# FINANCE MAGNATES

## INTELLIGENCE MAGAZINE

**Q1 2018**

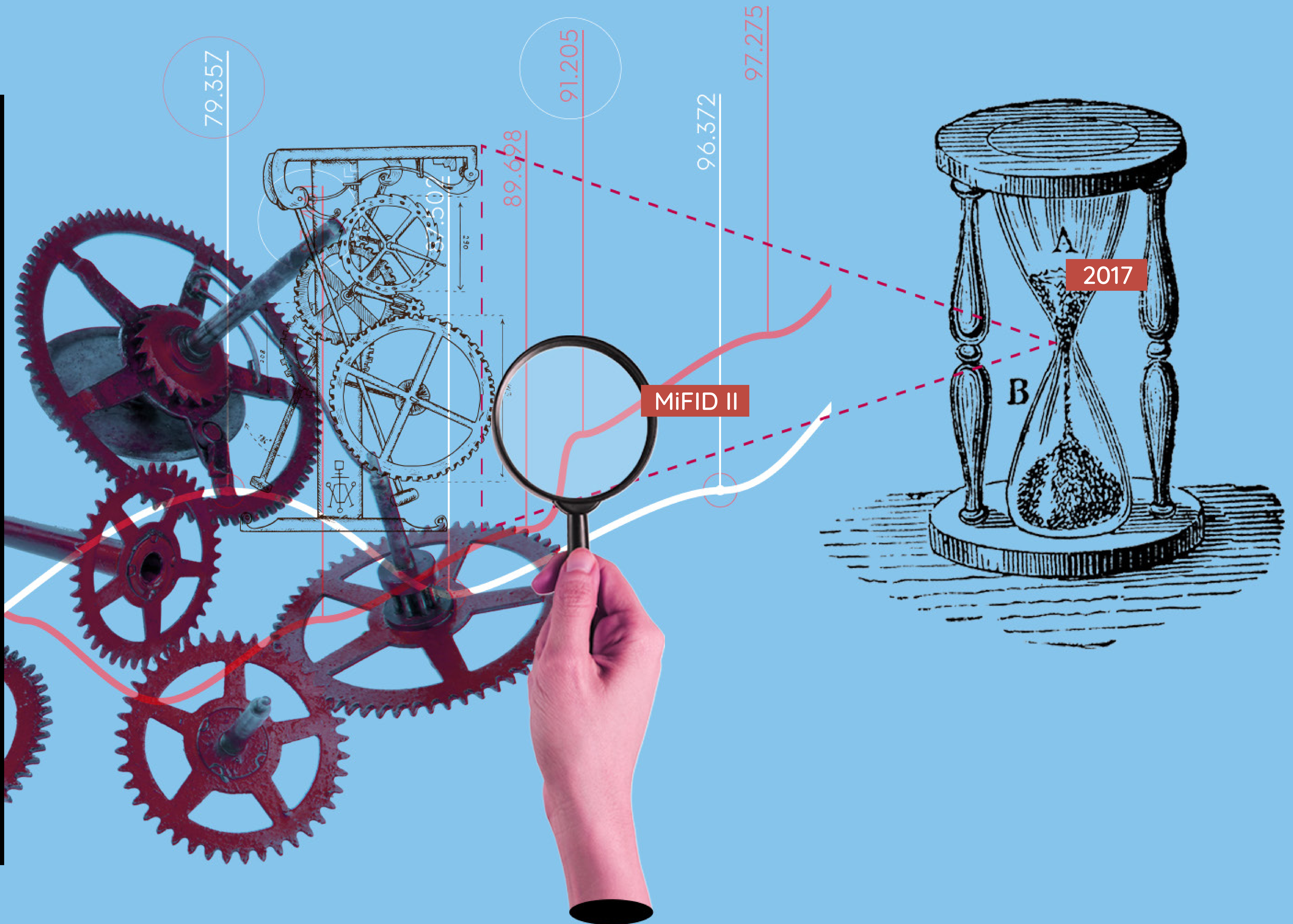
IN THIS ISSUE:

Cryptocurrency Infographic

Featured country

Articles

FM INTELLIGENCE



# EDITOR'S NOTE

**Sylwester Majewski,**
**Intelligence Team Lead**

[ sylwester@financemagnates.com ]

Usually, the last quarters of the year are very calm periods, when the markets are sleepy and the industry awaits the new year. This time it was different, at least when it came to the atmosphere in the industry. January 2018 was bringing the MiFID II directive into force, drastically changing the environment in which companies will work, and not only in Europe.

Finance Magnates talked to experts and market participants and discovered that the situation in Q4 2017 is much more difficult and complicated than was thought. Not all brokers are properly prepared for the upcoming reality, and a majority of them are simply waiting to see if their understanding of the directive was correct or if they will need to modify their systems.

Apart from the stress of waiting for MiFID II, the trading industry suffered some early problems in Q4 in relation to cryptocurrency CFDs. After the initial euphoria, some brokers found themselves in the difficult position of not being able to properly manage the risk associated with hedging positions.

The bullish stance of cryptocurrency traders made it very difficult for brokers to generate profit in this one directional market. As our article reveals, many investment companies that were waiting for the introduction of Bitcoin futures realized that hedging their exposure via CBOE or CME Group was not a feasible option for them.

In this edition of the report we have introduced a completely new section dedicated to cryptocurrency, where you will find two benchmarks created by Finance Magnates. Using these, we aim to show the broad condition of the cryptocurrency market, focusing on the biggest currencies which are most often traded by retail investors.

We remain open to your comments regarding topics covered by us. If you would like to contribute to the next issue, or have some suggestions, please let us know.

# INDEX

**In the Spotlight**

*Featured Country*


**Crypto Quarterly Review**

*Cryptocurrencies performance benchmark*

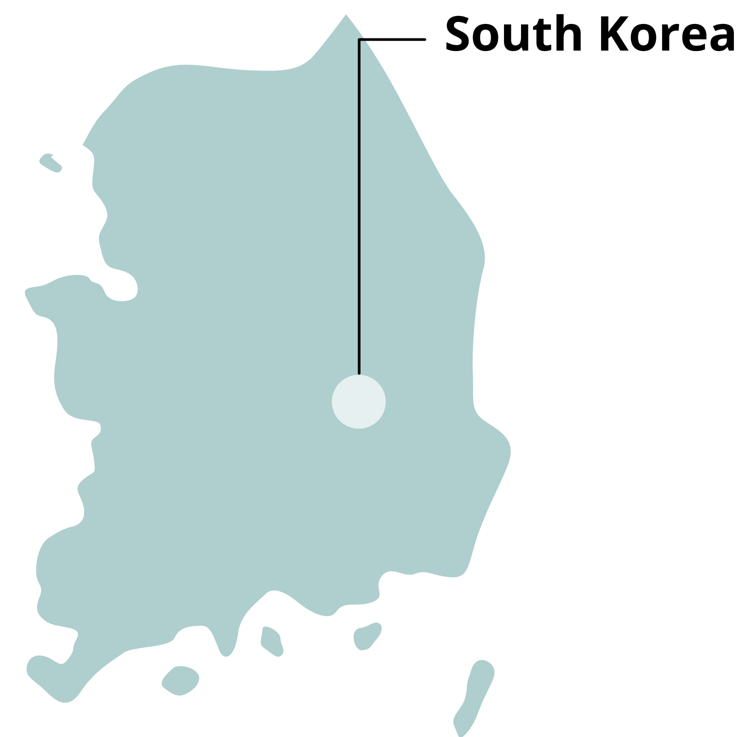
*Relative performance benchmark*


**Articles**

*Retail brokers jumping off the cryptocurrency carousel, waiting for next ride*


*At the eleventh hour - MiFID II is knocking on the door, but not many are ready to open it*

## *Featured Country* South Korea




With the growing maturity of the FX/CFD markets in Europe, USA and Australia, industry participants are increasingly looking to other regions of the world in search of hidden potential. One such region is the diverse continent of Asia.

There can be found countries like Japan, which happens to be the biggest retail FX market in the world, and China, which is still quite closed to foreign firms but offers much potential for the future. There is also another country, totally off the radar for most in the FX/CFD industry – South Korea. This country has recently been on everyone's mind, but for different reasons.

