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Theme for 2018: Who will win from MiFID II in fixed income?

MiFID II rips up the market rulebook — and replaces it with a whole bookshelf of new rulebooks. Entire divisions have worked flat out to get ready for the regulation's official start on January 3, and it's certain to overturn the established competitive order. Nell Mackenzie looks at the winners and losers.

By Nell Mackenzie *03 Jan 2018*

MiFID II will transform the financial markets in Europe and the world. It's big — 1.5 million paragraphs, including guidance standards, technical standards and implementations — and it's supposed to transform the old order.

But some firms stand to benefit more than others. Markets that were once dark will become transparent, trading that was once done over the telephone will be automated and electronified, while whole markets will be created for products that were once free. In the turmoil lies opportunity, and risk.

Sources GlobalCapital has canvassed, across private banking, asset management, financial advice, investment banks, funds, tech and advocacy argue that companies which embrace the regulations and use them to improve their technological capability should be the best bets to be MiFID II's winners.

Big firms will have it easier

"The scale and size of MiFID II is easier for firms with enormous operational departments, legal teams, government affairs people, compliance experts and so on," says a financial trade association spokesperson.

"We are guilty as an industry of not embracing technology as we should have done"

Rebecca Healey, Liquidnet

The rules have been expensive and troublesome for the largest trading operations, but they have the budget to build the infrastructure MiFID requires for record-keeping. They can spend the money to take trading electronic, and may have the scale to produce research that can stand out from the crowd.

They have the breadth of staff to produce research that might be offered for profit. The association has members in larger firms and, he says, they are very happy with how prepared they are for the January 3 deadline.

Nevertheless, the association's member firms still had questions about some of the variations in interpretations of MiFID II as GlobalCapital prepared this piece in the final run-up to January 3.

National regulators differ from one another on interpretations of post-trade reporting, research unbundling and trading on the systematic internaliser regime.

Firms are hoping that after the January 3 deadline, regulators will offer some more clarity.

The UK's Financial Conduct Authority has acknowledged that there are questions about interpretation, and that processes need to be smoothed out from January. Mark Steward, director of enforcement and market oversight, said in a speech in October that the watchdog would take a reasonable view towards firms that have made an effort to meet the deadline.

Tough for small firms

It's not just banks and trading firms that have had to retool to meet the tsunami of regulation, but also the essential service providers that allow markets to function. IHS Markit provides benchmarks, but also offers 22 other products that it has had to change or overhaul because of MiFID.

In the run-up to the deadline, Kirston Winters, product management lead for MiFID II at IHS Markit, says his firm worked with clients of various sizes and they acted in different ways.

He describes large sellside institutions running multiple work streams, each looking at the different areas and co-ordinating between the streams to make sure they are fully compliant.

The smaller banks and buyside firms including asset managers, he says, might be more nimble but are also less well resourced.

Winters points to US regulations for futures commission merchants (FCMs) as an example of how regulation could hit small firms hardest.

"The regulation got tougher and tougher and loads of those firms did not stay in the business, because ultimately you need to be a player of scale to be able to have all the processes and procedures and technology in place and to compete and be compliant with all the regulations," he says.

"There is no doubt in my mind that if you increase the regulation by an order of magnitude, then some small players won't be able to cope or won't want to."

Ticking the tech box

Though some argue that larger players will naturally fare better in coping with the new regulation because they have more to spend on technology and transformation, smaller players are rethinking their place in the markets and negotiating a smarter approach.

The asset management industry was facing consolidation already, says Rebecca Healey, head of EMEA market structure at Liquidnet, a global peer to peer electronic trading platform for asset managers. But she does not believe the future is as simple as saying that the large will prevail and the small will suffer.

She says financial markets were due a change and have reached a juncture.

Shifting to more automated trading, not just adding algorithms, she argues, is the answer to meeting the challenge of MiFID and making a success of it.

Healey, whose firm is promoting a fixed income dark pool, points to the dangers of traditional fixed income workflows, in which a buyer looking for a specific asset has to call around, hoping each counterparty it calls has good prices and liquidity for the asset it is looking for, leaking information into the market about the trade.

"We are guilty as an industry of not embracing technology, as we should have done," says Healey. "The shift to more automated trading, the ability to leverage technology to facilitate workflow and meet regulatory compliance will accelerate through 2018."

Some of the smaller banks and asset managers GlobalCapital spoke to have already begun their own processes of embracing technology, encouraged by MiFID.

Bojidar Kounov, chief executive of Adamant Capital Partners in Bulgaria, says he has been following MiFID from the beginning and felt ready for the regulation to go live.

