will need to compile a total of 65 reporting fields, including information on buyers and sellers, transaction details such as currency and size, and instrument descriptors. Nearly all asset classes are considered reportable, including OTC derivatives.

Buy-side firms can either transmit reportable transactions to their brokers, if the broker is willing to perform transaction reporting (through a transmission of order arrangement), or to an ARM. ARMs provide clear advantages for firms trading with a non-MiFID broker or with brokers outside of the European Economic Area (EEA). Reporting all transactions to a single ARM streamlines reporting obligations and removes the liability of transmitting personal data to a broker.

Transaction reporting presents one of the biggest MiFID-related data management challenges. Massive data quantities need to be sourced, normalized and reconciled from a variety of internal and external databases.

Charles River provides an extensive data management and reporting framework to support the MiFID II transaction reporting requirements. Key capabilities include:

- Track all MiFID II transaction reporting data requirements across different instruments
- Automate the assignment of the investment decision maker based on user defined rules
- Determine whether an order meets either large-in-scale (LIS) or size-specific-to-instrument (SSTI) criteria
- Additionally, Charles River certifies connectivity to new and existing ARMs, and helps clients design firm-appropriate workflows for submitting initial and amended transaction reports.

Commission Management

MiFID II significantly impacts how commissions paid to brokers and research providers are funded, budgeted and tracked. Firms will need to establish Research Payment Accounts (RPAs) to pay for research and can choose from one of three funding options, depending on client preferences:

- **Transactional:** use existing commission sharing agreements (CSAs) to fund research via commissions
- **Accounting:** bill clients directly for research
- **P&L:** pay for research using the firm's own P&L

Still unresolved at present is whether MiFID II will require asset managers to establish separate RPAs for each client. None of these options is clearly superior, but each provides certain advantages to firms and their clients depending on size, volume of research consumed, and trading frequency.

All three options, however, place significant demands on a firm's regulatory reporting infrastructure. At a high level, systems must be able to provide clients and regulators with a periodic, detailed report of how research funding was budgeted, accrued, and allocated. Ideally, technology vendors will provide automated commission tracking built on a flexible, criteria-based rules engine to accommodate all three RPA options.

Charles River's commission management capabilities support these requirements by allowing firms to define commission budgets and targets, track execution and research commissions on a per trade basis and view budget status in relation to targets.

Trade Reporting and Post-Trade Transparency

MiFID II requires near real-time reporting of trade executions for equities, depository receipts, ETFs, certificates and similar instruments, bonds, structured finance products, emission allowances and derivatives. This requirement governs both on- and off-venue trades, as well as brokers registered as a 'systematic internaliser' (SI).

In the context of MiFID II, an SI is any firm that deals in its own account on an organized, frequent, systematic and substantial basis outside a trading venue when executing client orders. Trade reporting deferrals may be granted for trades in illiquid markets or those meeting LIS or SSTI criteria. These deferrals are designed to protect liquidity providers in thinly traded names from undue risk.

"Post trade transparency for OTC transactions raises similar types of issues given the extension of scope to non-equities. The possibility remains that portfolio managers will have new formal obligations to report trade details. Although those obligations may be outsourced, they still represent a new type of compliance burden for managers."

From Skadden, Arps 2016 Insights: "MiFID II Expected to Have Significant Impact on Investment Managers"

Trade reporting must be satisfied through an authorized APA. A number of organizations are in various stages of launching APAs and obtaining regulatory approval.

Charles River applies rules (*figure at right*) to determine whether a particular trade requires reporting, and transmits real-time reports for trades not covered by trading venues or counterparties to the firm’s designated APA. Charles River also certifies connectivity to both existing and emerging APAs.

OTC Derivatives

MiFID II introduces new OTC-specific regulations for Eurozone participants, with the intention of increasing pre- and post-trade transparency. Among these requirements are LIS and SSTI determinations, commodity derivative risk reduction, and notional change reporting. MiFIR also requires that certain OTC derivatives mandatorily cleared through a central counterparty (CCP) as of January 2018 will need to be traded on Multilateral Trading Facilities (MTFs) or Organized Trading Facilities (OTFs). Currently, no trading venues have registered as an OTF, though this is likely to change prior to the MiFID II implementation date.