There are several reasons why South Korea is inaccessible for the retail FX/CFD industry. First of all it has a very demanding regulatory system, which as a two-layer structure. The direct regulatory body for financial firms/brokers is the Financial Supervisory Service (FSS). This authority was established in January of 1999, and supervises banks and non-bank financial companies, such as financial investment services providers.

These activities are delegated by the Financial Services Commission (FSC). The FSC is an integrated supervisory government body responsible for the drafting and amending of financial laws and regulations.

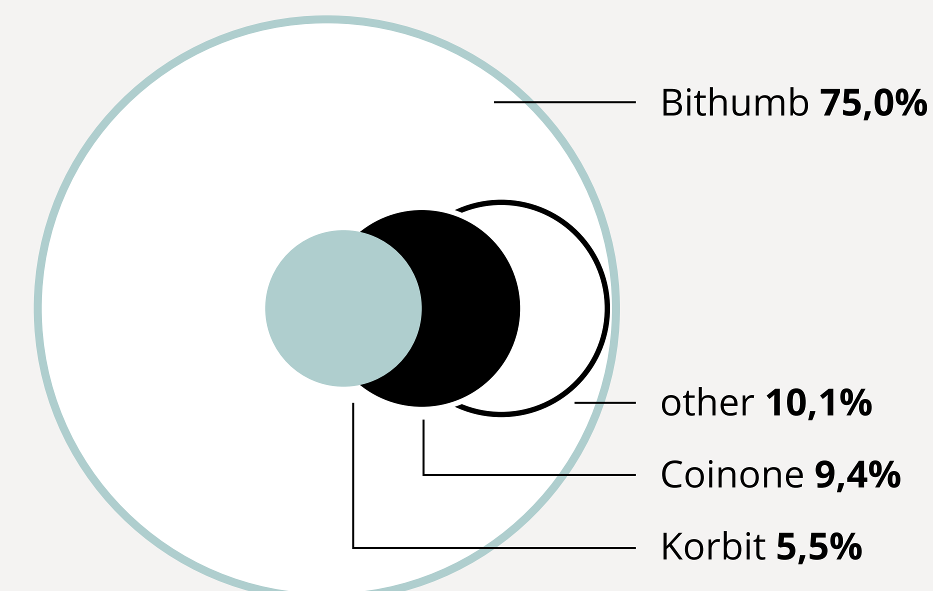
Regulated firms in South Korea are required to maintain a net capital ratio above 100% level in order to avoid insolvency, as well as several other harsh requirements such as a strict leverage restrictions. With a required margin of 10%, South Korea remains one of the most demanding regulatory systems in the global retail forex industry. This environment is not attractive to serious market players

Yet, South Korea recently plays a very important role in the financial world via the Bitcoin phenomenon. The country is home to some of the world's biggest and most important BTC exchanges. It has been estimated that South Korea is solely responsible for 20 percent of all the Bitcoin trading volume in the world.

One of the reasons that demand for Bitcoin in the country is materially higher than in other places is the rapid adoption of digital technology in the country. In an effort to curb the BTC-mania, local authorities have taken a series of actions, including a ban on ICOs and its recent ban on new cryptocurrency trading accounts. It also requires that users use their real names - anonymous trading is no longer allowed. If these measures will stop the South Korean cryptocurrency market from overheating or not, only time will tell.

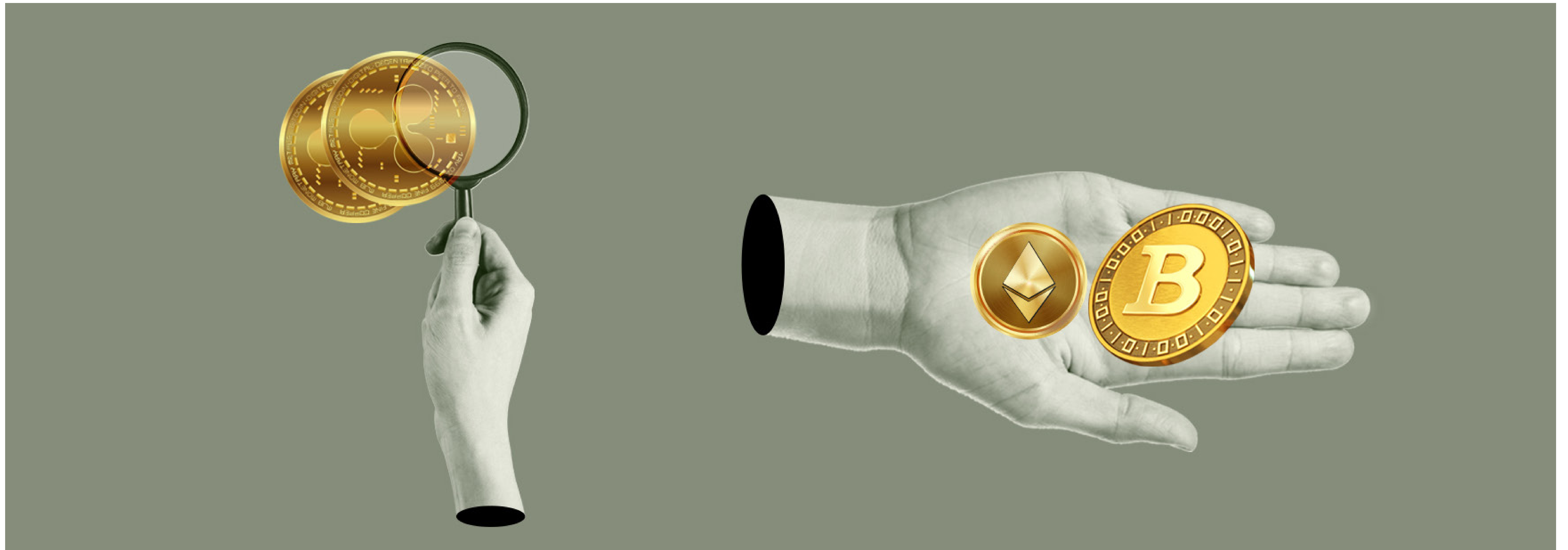
**Bitcoin Exchanges in South Korea**

Fig. 1




*source: coinmarketcap.com, Finance Magnates*

# *Cryptocurrency Quarterly Review*



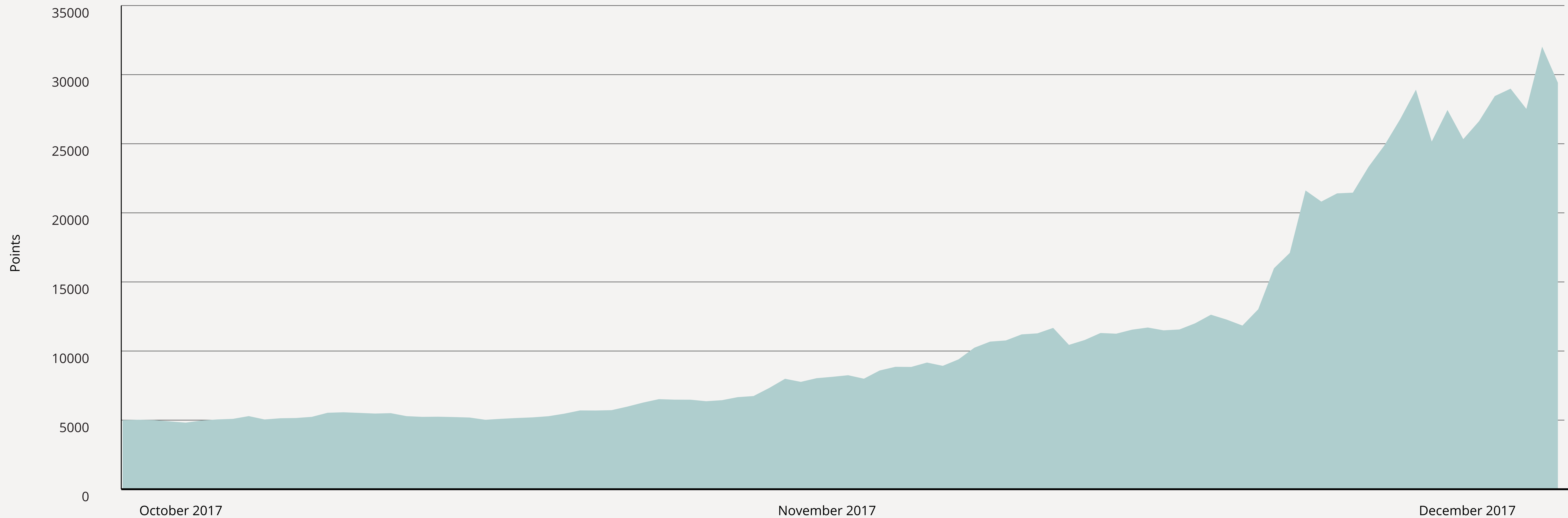
*Cryptocurrencies performance benchmark* >

*Relative performance benchmark* >

# Cryptocurrencies performance benchmark

Fig. 2

Our performance benchmark shows that all the biggest cryptocurrencies gained ground in Q4, pushing prices to all-time highs. The strong uptrend had its start in the first half of December. While some retracement is expected for the overheated markets, the overall condition of the broader market may remain good in early 2018.