Adamant started recording calls from day one, he says, and the regulation has changed his business strategy to include more focus on what technology can do to make asset management more efficient.

“We have been developing an in-house system that provides our counterparties with electronic access in order to reduce transaction costs and to automate reporting,” he says.

Even financial advisers, which are not MiFID registered, are looking forward to the transparency MiFID will bring in terms of price data.

“When all you get is one quote you never know what is behind that,” says Abhishek Sachdev, chief executive of Vedanta Hedging, a derivatives expert who advises large property firms and public limited companies.

He continues: “We look forward to the transparency in derivatives markets that MiFID II will bring and provide for the customers we advise.”

Cost of unbundled research

Unbundled research, another side of MiFID II, could also be a bonanza for some firms — and a big problem for others.

Firms that used to provide research for free will now have to charge buyside customers from January 3 for financial research in several categories.

Patrik Karlsson, a director of regulatory policy at ICMA’s Asset Managers and Investors Council, says MiFID will increase quality but may squeeze the industry in the middle.

Because of the costs involved, Karlsson says, the larger buyside firms will be likely to benefit. Larger asset managers have bigger budgets to absorb research costs. Active portfolio managers, which require research, unlike their passive management competitors, will be disproportionately affected.

“Smaller firms will have to choose more carefully what research they pay for, so they can get the best value out of it,” says Karlsson.

Investment decisions will be made more difficult, he says, because smaller firms will potentially lack the broad variety of research they had access to when it was bundled with trading costs and they got it for free.

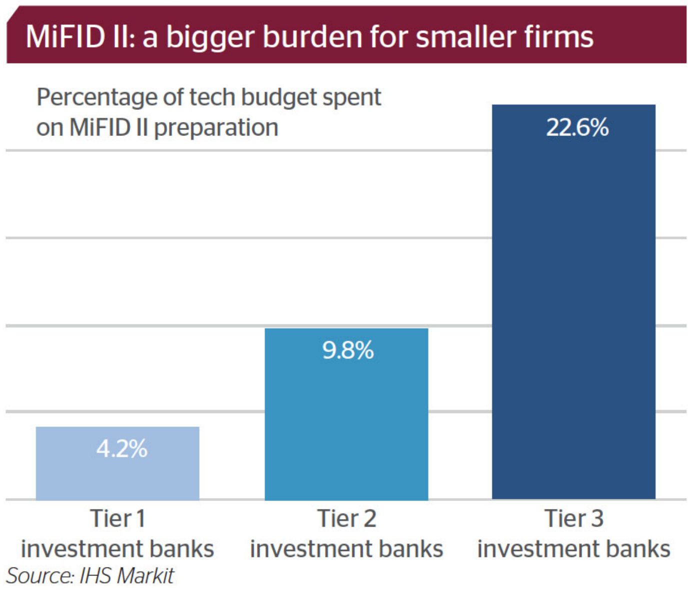
Karlsson also describes how mid-sized research providers might see themselves squeezed out by larger broker dealers with deep capacity, who can price research aggressively because they have economies of scale.

“So, the payers of research will go to the one specialised firm for the one analyst they’ll go to, or access the very large firms for the broader capability,” says Karlsson.

Market correction either way

One source from a buyside division attached to a large systemically important bank says that the firm has reduced the number of companies it receives research from.

The company uses several providers, from boutique houses to larger players, and the source says the firm was already grappling with internal conflicts, because different departments have strong feelings about which analysts they want to read.



"People are asking tough questions," says the official. He also says the pricing for most research is coming down and buyers will not tolerate large bills for research.

Some people are going to get found out, says the source, for not providing differentiated thinking, and pay for it. "As independent companies, they'll go bust, and at banks they'll be let go. It is probably a market correction either way."

Picking winners

The years of preparation for the new regulation has laid the groundwork for figuring out which firms will float and which will sink under the new regime. Technology investment, nimbleness in business models and behaviours, careful co-ordination across divisions will determine the ultimate victors — but it won't be instant.

Though everything went live on January 3, there's still plenty of work to do, and the process is going to keep going all year, as regulators refine their understanding of the rules, and businesses adjust to the new environment.

"MiFID is creating challenges for firms and they are having to adjust and change," says Healey. "This is all part and parcel of the G20 and the end results of the financial crisis."

The sprint to be ready by the end of 2017 was not a sprint to the finish line. It was a sprint to a checkpoint along the way — and the MiFID II race will continue through 2018.

• See MiFID II: shake-up of research carries risks for capital raising for more on the regulation's effect on equity markets

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