MiFID II – Capital Markets Reform with Communications

Can you listen, read, record, retain, audit, report, supervise and be in compliance?

WHITEPAPER

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1. MiFID II & Communications

About MiFiD

MiFID II is one of the most ambitious and contentious reforms introduced by the EU in response to the 2008 financial crisis. It governs everything from where and how derivatives can be traded to measures to reduce volatility and police potential conflicts of interest among financial advisers.

The trauma of the crisis led to a political sea change in opinion on how far the EU should go in policing the safety and soundness of the financial system.

Michel Barnier, EU internal market commissioner from 2010 to 2014, set himself the goal of establishing a “single rule book” for financial services that would prevent excessively risky practices of the past occurring again while also removing some key decisions from national regulators who failed to prevent the crisis.

While more than 40 pieces of legislation were adopted during Mr Barnier’s mandate, some were more significant than others. Two of the biggest initiatives were CRD IV, which toughened capital requirements for banks, and MiFID II, which seeks to enhance the robustness of financial markets.

Mr Barnier proposed his draft version of MiFID II in October 2011. After more than two years of negotiations, a deal on the final version of the law was approved by national governments and the EU parliament in 2014, with a start date of January 3 2017.

MiFID II

MiFID I was a very different beast, born in a very different time. In the early 2000s, the EU sought to break down barriers to cross-border trading. MiFID, which took effect in 2007, was the legislative centrepiece of that effort. It swept away monopolies enjoyed by traditional national exchanges and facilitated the development of alternative trading platforms. The rules primarily focused on equities markets.

It was always intended that MiFID would be reviewed, although the commission’s original plan was that this would result in some limited tweaking. This outlook completely changed after the crisis.

Damian Carolan, a partner at Allen & Overy, called the resulting MiFID II “incredibly ambitious”, adding: “I’m not sure they realised the extent of what they were taking on.”

Communications in MiFID II

While conducting an informal survey, financial institutions are exploring sophisticated methods to further their supervision/ review of all communications in this challenging mandate from MiFID II.

This increasingly complex regulatory reform, financial institutions are discovering that their historically siloed approach to combating Communication Surveillance and Recording Keeping for the MiFIDII requirements and retentions records is putting them at a significant operational and infrastructure compliance nightmare.

These institutions increasingly require solutions that can offer a holistic view of risk across their organizations allowing them to connect the dots across all areas related to these multi-asset transactions with the communications related to these transactions and investigations, review and supervision in near real time.

A centralized system can help companies do just that. By taking a more panoramic and risk-based approach to identifying communications the financial community can prevent criminal activity before it happens—and comply with the enhanced MFIDII mandates.

Organizations will need a plan and ensure that spans across individual regulations. Managing them one-by-one will incur significant costs and duplications and will simply stretch even large organizations beyond their capabilities. Challenges firms are underestimating on MFIDII have a far-reaching impact to their communications requirements.

Firms will have no option but to start modelling scenarios and infrastructure for communications or they will be caught in their internal processes and behind the regulatory reform that has been outlined.

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1 From Financial Times, http://www.ft.com/cms/s/0/77d46b66-87aa-11e5-90de-f44762bf9896.html#ixzz42DvmRKRm
2. The scope and impact of MiFID II on Communications

Examination of the MiFID II regulation shows the following impact on Communications and Recordkeeping:

- **New Market Structure**: Investment Banks, Investment managers/Insurance, Custodian bank, Private and retail banking.

- **Market Transparency**: Pre/Post Trade Transparency equity-like and commodities, best execution liabilities.

- **Investor Protection**: Client classification, client information, Suitability, Appropriateness, client/asset/money, inducements, Client reporting.

- **Internal and external controls/reporting**:
  1. Regulatory Supervision - Inter-regulatory cooperation
  2. Third Countries - Reciprocal third country access
  4. Systems and controls record-keeping-order reporting, transaction reporting, systems with records, Governance and compliance controls, and outsourcing.