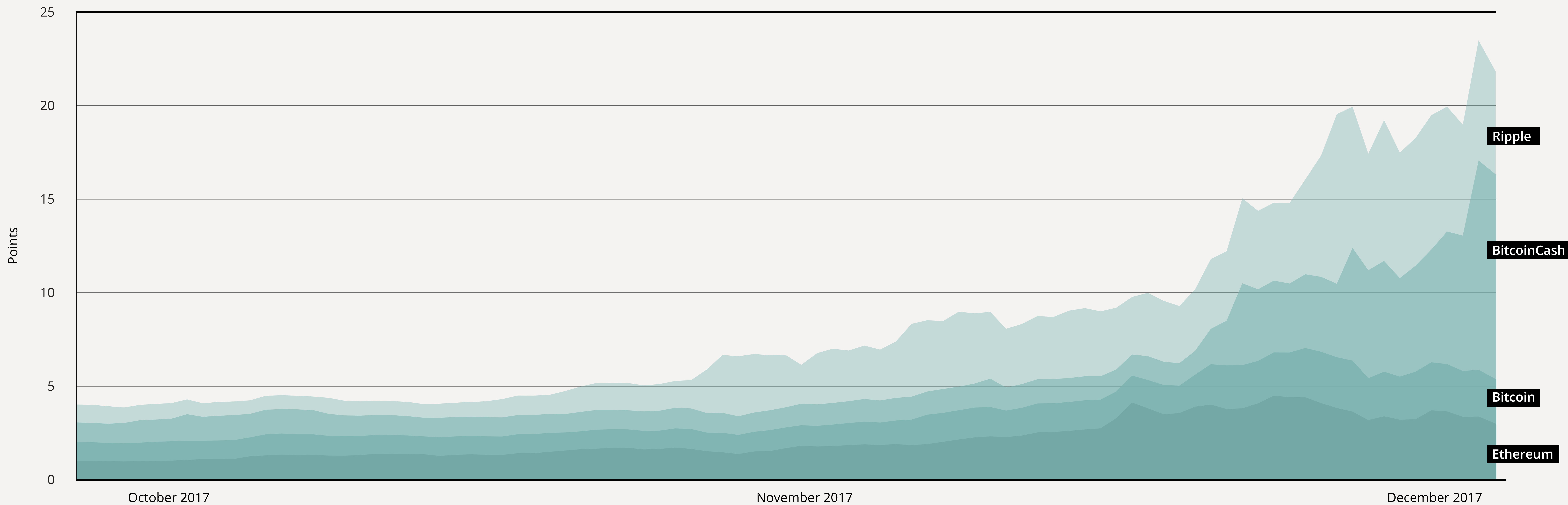



*source: Finance Magnates (based on coinmarketcap data)*

# Relative performance benchmark

Fig. 3

What may be surprising is that Bitcoin was not the fastest growing cryptocurrency in Q4, despite all the buzz surrounding it. The price of Bitcoin Cash increased faster, and the last days of December were totally dominated by Ripple, as its price skyrocketed. Only Ethereum presented a weaker performance than Bitcoin, while all the remaining top currencies (by market cap) left Bitcoin behind in terms of relative performance.




source: Finance Magnates (based on coinmarketcap data)

# Retail brokers jumping off the cryptocurrency carousel, waiting for next ride

By Damian Chmiel

Soon after brokers began appearing in the cryptocurrency market, some quickly changed their minds and escaped from it because adverse conditions were generating excessive costs rather than the forecasted profits. Finance Magnates checked how the biggest retail forex and contracts for difference brokers reacted to the cryptocurrency boom over the last quarter of 2017 and gathered their opinions regarding the new market – both for traders and investment services providers.

In the latest issue of the Quarterly Industry Report, we wrote about the dynamically developing trend of CFD brokers jumping on the cryptocurrency roller-coaster, not wanting to miss out on the lucrative opportunities. It turned out, however, that despite the uncertain regulatory situation, huge volatility and lack of proper liquidity sources, they had to face something far more difficult, that seemed impossible. We are talking of course about the one-sided, continuously growing crypto market, which caused

**Jens Chrzanowski,**
member of the
Admiral Markets
Group AS

**"...the majority of reputable brokers had a break in late 2017 with their cryptocurrency offer, and so did we. Why? The basic principle of trading – supply and demand – didn't apply anymore, bid and ask have to find a balance. If the demand is only on one side of the market, no exchange or liquidity provider will be able to execute orders properly. If the market in general will not find the usual balance between supply and demand, such breaks may occur again, for any broker".**

the 'casino' to lose its edge – hodling became a powerful tool in the hands of retail investors.

Some brokers decided to temporarily suspend their cryptocurrency offers, while others completely withdrew the instruments from their portfolios. Alpari is in the first group, and according to Roberto d'Ambrosio, CEO of Alpari Research & Analysis, cryptocurrencies will be returned when market conditions become more favorable:

"Alpari's first and foremost commitment is to provide its Clients with the most reliable and stable trading environment possible, at the same time carefully monitoring the market for new trading instruments. When it will be possible to provide our traders with such instruments with an adequate level of confidence as per our quality standards, we will surely move towards including cryptos in our offer."

## [ From euphoria to panic escape – 6 long months in the cryptocurrency market

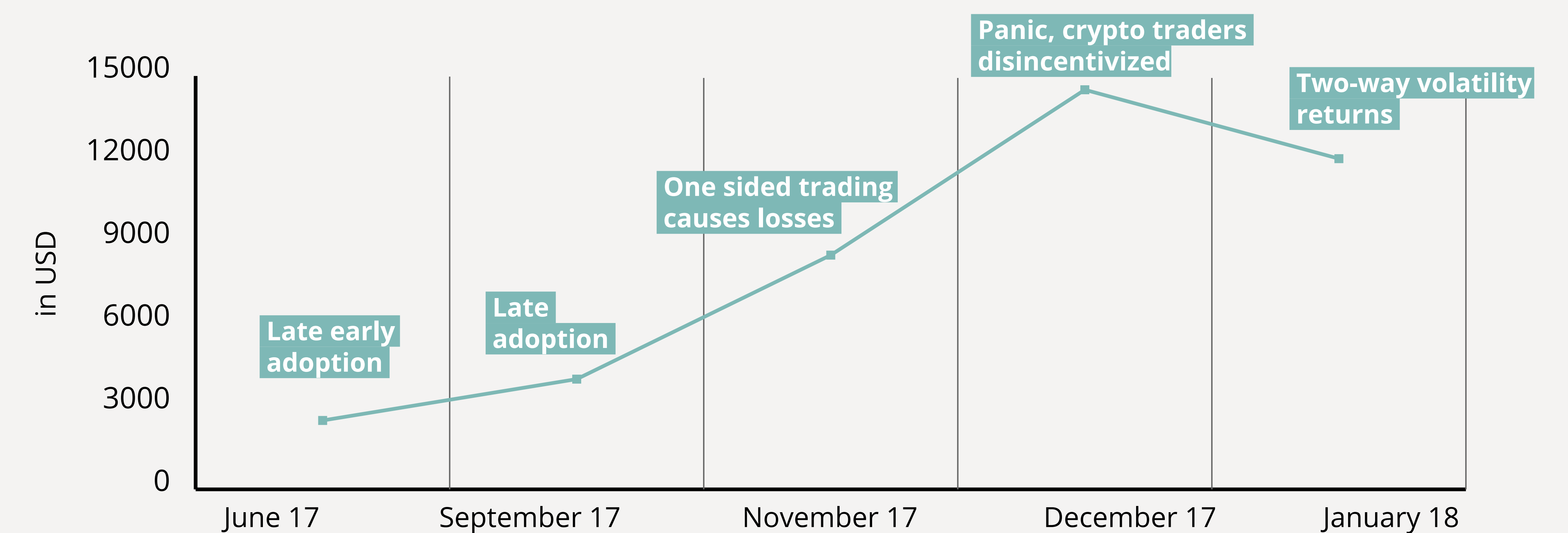
To create an outline of the events and sketch what happened on the cryptocurrency derivatives market, we should move back to the middle of last year when the crypto rush began to become visible. In the face of the booming volatility of the most popular cryptographic tokens, brokers wanted to join the speeding market and make use of one of the surest brokerage business rules – excessive movements of a given asset will attract a large number of investors, and sooner or later those investors will suffer serious capital losses.