Two factors determine which CCP-cleared derivatives fall under this new “trading obligation”. The **venue test** states that a particular class of derivatives must currently be trading (or deemed eligible for trading) on a least one trading venue, while the **liquidity test** determines whether the instrument is sufficiently liquid to support viable trading opportunities. While the transition to MTFs and OTFs raises the expense of trading derivatives, it benefits both sides of a trade because the CCP assumes contingent default risk and guarantees any coupon payments.

To address MiFID II requirements, Charles River leverages considerable expertise and experience gained from designing derivatives solutions for Dodd-Frank compliance:

- Establishing, certifying and maintaining connectivity between MTFs and Charles River IMS
- Setting pre-trade LIS and SSTI transaction reporting waivers for applicable OTC derivatives
- Determine whether an OTC transaction is a notional increase or decrease
- Tracking whether orders are eligible for trading on an MTF, and the jurisdiction of the different allocation funds
- Allowing orders to be split by jurisdiction: this supports CFTC workflows where swaps need to be executed on a Swap Execution Facility as well as ESMA workflows where the trades need to be executed on an MTF



Best Execution

MiFID II's best execution reporting requirements pose yet another significant data management challenge for buy-side firms. Details regarding the content and format of required best execution reports are detailed in Regulatory Technical Standard 28:

- Reporting requirements apply to all asset classes, and must be published for client orders executed on EU and third country execution venues. Reports are to be published on a quarterly and annual basis.
- Firms must publish data for each of their top five execution venues based on trading volume. Reports apply to orders executed on behalf of both retail and professional clients.
- Additionally, firms are required to publish the percentage of client orders executed on each execution venue. Such information needs to be broken down into passive orders (those that provide liquidity), aggressive orders (that take liquidity), or client-directed orders.

The principal impact is that these rules apply equally across asset classes, not all of which have established execution quality methodologies, such as Transaction Cost Analysis (TCA) in equity markets.

Charles River has implemented an execution analysis facility within its Order and Execution Management Systems (OEMS) that supports these reporting requirements and provides traders and compliance officers with extensive analytical capabilities. The facility captures key data points in portfolio manager and trader workflows, the reason for each order, execution priority, trader intent and placement reason.

This helps firms better understand the factors and decisions that impact execution quality, demonstrate adherence to best execution standards throughout the order lifecycle, and audit the full order history based by incorporating detailed historical data.

Solving MiFID II Compliance Challenges with Charles River

With its global reach, broad asset class impact, and depth of technical detail, MiFID II represents a regulatory sea change for institutional asset managers. By partnering with Charles River, firms gain access to a trusted source of domain expertise and the ability to leverage a single technology platform capable of fully supporting MiFID II's extensive requirements. Specifically, Charles River's SaaS-deployed solution provides the requisite scalability to capture and store significantly larger data volumes, a flexible data model to incorporate new internal and external data sources, and highly configurable transaction and trade reporting capabilities.

“Accenture’s work suggests that firms may need to source up to 50 percent of the required best execution data points for the first time. Organizations may find themselves spending a significant amount of time performing a non-trivial data sourcing and remediation exercise.”

From Accenture Whitepaper: Best Execution, Helping financial firms effectively manage their MiFID II obligations

Looking beyond the implementation of MiFID II, firms that invest in robust compliance and reporting solutions stand well positioned to adapt to the emerging global regulatory landscape. Investment managers benefit from lower operational and reputational risk, the ability to support their investors across geographies and product lines when new regulations are implemented, and cost reductions gained from consolidating regulatory compliance and reporting on a single platform.

About Charles River

Charles River enables sound and efficient investing across all asset classes. Over 350 firms worldwide use Charles River IMS to manage more than US\$25 Trillion in assets in the institutional investment, wealth management and hedge fund industries. Our SaaS-based solution automates and simplifies investment management on a single platform - from portfolio decision support and risk management through trading and post-trade settlement, with integrated risk and compliance throughout. Headquartered in Burlington, Massachusetts, we support clients globally with more than 750 employees in 11 regional offices.