**Provisions under MiFID II in the spotlight**

**Market structure**

By way of impact, various issues relating to trading mechanisms, venues and products would need to be considered.

- **Market structure**: there has been an intense debate as to how the rules on market structure might be amended. The options include a new category of trading venues called organized trading facilities (OTFs) alongside regulated markets, multilateral trading facilities (MTFs), and the amended scope of systematic internalizes (SIs).

- **Position limits and trading restrictions**: MiFID II implements trade restrictions and position limits on commodity derivative contracts that any given market members or participants can enter into over a specified period of time. These limits and restrictions, which target excess speculation, will be determined by ESMA and, as adopted in the text by the European Parliament, applied on a net position basis. These restrictions will not be imposed on positions built for hedging purposes by non-financial service firms.

  - HFT/Algo trading: a more restrictive regime coupled with enhanced disclosure covering high frequency and algo trading will be introduced. Business resilience and continuous liquidity provision will be areas of focus. It is envisioned that non-broker intermediated direct market access (DMA) will no longer be permitted. Arrest time of half a second might be applied to all orders that are delivered to market via HFT mechanisms. Coupled with the introduction of cancellation fees, it could force HFT traders having to rethink their trading strategies. Firms engaged in HFT will need to review the implications and their business options.

**Investor protection**

The number of investor protection cases has raised sharply in terms of poor governance, miss-selling, client assets and money infringements resulting in large fines for firms across the EU Member States.

- **Product, client coverage and ban of inducements**: MiFID II extends the conduct of business rules to new asset classes, and limits the “execution-only” regime to “non-complex” products, albeit within the existing client categorization rules. This allows for institutions such as local authorities to elect for “retail classification” if they are not already pre-classified as such. The widely debated ban of inducements will probably not be implemented for all 27 EU Member States. Local regulators will be allowed to specify their own inducement approach as they see appropriate and, indeed, some countries such as the Netherlands, Denmark and the UK are planning on introducing a “ban of inducement” regime. In any case, a more stringent, up-front disclosure requirement (like detailing any financial inducements received from third-parties as a result of products sold to retail clients) seems to have received backing. Lastly, the provisions relating to suitability of investments, especially to retail investors, is strengthened.
When providing investment advice, the investment firm needs to detail how the advice meets the client’s objectives, and indicate whether the advice is provided on the basis of a restricted, or otherwise, range of financial products.

Internal controls/governance

Corporate governance: MiFID II establishes a greatly strengthened corporate governance regime, encompassing rules on time commitments and fit and proper criteria for board directors. It also strengthens the role of the compliance officer. Although MiFID II does not require complete independence of the compliance function, it does require a recording of where senior management deviates from the compliance officer’s assessment and recommendations, and an explanation as to the remedial action the investment firm intends to take.

External controls/governance

Third-country access: as with all EU regulations and directives, the issue of third-country access is one of the more controversial areas. The revised MiFIDII proposes to introduce a harmonized third-country equivalence regime for the access of investment firms and market operators to the EU. Since MiFID II follows a similar direction to the Alternative Investment Fund Managers’ Directive (AIFMD), it was assumed that third-country regulators will need to pass several mutual recognition tests and operate co-operation agreements with EU and European Economic Area (EEA) regulators. However, it seems that the council is not in favor of reciprocity anymore as a basis for allowing access to the EU. A consensus seems to be evolving for non-EU investment firms wanting to provide services to retail clients, professional and eligible counterparts. Firms wanting to service retail clients will be required to establish an EU branch, as well as obtain branch authorization from the local authority where the branch is situated. For firms wanting to provide investment services to professional and eligible counterparties only, no mandatory presence with a branch in an EU state is needed. It remains to be seen to what extent this will be incorporated into the final text. Important questions have been raised as to how bilateral agreements could be established and maintained between every EU Member State and each of the other 110 or so countries who are members of the International Organization of Securities Commissions (IOSCO). Practitioners have challenged the measure of having equivalence and reciprocity tests, partly because a supervisor would need to review hundreds of countries to assess whether the regulatory regime is equivalent to the European one, which creates a lengthy and inefficient acceptance process.