Wanting to remain competitive, retail brokers started offering higher and higher financial leverage, weekend trading and an expanded number of crypto assets available for trading. Unfortunately, September 2017 brought more dynamic upward trends and the first crisis started when the SegWit2x fork was officially canceled. The rapid rise of Bitcoin Cash, which increased its value almost fivefold, caused losses in the multi-millions for brokers operating under the market-making model.

In the last months of Q4, it turned out to be just the beginning of an impossible bull trend, which accelerated once again when CBOE and CME Group announced the introduction of Bitcoin futures contracts. When in December 2017 investors were paying almost $20,000 for one bitcoin, brokers began to leave the cryptocurrency deck in panic, which turned out to be another case of bad timing. As it turns out, it is not only necessary for traders to plan their actions, but for investment companies too - January brought dynamic declines and a blood-

**Crypto market from the perspective of retail brokers**

Fig. 4

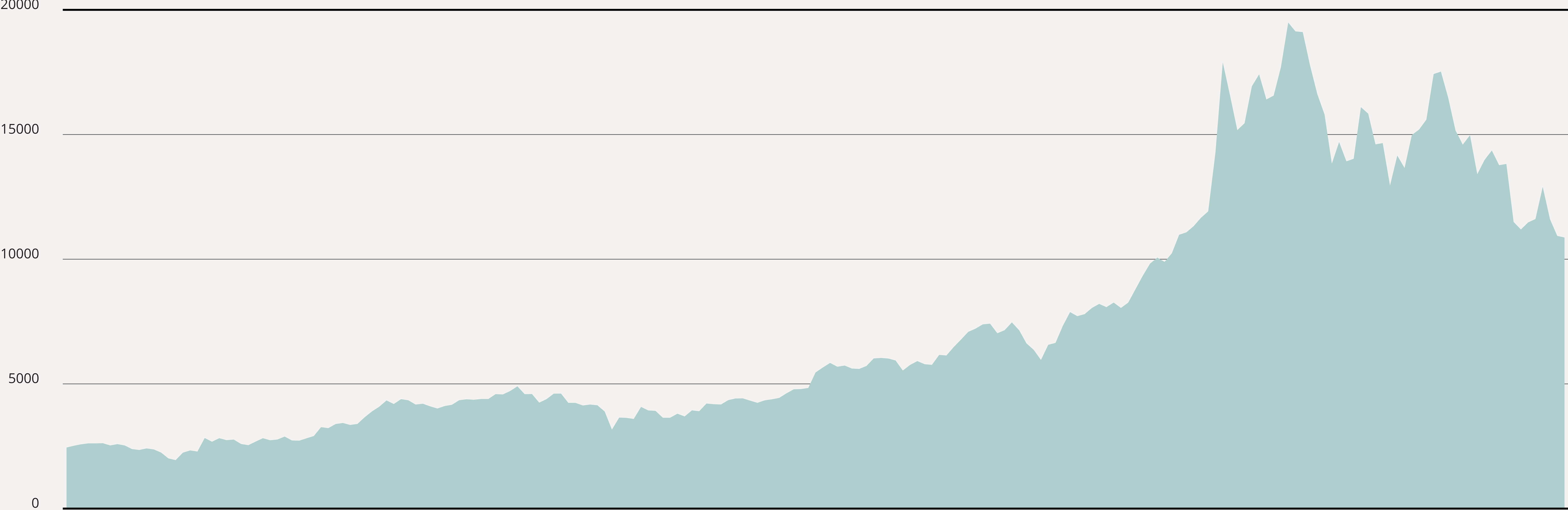



*source: coinmarketcap.com*

**Bitcoin dynamic uptrend caused brokers to flee**

July 2017 - January 2018

Fig. 5




*Source: Price data from Bitfinex*

“

**Tom Higgins,**
CEO of Gold-i

**“The cryptocurrency market is relatively new, so the most challenging factor we had to deal with was liquidity. In fact, the quality of liquidity was an aspect that created difficulties for us. However, our strong interconnections enabled us to secure high quality liquidity for our clients. Protecting them is at the heart of our operations, so we will offer new cryptocurrencies provided that we can obtain exceptional liquidity".**

“

bath for the largest cryptocurrencies.

Suddenly it turned out that cash-settled futures might be helpful when it comes to hedging exposure in the volatile and uncertain crypto world. But for many brokers it was too late, as they either suspended their offerings or discouraged investors by offering unattractive trading conditions. Entering the cryptocurrency market in the course of its dynamic growth and missing the new year sell-off turned out to be a painful mistake for many brokers.

It is worth recalling that some investment firms have actually been present in the cryptocurrency market for quite a few years. They definitely remember the Mt Gox fall, the first euphoria which took the price of Bitcoin to over $1000 and then dropped it by 90%. The cryptocurrency market has been present in CFD instruments' yard for some time now. Of course, the events of November and December 2017 were unprecedented, but some brokerages managed to survive this tough period and convert their initial losses into profits later.

Duncan Anderson, Chief Executive Officer of Tickmill, pointed out to Finance Magnates that the demand for cryptocurrency has been visible for the last two years. That is why the company decided to introduce the BTC/USD trading pair and is considering adding additional instruments like Ethereum, Litecoin, and Ripple. However, it is necessary to find the right source of liquidity, which still is one of the biggest weak points of the still expanding environment:

“The cryptocurrency market is relatively new, so the most challenging factor we had to deal with was liquidity. In fact, the quality of liquidity was an aspect that created difficulties for us. However, our strong interconnections enabled us to secure high quality liquidity for our clients. Protecting them is at the heart of our operations, so we will offer new cryptocurrencies provided that we can obtain exceptional liquidity”.

## [ Bitcoin futures, CFD limitations, and regulatory wrath

The biggest wave of brokers abandoning crypto to CFDs happened in the middle of December 2017, just two weeks before the dynamic market retreat. Many investment companies that were waiting for the introduction of Bitcoin futures realized that hedging their exposure via CBOE and CME Group was not a feasible option for them. Ultimately, the initial excitement brought only higher prices for crypto assets, leaving retail brokerages without an effective hedging tool. Looking at the Chicago exchanges' collateral requirements, it is clear that they are relatively costly. Brokers looking to hedge an exposure worth 5 bitcoins would need to post between $33,750 and $41,800 with the exchanges and require the same amount from their clients, which make the product really unattractive and rather niche. Adding the risk management issues during the weekends when the cryptocurrency market becomes illiquid, brokers found themselves in a very difficult environment, totally different from the much calmer forex, commodities and even stock CFD markets.

“

**Duncan Anderson,**
Chief Executive Officer of Tickmill

**“The cryptocurrency market is relatively new, so the most challenging factor we had to deal with was liquidity. In fact, the quality of liquidity was an aspect that created difficulties for us. However, our strong interconnections enabled us to secure high quality liquidity for our clients. Protecting them is at the heart of our operations, so we will offer new cryptocurrencies provided that we can obtain exceptional liquidity".**

“

Jens Chrzanowski, member of the Admiral Markets Group AS management board, honestly admits that “...the majority of reputable brokers had a break in late 2017 with their cryptocurrency offer, and so did we. Why? The basic principle of trading – supply and demand – didn't apply anymore, bid and ask have to find a balance. If the demand is only on one side of the market, no exchange or liquidity provider will be able to execute orders properly. If the market in general will not find the usual balance between supply and demand, such breaks may occur again, for any broker”

Losses generated from the one-sided market were enlarged by generous payouts to affiliates for traffic that was bringing in new crypto traders. In an environment of sudden mania, everyone wanted to win as many customers as

possible, accustomed as they were to handling flow that is usually advantageous to the broker. While there are still new waves of crypto newbies coming to the market, brokers are already paying significantly less for them.

If that was not enough, the pan-European financial market watchdog also decided to take a stance in the cryptocurrency rush. The European Securities Market Authority (ESMA) informed the market that it is considering limiting CFD trading, with a special consideration for Bitcoin and its peers. In the consultation document, the regulator asked industry representatives what they think about a possible limitation on the maximum leverage on cryptocurrencies, setting the cap at 5:1 or even 1:1. This may put European brokers at a disadvantage, as traders usually look for the highest possible leverage.

According to Jens Chrzanowski:

"There is volatility, and there is cryptocurrency volatility. News about stricter regulations or any related events will cause big movements and corrections. Right now, all brokers offer a smaller leverage for cryptocurrency CFD compared to their Forex offer (...). But like I said earlier: the most important thing is that the market in general will find balance – balance between supply and demand is one of the most essential factors for any market."

## [ Did FOMO lead to inappropriate marketing decisions?

FOMO is an abbreviation of 'fear of missing out', which is defined as "a pervasive apprehension that others might be having rewarding experiences from which one is absent" (Computers in Human Behavior, Andrew K. Przybylski). The phenomenon was first observed in relation to social media channels, but during the crypto craze it was adopted by industry media in relation to cryptocurrency.

FOMO pushed everyone to join the cryptocurrency trend, and for brokers it has not proved to be beneficial. The fierce competitive struggle led many companies to take adverse marketing decisions, and enter the cryptocurrency market without adequate preparation. Brokers thought that offering CFDs on Bitcoin and other cryptocurrencies would guarantee faster customer acquisition and higher earnings. The end of 2017, however, brought about something completely different. Offering as high leverage as possible turned out to be a shot in the foot, as it let clients take huge long positions on crypto assets with very little margin upfront.

May retail CFD brokers focused on generating the largest possible profit in the shortest possible time, forgetting about long-term strategies and goals. It should be made clear that cryptocurrency derivatives are often much more desirable for traders than trading through a crypto exchange. High leverage, tight spreads and unattractive SWAP requirements are not needed to encourage investors. When comparing brokers and exchanges, the former should always win, especially when it comes to client support, ways of depositing funds, the ability to go short and fund security thanks to regulation and licenses. This is confirmed by the Coincheck hack which took place in January – tokens worth over $500 million were stolen from client accounts, and as we know, in the case of CFD brokers such a situation is practically impossible.

Omar Arnaout, chairman of the board of directors of X-Trade Brokers, also claims that CFD contracts have an advantage over 'physical' crypto assets: "Not all cryptocurrency holders, actually want to hold the digital tokens, because they are often worried about the risk of the given crypto exchange collapsing. Another reason includes the possibility of going short to be able to make the most of market corrections which have occurred lately. Additionally very often trading platforms used within the CFD industry are more advanced and give investors bigger capabilities."

With all of the aforementioned advantages, potential clients should not have any problem with paying a premium. That is why some brokerages were able to defend themselves effectively against the one-sided market and the increasing revenue of crypto traders by adding commissions (which are the daily bread of crypto exchanges), offering altcoins and implementing proper risk management strategies such as multiple liquidity providers, hedging with futures, and low leverage.

Patience is also very important, which was confirmed by Piotr Baszak, TMS Brokers' Head of

**Bitcoin regulation in Europe**

Fig. 6

*Source: Finance Magnates*

Trading Department: "Due to the fact that CME and CBOE started trading and the global banks are preparing their trading desks we expect the increase in the market liquidity which should trigger decrease in volatility and should be an important factor of stabilization of the prices in different venues. However along the way we will probably experience shocks, crashes and new born trading stars in the area."

Educating current and potential clients might also be a good idea to prepare for entering and maintaining the cryptocurrency market if the trend of Q4 2017 repeats itself. "Of course, everything depends on how the market will evolve. As crypto products are relatively new, extremely volatile and not as transparent as other asset classes we need to take certain steps to make sure that clients understand the risks. That is why we need to put lots of stress on clients education in this area," added Mr. Baszak.

**[ If you had to name the one aspect of cryptocurrency trading that is causing your business the most difficulties, it would be...**

Volatility and liquidity. According to the statements of representatives from brokers that agreed to share their experiences with Finance Magnates, these two factors are amogst the main difficulties they encountered. This was also confirmed by the results of an anonymous survey conducted amongst large retail brokerages in terms of monthly volumes. Around half of them are planning to widen their current cryptocurrency offerings in the near future, while a fifth of them have no such intentions.

Tom Higgins, CEO of Gold-i, which provides services for MetaTrader brokers, said:

"Whilst demand remains high for brokers wishing to diversify and offer this new asset class to clients, we are seeing an increasing number of brokers who are re-assessing opportunities. They are treating the Cryptocurrency market more like a traditional CFD market and are looking for high quality Liquidity Providers to cover their trades rather than warehousing the risk themselves or trading directly on the physical market. We are certainly seeing increasing demand for real CFD Cryptocurrency products,

**Crypto CFDs vs exchanges**
Comparison of two trading methods

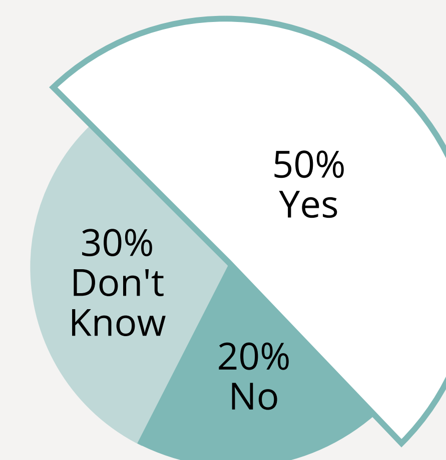
Fig. 7

| Contracts for difference (CFDs) | Exchanges |
|---|---|
| Speculation on cryptocurrency prices without ownership rights | Ownership of cryptocurrency |
| Traders do not owe capital gains tax | Traders pay tax on generated profits |
| Exposure to benchmark of price changes on multiple exchanges, which lowers volatility | Exposure to price changes on a single exchange |
| Direct trading from current brokerage account | Account at exchange necessary |
| No maximum deposit limit (varies between brokers) | Maximum deposit limits |
| No fees for deposit and withdrawal | Fees for deposit and withdrawal |
| Investor can use financial leverage and cover only a fraction of the total position size | Investor covers the full value of the purchase |
| Regulations guarantee additional fund security | Most exchanges are still not regulated or licensed |
| Ability to go short and long - earning on declines and increases | No short sale option (although there exceptions) |

*Source: Finance Magnates*

**Do you plan to widen your current cryptocurrency offering in the near future?**

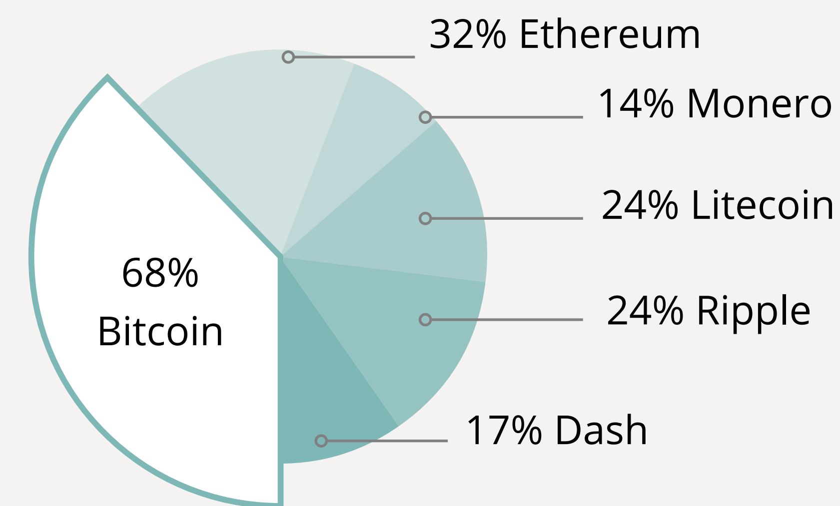
Fig. 8




Question asked to FX/CFD retail brokers during an anonymous survey by Finance Magnates

**Percentage of top 40 brokers offering given cryptocurrencies**

Fig. 9




*Source: Finance Magnates*

offered by existing Liquidity Providers or new entrants such as B2C2."