Outsourcing: MiFID II could present a shift in the industry toward more outsourcing providers. The move to execution on trading venues is likely to result in higher volumes of smaller value transactions in quote-driven markets, just as those that occurred with equity trades across Europe from 2007–12. Enhancing the scalability of OTC derivative trading, trade confirmation, as well as novation and netting systems will be imperative. Many asset managers and other intermediaries, who lack the scale to invest in systems, may look toward new outsourcing service providers as a way to provide support services and facilitation at the appropriate price points. Parties who outsource will still need to perform the necessary regulatory due diligence and manage operational complexities in the front, middle and back offices.

Systems, processes and controls

Front-to-back infrastructure impact: the implementation of MiFID II, MAD II and EMIR may usher in significant market microstructure changes by introducing auction systems competing with dealer pricing, as “former OTC products” become more “equity like.” A whole array of system and process changes would be required to cater for the auction models impacting both the sell-side and buy-side.

Trading impacts: MiFID II and Dodd Frank will stimulate a high degree of trading process changes over the next five years. This includes multiple competing trading venues with the potential for a) order-driven models (both continuous-auction and batch-auction systems in the secondary OTC market) and) quote-driven models (the evolution of OTC dealers to full market makers or a more hybrid system).

Data and reporting MiFID II will essentially mirror the scope of MAD II, which will require further adjustments (due to its ongoing review) as well as major changes in both operational and reference data.
unique trade identifiers, counterparty and legal entity identifiers and product identifiers. Those firms that have already invested in enhancing their data architecture across multiple asset classes will be best placed, while others will need to investigate this infrastructure as an immediate priority.

Record-keeping and documentation: most firms have already implemented their transaction-reporting capabilities to comply with MiFID I, resulting in robust arrangements in which to store their records on machine-readable and durable media for five years. However, because there were several high-profile cases in recent years where firms were fined for misdemeanours, audit trails will need to be more robust. They should now include on-demand documentary retrieval for more complex instruments, such as OTC derivatives, to evidence best execution with regard to the broader OTC-traded markets. In addition, some Member States, such as the UK, will remove the exemption for mobile phone conversations for reasons of market abuse prevention. As a result, MiFID II will strengthen the treatment of client assets and money, which will necessitate further investments in data management.

Near real-time reporting: the near real-time post-trade reporting requirements will drive system, process and cultural change. This will enhance timing of trade capture down to 15 minutes after trade execution, for trading venues and single dealer platforms (SDPs) of investment banks. To improve the quality and consistency, the amendment requires firms to publish their trade reports through approved publication arrangements (APAs) for all asset classes of MiFID II, with harmonized reporting standards across all Member States and alignment with EMIR trade reporting.
3. Aligning MiFID II with other regulations

Depending on the type of financial services offered by an organization and the degree of internationalization, a number of other regulations need to be considered in conjunction with MiFID II.

Common global programs are essential for those organizations impacted by related US measures, such as Dodd Frank (DF). However, the differences in the timing of implementation and emergence of detailed rules will prove challenging, as will the evaluation of potential extra-territorial impacts. Organizations that aim to establish one platform covering swap execution under DF and OTF trading will have to manage the different requirements of each jurisdiction and ensure that their platform is flexible enough to cater for each set of requirements. Independent platform providers maybe placed at an advantage over dealers providing pricing for standardized swaps on their SDP as they appear to be banned, requiring a significant change in the dealer’s business model.

In addition, non-banking organizations, such as insurance firms, will need to start aligning any MiFID II analysis, especially in relation to investor protection. Measures and commission prohibitions, as these could significantly change business models by reducing the choice of products for policyholders.

National regulations will come into play earlier and potentially interact with MiFID II; in the UK, for instance, the Retail Distribution Review (RDR) is implementing many of the original MiFID II requirements on the ban of inducements. With the sheer number of upcoming regulations that overlap in key areas, it is inefficient to look at their impacts independently, but rather identify all relevant regulations and determine commonalities and overlapping themes. This will ensure a more cost effective implementation of the requirements, as it reduces the duplication of work in the overlapping areas.

**Overall voice and electronic communication priority actions**

►► Conduct initial impact assessment for MiFID to determine communication surveillance requirements

►► Establish cross-regulatory reform agenda and ensure that MiFID II analysis is joined up with other regulatory communication surveillance projects conduct overall market communication impact analysis to identify suitable opportunities

►► Review validity and record retention of Voice communications

►► Assess MiFID II impact on the trading floors voice recording with the intent of an order to be executed by the various lines of business within the financial institution

►► Conduct asset class-specific MiFID II front-to-back impact analysis

►► Review MiFID II impact specifically from a risk and compliance management point of view (e.g., managing times of prohibited or restricted trading (commodity derivatives)) supervision, review and audit capabilities.
4. The relevant provisions in MiFID II

These are the relevant articles with regards to Communications & Recordkeeping in the DIRECTIVE 2014/65/EU OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU

Article 16(7)

“Records shall include the recording of telephone conversations or electronic communications relating to, at least, transactions concluded when dealing on own account and the provision of client order services that relate to the reception, transmission and execution of client orders.

Such telephone conversations and electronic communications shall also include those that are intended to result in transactions concluded when dealing on own account or in the provision of client order services that relate to the reception, transmission and execution of client orders, even if those conversations or communications do not result in the conclusion of such transactions or in the provision of client order services.

For those purposes, an investment firm shall take all reasonable steps to record relevant telephone conversations and electronic communications, made with, sent from or received by equipment provided by the investment firm to an employee or contractor or the use of which by an employee or contractor has been accepted or permitted by the investment firm.

An investment firm shall notify new and existing clients that telephone communications or conversations between the investment firm and its clients that result or may result in transactions will be recorded.

Such a notification may be made once, before the provision of investment services to new and existing clients. An investment firm shall not provide, by telephone, investment services and activities to clients who have not been notified in advance about the recording of their telephone communications or conversations, where such investment services and activities relate to the reception, transmission and execution of client orders.

Orders may be placed by clients through other channels; however such communications must be made in a durable medium such as mails, faxes, emails or documentation of client orders made at meetings. In particular, the content of relevant face-to-face conversations with a client may be recorded by using written minutes or notes. Such orders shall be considered equivalent to orders received by telephone.

An investment firm shall take all reasonable steps to prevent an employee or contractor from making, sending or receiving relevant telephone conversations and electronic communications on privately-owned equipment which the investment firm is unable to record or copy.

The records kept in accordance with this paragraph shall be provided to the client involved upon request and shall be kept for a period of five years and, where requested by the competent authority, for a period of up to seven years”.

Types of telephone conversations and electronic communications

MiFID II sets out that the investment services to be captured by telephone/electronic recording requirements are the following services:

i. reception and transmission of orders;
ii. execution of orders on behalf of clients;
iii. dealing on own account.

The specific conversations and communications that should be recorded in relation to the investment services outlined above are:

- the receipt of an order from a client;
- the transmission of an order (both where the investment firm will transmit the order, and where it will execute it);
- the conclusion of a transaction when executing orders on behalf of clients;
- the conclusion of a transaction when dealing on own account regardless of whether a client is involved in the transaction.