Gold-I, however, sees that the initial fervor amongst brokers has subsided and has been replaced by a more measured approach of trying to create an offering which is profitable and sustainable. Mr. Higgins projects that 2018 will bring a Bitcoin futures offensive on all major futures exchanges, and the addition of the other top five cryptocurrencies. Such a scenario would lead to reduced volatility, which would in turn increase the number of retail brokers offering crypto CFDs.

Moving back to the plans of investment companies for the current year, more than 30% of the brokers offering Bitcoin trading are considering adding another asset – the biggest ones (in terms of market capitalization) are the most frequently mentioned. Bitcoin Cash, Ethereum, Ripple, and Litecoin are among the most popular ones. According to data gathered by Finance Magnates, 68% of the top 40 brokers by volume currently have at least one digital coin in their portfolios, and in most cases it is BTC.

## [ Summary

On the one hand, last year's euphoria for the cryptocurrency market has already passed, and the recor-breaking price rises of Bitcoin and the entire cryptocurrency market have calmed down. On the other hand, it gives investment firms a chance to catch their breath and re-evaluate their offerings on this new and dynamically growing environment. The unilateral nature of the market was the deciding factor that forced brokerages to suspend or totally remove cryptocurrencies from their offerings. It also became a very important lesson, showing the market that crypto CFDs are quite different from traditional assets like forex and commodities.

By presenting derivatives as a safer alternative to cryptocurrency exchanges, brokers can count on the long-term interest of traders, without building their marketing strategies soley on the wave of new investors wanting to get rich quick with the cryptocurrency bull market. Now that the cryptocurrency fever has dropped, at least for the moment, it is a good time to rebalance current offerings and present solutions suitable for both traders and for brokers' own business.

# At the eleventh hour / **MiFID II is knocking on the door, but not many are ready to open it**

By Sylwester Majewski

**With 2017 coming to an end, the financial industry in the EU is quickly approaching a new era – the era of MiFID II. Time is running out and the changes will be drastic. How well-prepared is the industry for the inevitable, and what are the biggest pitfalls that await? Finance Magnates talks to key experts and surveys brokers to understand their fears and possible problems in early 2018.**

One would think that the industry would have had enough time to prepare for MiFID II, since the proposal was first heard 2011, and consultations were available throughout this whole period, including Q&A documents offered by ESMA (the European Securities and Markets Authority). But as Finance Magnates has learned from its sources, Q4 was an intense period for brokers as they waited for the application of the new rules in January 2018. When we asked what the biggest obstacles and sources of stress for FX/CFD managers were, we found that there were actually several.

In order to understand what went wrong, let's start with some background.

## [ Rationale behind introduction of MiFID II

The first MiFID directive arrived in 2007. Not long after, the financial crisis of 2007-2008 hit, creating the biggest market turmoil since the Great Depression of the 1930s. While the original MiFID introduced many positive changes to the market, MiFID II has widened the scope of regulations in an attempt to better regulate the over-the-counter (OTC) markets where direct transactions between buyers and sellers take place. The directive also attempts to push them onto exchanges and regulated venues.

According to ESMA, the changes brought by MiFID II and MiFIR (Markets in Financial Instruments Regulation) should ensure fairer, safer and more efficient markets. They should also facilitate greater transparency for all participants. Thanks to the new reporting requirements, the amount of available information on trades will be increased, and a reduction of dark pools and OTC trading should be seen. At the same time, provisions regulating non-discriminatory access to central counter parties, trading venues and benchmarks should increase competition.

New requirements regarding product governance and independent investment advice, and the improvement of requirements in areas such as reporting to clients, cross-selling, remuneration of staff and best execution should strengthen investor protection, according to ESMA.

**MiFID II in short**

Fig. 10

| Aims | Markets covered | Who it affects |
|---|---|---|
| Introduce more safety and transparency to markets | Equities | Banks |
| Restore investor confidence | Fixed income | Exchange, trading venues |
| Move OTC trading to regulated venues | Commodities | Brokers |
| | Currencies | Retail investors |
| | Futures | Introducing brokers |
| | CFDs | |

*Source: Finance Magnates*

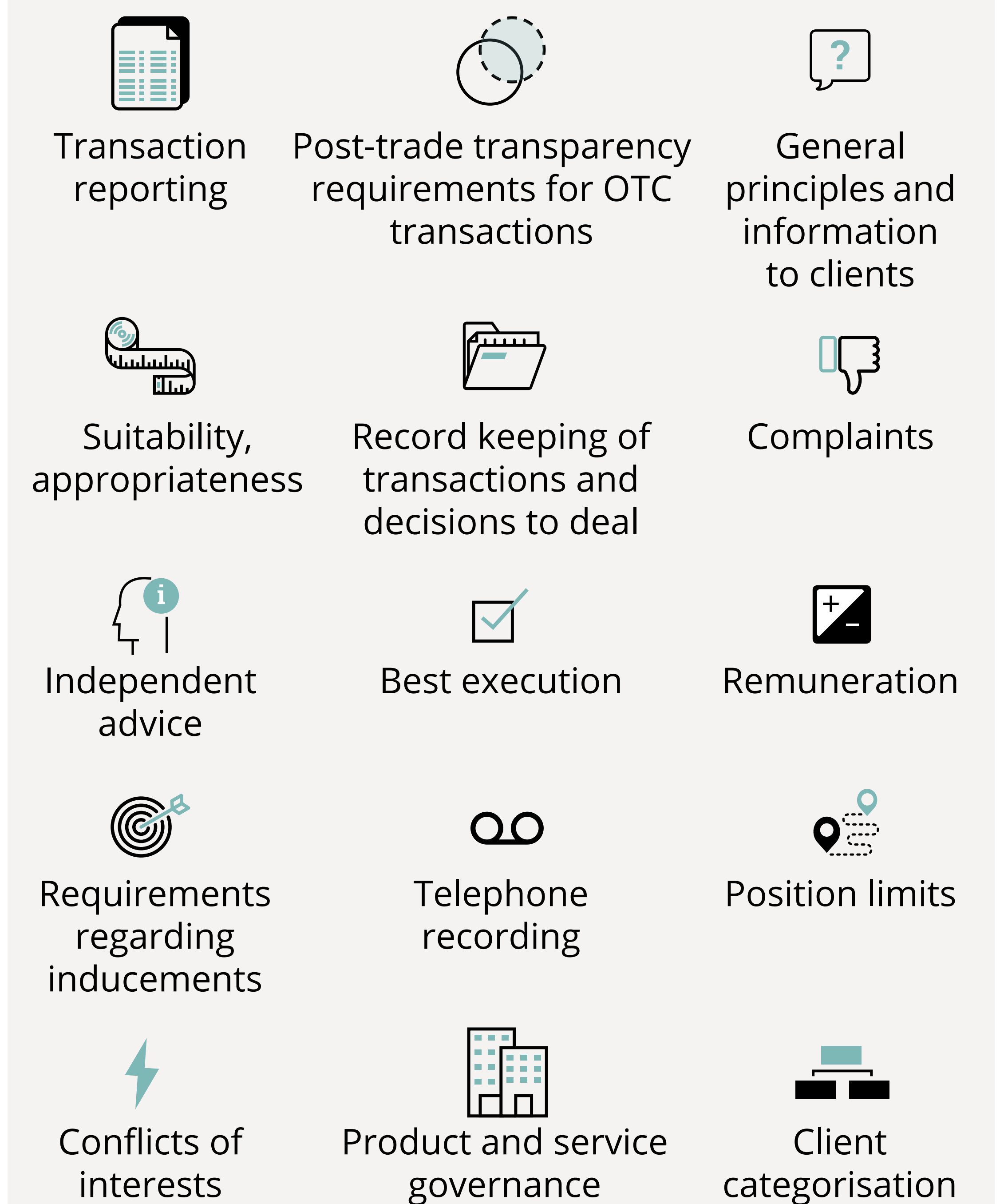
## [ Main changes and the state of things today

The changes being introduced are drastic and will have major impact on the industry. Up until the end of 2017, MiFID II was not integrated in all countries of the EU. The directive needs to be enacted according to local law. The countries which had fully integrated MiFID II by the end of December were Ireland, the UK, France, Germany, Italy, Austria, the Czech Republic, Slovakia, Hungary and Cyprus. Ten other countries had not taken on the directive at all at that time, and the remaining countries had only partially. This is the situation that MiFID II find itself in as we approach 2018. However, Finance Magnates was told by several sources that CySEC (the Cyprus Securities and Exchange Commission) was in reality lagging behind, lacking integration with ARMs (Approved Reporting Mechanisms).