This includes all telephone conversations and electronic communications relating to these activities that are intended to result in the conclusion of an agreement, even if those conversations or communications do not result in the conclusion of
such an agreement. The recordings shall not only include any placed orders, but also modifications and cancellations of orders, as executed orders and indications of interest. The term ‘electronic communication’ has a wide application. It captures any electronic communication involving the provision of the services listed in Article 16(7) of MiFID II. Due to the continuing innovation and advancement in technology, an exhaustive list would frequently become outdated. ESMA would expect senior management to exercise their judgement in this area.

The CESR advice of 29 July 2010 suggested that it was not intended that such recording requirements would capture internal conversations and communications within investment firms (although it would capture conversations and communications between two investment firms in the same group). However, ESMA considers that some internal calls are subject to the MiFID II recording requirement where the internal call in question “relates to or is intended to result in transactions” in the provision of investment services subject to the telephone recording obligation. This view aligns with Recital 57 of MiFID II which sets out that: “such records should ensure that there is evidence to prove the terms of any orders given by clients and its correspondence with transactions executed by the investment firms, as well as to detect any behaviour that may have relevance in terms of market abuse, including when firms deal on own account”.

Market abuse is one of the most difficult offences to investigate and prosecute. Good quality recordings of voice conversations and of electronic communications can assist NCAs in detecting and deterring inappropriate behaviour. Capturing relevant conversations and communications will enable NCAs to capture and deter more inappropriate behaviour which would not be in the clients’ best interests. ESMA considers that the recording requirements should be imposed on investment firms and on branches of third country firms authorised in accordance with Article 41 of MiFID II.

**Face-to-face conversations**

Article 16(7) subparagraph 7 of MiFID II provides for the provision of orders through other channels. Communications made by “other channels” must be in a durable medium, and include the documentation of client orders made at meetings. The content of relevant face-to-face conversations with a client may be recorded by using written minutes or notes. ESMA proposes that where relevant face-to-face conversations taking place with clients result or may result in transactions in respect of the client order services listed in Article 16(7) subparagraph 1 of MiFID II, firms are required to document the content of these conversations. ESMA proposes to set out the minimum required information.

These recording rules do not apply generally to the service of investment advice, however conversations will need to be recorded when they result or may result in the provision of the following services: reception and transmission of orders, execution of orders on behalf of clients and dealing on own account.

**Instruments subject to the telephone conversations and electronic communications**

In relation to the financial instruments included in the recording requirement, MiFID conduct of business protections extend to transactions in all instruments covered by the definition of a financial instrument in Annex 1 of MiFID II.

**Equipment provided by an investment firm and privately owned equipment**

Article 16(7) subparagraph 3 of MiFID II provides for the firm to take all reasonable steps to record conversations and communications under the scope of the recording requirement, including equipment provided by an investment firm to its employees and contractors and privately owned equipment that has been accepted or permitted for use by the investment firm. The firm should have in place organisational requirements to ensure that this requirement is effectively implemented.

Article 16(7) subparagraph 8 of MiFID II includes an explicit reference to the treatment of privately owned equipment, which the firm cannot record. Firms should take all “reasonable steps to prevent” the use of privately owned equipment, which the firm is unable to record or copy (i.e. equipment that has not
been accepted/permitted by the firm). The firm should be required to have robust organisational requirements in place to ensure that it has satisfied that it is in the position to demonstrate to the NCA compliance with its telephone recording requirements.

Proposals in this area, which are also based on the work carried out by CESR since 2010, seek to build on the strong investor protection focus of MiFID II. To achieve this, ESMA proposes that in-20 2002/58/EC. 21 95/46/EC.36 vestment firms should have effective policies and control and oversight in place to ensure that the recording obligations are met and that compliance in this area is monitored. ESMA also aims to ensure consistency among investment firms in terms of the storage and retention of records.

Control and oversight

1. Investment firms should establish, implement and maintain effective organisational arrangements to ensure compliance with the rules on recording telephone conversations and electronic communications.

2. Investment firms should ensure that the management body has effective oversight and control over the policies and procedures relating to the firm’s recording of telephone conversations and electronic communications.