And it is not only regulators that were unpre-

**Aspects of MiFID II which have been causing most concern**

Fig. 11




*source: moorestephens.co.uk*

pared. The Financial Conduct Authority offered a last minute extension for the introduction of MiFID II to the London Metal Exchange and ICE Futures Europe, until 2020. Similar extension was given to Deutsche Börse-owned, Frankfurt-based futures exchange Eurex by German regulator BaFin. The biggest difficulties were however expected to be faced by brokers. January 2018 was expected to bring technical problems for brokers and system outages for regulators.

**Quinn Perrott,**
General Manager at
TRAction Fintech

**"Another curious issue we are finding, which has not been contemplated at all by the new regulations, is the naming convention for clients. Not only are there European characters – umlauts, eszetts, cedilles and accents of all types, but non-latin characters which are not accepted by the Approved Reporting Mechanisms (ARMs) and need to be translated."**

## [ How to report properly

During discussions with brokers and industry experts, it is easy to spot which area of MiFID changes seems to be the most painful for all involved. Finance Magnates asked Ido Pickel, product specialist at Cappitech:

"MiFIR Transaction Reporting. This is due to the client and personal data required to be included in the report. Unlike EMIR, MiFID II requires more information of the underlying clients, personal data of internal traders and portfolio managers. This information needs to be both collected and uploaded in a secure method to comply with the reports. Specifically for brokers, many have had to change their onboarding process. For Legal Entities, this meant making sure these clients had and a registered LEI [Legal Entity Identifier] before they could trade with them. For individuals, for many clients this required collection of Passport or National ID information. While brokers collect identification documents of their clients, many only hold images to verify their clients and don't input the numbers to their CRM. Therefore, with MiFID II, brokers now have to store the ID #'s in a way that can be used for trade reports and not just a JPG or PDF image."

His opinion was echoed by Quinn Perrott, General Manager at TRAction Fintech: "Client data has been the biggest issue for our clients. Getting the additional information required by the national identifier regime has proved difficult. Many brokers have either not yet made a request haven't got national identifiers and clients are not responding to requests for it."

**Key turning points before MiFIDII introduction**

Fig. 12

| 2011 | 2014-2015 | 2016 | 3 July 2017 | 3 July 2018 |
|---|---|---|---|---|
| Proposal for MiFID II | ESMA consultation | MiFID II application delay confirmed | Deadline of incorporation of MiFID II into EU member state laws | MiFID II apply |

*source: ESMA*

An LEI is a 20-digit alpha-numeric code that enables unique identification of the legal entities participating in financial transactions. LEIs are needed by firms to fulfill their reporting obligations. They are also key to matching and aggregating market data for transparency and regulatory purposes.

LEIs are linked to information relating to the legal entity in question, including name and address. Once a legal entity obtains a code, the code is assigned to that legal entity for life. The EMIR code is required for counterparties to derivatives contracts, as well as beneficiaries, brokers, CCPs and clearing members.

Among other frustrations for the industry, Perrott shared an interesting observation: "Another curious issue we are finding, which has not been contemplated at all by the new regulations, is the naming convention for clients. Not only are there European characters – umlauts, eszetts, cedilles and accents of all types, but non-latin characters which are not accepted by the Approved Reporting Mechanisms (ARMs) and need to be translated."

An ARM is a person authorized to provide the service of reporting the details of transactions to domestic competent authorities, or ESMA, on behalf of investment firms. As Finance Magnates learned, CySEC had a problem with the integration of ARMs.

## [ What will happen to introducing brokers?

Another important aspect related to MiFID II that is worrying the industry is relationships with IBs and affiliates. The new guidelines require greater disclosure of payments to IBs. They also make it difficult to support on-going

**Ido Pickel,**
Product Specialist
Cappitech

**“We probably won’t see sweeping changes under Best Execution in the beginning of 2018 due to regulators focusing on Trade and Transaction reports. But, once they get around supervising those reports, there is an expectation that regulators will take a broker by broker look at execution quality. “**

payments without having a defined additional value on a per trade basis.

Before MiFID II implementation, IBs were not obligated to provide any real service to introduced customers and could still collect revenue from their trading. With the new regulations, IBs are forced to provide additional services to their clients. In most cases, brokers demanded from their IBs in Q4 to provide to introduced clients access to marketing analysis and information that is not generally available to non-customers.

IBs were also asked to start providing customers with expert knowledge on the suitability of particular platforms, as well as training and education on applicable systems. This however also requires the IB to have multiple platform providers available to clients.

Both brokers and IBs were faced with another requirement that will potentially hurt their business. MiFID II includes enhanced disclosure rules whereby a broker is obliged to disclose all costs and fees charged to introduced clients.

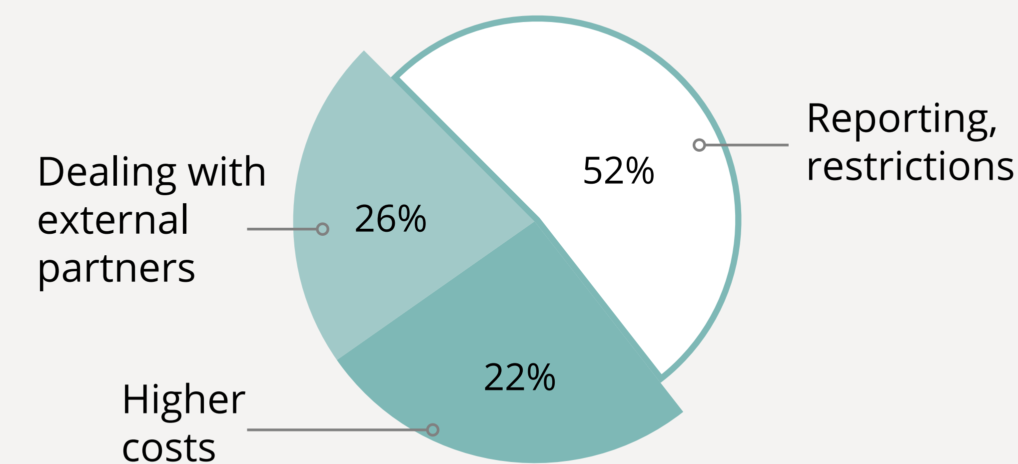
They also have to disclose the allocation of those costs between broker and the IB. Finally, brokers are required to disclose cumulative fees (and their impact on returns) at least annually to introduced clients. As can be imagined, such requirements may hurt introducing brokers.

Usually IBs do not want their clients to see how much they earn from them. This will force brokers to search for solutions to overcome that problem.

Some brokers, including Plus500, have already been moving away from ‘revenue share’ models of cooperation for several months already. Pickel says that this trend actually started earlier: “In reality, changes to IBs and affiliate networks started occurring for the past few years as regulators have been applying MiFID I era rules. MiFID I already contained rules against aggressive marketing and product suitability. Therefore, brokers are responsible for the marketing and sales practices used from their underlying IBs and Tied Agents. As European regulators have been enforcing marketing rules, brokers have limited their involvement with IBs and affiliates. A great examples was the May 2017 iFX EXPO. Unlike previous years, there were nearly no exhibiting brokers that were soliciting IBs and affiliates. The closes you saw to this were white label and tied agent deals being offered.”

**Which aspects of MiFID II do you think will most hurt the industry?**

Fig. 13




*source: Finance Magnates survey*

Some brokers have decided to comply with the new requirements while others are attempting to create alternative options for their most profitable partners. For instance, Finance Magnates learned that Forex.com was offering that its IBs transfer partnership to Forex.com GGMI, a CIMA-regulated entity, where they would be able to continue to get paid on a rebate basis.

Finally, other brokers used this opportunity to terminate agreements with IBs that were not delivering satisfying results.

## [ Some other problems that the industry gossips about

Discussions with industry participants at the end of 2017 revealed that the situation was much more chaotic than what could be expected judging by the scope of changes and fields that these changes apply to.

Many industry representatives shared with Finance Magnates their feelings before the introduction of MiFID II. While executives were obviously reluctant to reveal their position and weak points, the impression that we received was far from optimistic. Many brokers have completely different understandings of what they will be required to do and how they will be able to overcome the upcoming difficulties. Many of them are simply looking to each other for answers.

Sometimes, lawyers and consultants are hired by the bigger firms do not help either - Finance Magnates has seen MiFID II preparation reports that were simply incorrect.

Finally, to summarize, it is worth presenting how the industry fears look from a statistical perspective. According to a brief survey conducted by Finance Magnates among some FX/CFD brokers, reporting issues were the biggest fear (52%). The second most worrying issue was related to dealing with external partners (26%), followed by higher costs (22%).

## [ Experts talk about additional potential problems, but also positives

Problems can arise during the transitional phase of any big change. The implementation of MiFID II is one such a innovation, and it will have longlasting impact on entire industry. That is the reason why, apart from the initial difficulties we can expect, additional complications could arise in the future, especially the intentions of lawmakers are confronted by reality.

Finance Magnates talked to fintech and regulatory experts to find out which changes they consider most likely to hurt the industry and why. Pickel pointed out that more resources may be needed by brokers due to reporting requirements: "Overall, MiFID II is expensive to comply with. Between supervising executions, submitting daily transaction reports and handling quarterly reports, brokers need to have more technology or manpower in place to comply."

He also notices financial risks for smaller brokers: "For smaller firms, MiFID II compliance expenses can put them out of business or push them to be unregulated. Even for larger firms, when your expenses rise, you have less funds going around towards marketing and creating new products. In 2017, FX brokers got lucky that currencies were fairly volatile and increased profits. However, what happens in a down year when brokers can't rely on trading profits to make up for the increased compliance expenses."

Perrott was asked the same question, and shared with us the following concerns: "Product intervention powers afforded to ESMA are the most concerning power under MiFID 2 at this stage. The margin FX and CFD products can be poorly understood by clients and used inappropriately in pursuit of fast gains that are only available outside of the risk parameters they would otherwise apply to their investments. Combine this with unscrupulous operators who are looking to make a fast dollar rather than set up a sustainable financial services business that operates for the long-term and holds the trust of clients and we have an industry that attracts a lot of attention of the regulators. We are facing a situation where, rather than clamp down on the inappropriate operators, the entire industry will be shut-down and move offshore where clients will be even less protected."

But there are also good things expected for the industry. Pickel pins his hopes on execution service improvements: "Best Execution. While not new, ESMA has updated Best Execution requirements created by MiFID I in 2007 for MiFID II. Specifically, ESMA is putting pressure on regulators to be more proactive to review broker transaction quality. The end result is that clients will have more transparency of how their trades are being executed and how it compares across the industry."

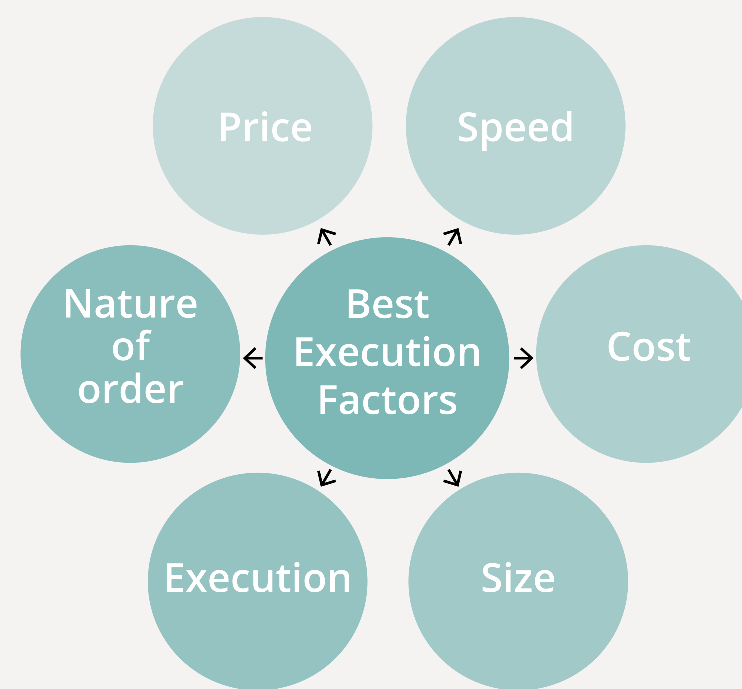
Perrott agrees: "The creation of a level playing field throughout Europe will help foster an industry that is more widely understood in line

**Ido Pickel,**
Product Specialist
Cappitech

**"In reality, changes to IBs and affiliate networks started occurring for the past few years as regulators have been applying MiFID I era rules. MiFID I already contained rules against aggressive marketing and product suitability. "**

**Best Execution Factors**

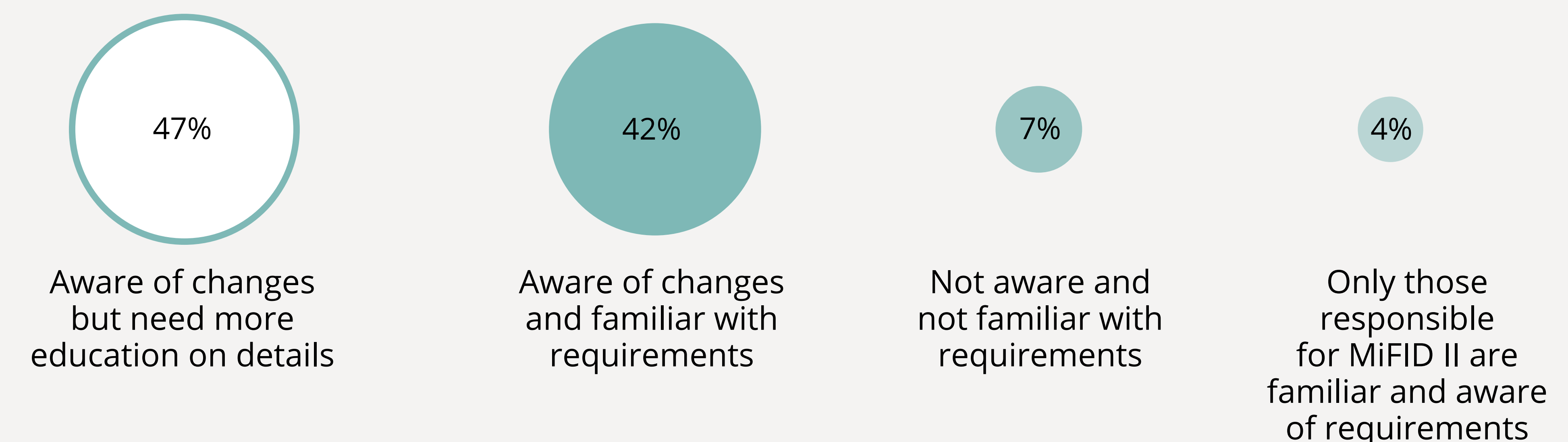
Fig. 14




*source: Thomson Reuters*

**Are financial firms ready for MiFID II?**

Fig. 15




*source: Teleware*

**Quinn Perrott,**
General Manager at
TRAction Fintech

**“Product intervention powers afforded to ESMA are the most concerning power under MiFID 2 at this stage. The margin FX and CFD products can be poorly understood by clients and used inappropriately in pursuit of fast gains that are only available outside of the risk parameters they would otherwise apply to their investments.“**

with the ability for the industry to operate more evenly.”

However, Pickel does not expect this to happen any time soon: “We probably won’t see sweeping changes under Best Execution in the beginning of 2018 due to regulators focusing on Trade and Transaction reports. But, once they get around supervising those reports, there is an expectation that regulators will take a broker by broker look at execution quality.”

Interestingly, our survey also revealed that the only facet of MiFID II that brokers identified as positive was the improved transparency that it will bring.

Apparently, brokers do not see any other positive aspects of the new rules at the moment, which is understandable because the whole process will mean operational and financial efforts on their part.

## [ Summary

Despite the fact that the introduction of MiFID II was a process lasting several years, during which time there were many chances for consultation and preparation, not everything has worked out as intended. Industry participants feel that the communications of ESMA were not clear or detailed enough, and did not leave them with a clear understanding of the new regulations.

While new difficulties may appear for brokers in 2018, one can imagine that with time the situation will become clearer. As time passes, the industry will find ways to apply the new rules according to intentions of the lawmakers. It is yet to be seen how higher operational costs will shape the landscape, and if it will push smaller firms out of the market.

Time will tell if retail traders are happy and if they really do feel safer now.