3. Investment firms should establish, implement and maintain an effective recording of telephone conversations and electronic communications policy, set out in writing, and appropriate to the size and organisation of the firm, and the nature, scale and complexity of its business. The policy shall include the following content:
   i. the identification of the conversations and communications that are subject to the recording requirements; and
   ii. the specification of the procedures to be followed and measures to be adopted to ensure the firm’s compliance with Article 16(7) subparagraph 3 and Article 16(7) subparagraph 8 where exceptional circumstances arise and the firm is unable to record the conversation/communication on devices issued, accepted or permitted by the firm.

Evidence of these circumstances must be retained in a medium that is accessible by the NCA.

4. Investment firms should ensure that the arrangements to comply with recording requirements are technology neutral. Firms must periodically re-evaluate the effectiveness of the firm’s measures and procedures and adopt any such alternative or additional measures and procedures as are necessary and appropriate. At a minimum, this should occur when a new medium of communication is accepted or permitted for use by the firm.

5. Investment firms should keep and regularly update a record of those individuals who have firm devices or privately owned devices that have been approved for use by the firm.

6. Investment firms should educate and train employees in procedures governing the Article 16(7) requirements.

7. Investment firms should have in place requirements to ensure compliance with the recording and record-keeping requirements in accordance with Article 16(7) and Recital 57 of MiFID II and their wider regulatory requirements. The firm shall periodically monitor the records of all transactions and orders subject to these requirements including relevant conversations, to monitor compliance with the regulatory requirements.

8. Investment firms should be able to demonstrate to the relevant NCA the policies, procedures and management oversight of these recording rules.

Face-to-face conversations

9. Investment firms shall record in written minutes or notes all relevant information related to relevant face-to-face conversations with clients. The information recorded is at the discretion of the firm but must include at least the following:
   i. date of meeting;
   ii. location of meeting;
   iii. identity of the attendees;
   iv. initiator of the meeting; and
   v. other relevant information about the transaction.
**Storage**

10. Records should be stored in a durable medium, which allows them to be replayed or copied and must be retained in a format that does not allow the original record to be altered or deleted. This supports the general record-keeping requirements under Article 51 of the MiFID Implementing Directive.

11. In addition, records should be stored in a medium so that they are accessible and readily available to NCA’s on request.

12. Firms should ensure the quality, accuracy and completeness of the records of all telephone recordings and electronic communications.

**Retention**

13. The period of time for the retention of a record begins to run from the date that the record is created.
5. What do you need to do

Voice and electronic communication surveillance requirements are not entirely new to the financial services industry; such surveillance is required in other jurisdictions. New regulations (such as the Markets in Financial Instruments Directive or MiFID II regulations) are expected to address voice communications, with some deadlines anticipated as early as 2017.3 The new regulations are also detailed and prescriptive about how these records must be stored, and how accessible they must be. The technology needed for effective voice surveillance is still in its early stages by some consultants and financial organizations, as well as technology firms, are struggling to keep up with these requirements, but NICE Financial Market Compliance Communication Surveillance has the capabilities to enhance and aid your compliance initiatives.
About NICE Systems

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Driven by cross-channel and multi-sensor analytics, NICE solutions enable organizations to improve business performance, increase operational efficiency, prevent financial crime, ensure compliance, and enhance safety and security.

NICE serves over 25,000 organizations in the enterprise and security sectors, representing a variety of sizes and industries in more than 150 countries, and including over 80 of the Fortune 100 companies.


About NICE Financial Market Compliance

NICE Financial Markets Compliance (FMC) is a significant business line within the NICE portfolio. NICE is the leader in this market, serving the largest financial services organizations globally. NICE FMC solutions respond to an increasing demand in the financial services market, where regulatory compliance is on the rise. NICE is focused on the communication compliance market and has together with NICE Actimize an unmatched presence in this domain.

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