

View Point



Turning RegNMS and MiFID Challenges into Opportunities

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Overview

It is quite clear that the Regulation National Market System (RegNMS) and the Markets in Financial Instrument Directive (MiFID) will cast long shadows on the capital markets landscape. RegNMS is a regulation targeted at the US markets, while MiFID aims at the markets in the European Union. The objective of these regulations, simply put, is to protect the investor by ensuring best price on every execution. However, this is easier said than done, and will investment firms) and sell-side (brokerages), besides market infrastructure participants such as Exchanges, Electronically Connected Networks (ECNs) and others.

The initial reaction from the capital markets was reactive and based on a superficial understanding of the impact, focusing merely on meeting the deadlines with a 'can do' attitude. This attitude turned into 'I am not so sure' on digging deeper into the impact areas and discovering a mountain instead of a molehill!

In many ways, this reaction is similar to what banks had some years back to the Basel II accord, another regulation in the area of risk management. But banks have since realized that such regulations can be turned into opportunities for automation and rationalization in various areas, leading to increased efficiency and reduced operational risk. Many banks, not previously subject to the Basel II regulations on a mandatory basis, have now chosen to implement these regulations voluntarily, since the medium to long-term benefits far outweigh the implementation costs.

Infosys believes there is a similar trend emerging in this case as well. We feel that firms that take a more proactive approach and build strategic solutions in parallel with tactical ones will benefit most from these regulations. On this note, we offer a preview of some solutions that we feel will help companies realize a bigger bang for their RegNMS/ MiFID compliance buck.

Timelines, estimated investment and the risk

The timelines are different for each regulation. As recently as about three weeks ago, SEC announced revised timelines for RegNMS. The deadline for the first phase of RegNMS completion now stands at the first quarter of 2007, while the deadline for MiFID is the fourth quarter of 2007.

It is clear that this current situation is no Y2K from an investment or an impact perspective. However, it is also obvious that firms will have to invest in upgrading their systems to comply with these regulations. For RegNMS there have been various estimates for the entire market, ranging from \$232 Million (M) to 700 M (SEC – 232 M, Aite Group – 544 M and Celent – 700 M). For MiFID the estimates are much higher and range from \$1 Billion (B) to \$6.5 B (Tower Group – 1 B, City Compass – 6.5 B). On an average, our estimate is that each firm will spend anywhere between \$3-15 M as the initial, one-time cost for gearing up to meet these regulatory requirements.

The risk here is that, depending on the approach they take, some companies would end up spending more in the long-run. Companies which adopt the “incremental” route to fix the problems will be spending a similar sum for the next 3-4 years in “fixing the fixes”.

Challenges to buy-side, sell-side and exchanges

The obligation to provide best execution lies with all participants. However, the impact will be felt more on sell-side firms and exchanges than on buy-side. The foreseeable impact on market data is obvious. The volume of market data flowing through the pipes will rise significantly. Market data is estimated to grow as much as 10-fold as a result of these regulations. All companies will need considerably greater capacity and increase in computing power to support such a radical growth of market data:

- Buy-side firms will need to upgrade their systems to be able provide transparency on all the available prices to investors.
- Sell-side firms will not only need to upgrade their systems to identify best execution but, more importantly keep a proof of the execution for their clients and the regulatory bodies. This implies maintaining history of market data, orders and executed trades.
- Exchanges and ECNs will need to upgrade their systems to provide routing mechanisms to each other to enable best execution for buy-and sell-side companies. Exchanges have already started responding to this by buying ECNs, engaging in cross border consolidation/mergers of market places, all of which is spurring consolidation to gain advantage, at the minimum, of a better technology platform.

Solutions to turn challenges into opportunities

Impact Assessment Solution:

We've seen time and again, that changes to front-office systems could sometimes have large impact on downstream systems. For companies doing this the first time, it can be a daunting task to chart out firm-level impact and prioritization of projects given the stringent deadlines.

Infosys offers an Impact Analysis Solution, which is essentially a framework to assess the overall impact of the regulation on a firm and assists in carving out a roadmap. The assessment will cover the necessary analysis to front-, mid- and back-office systems taking into account the unique challenges of trading systems and will come up with process and system impact analysis, as well as a prioritization roadmap. Since most firms are more than half-way into RegNMS, this may be more useful to companies which are in the early stages of MiFID implementation.

Routing and Trading Solution:

The technical and infrastructure challenges here are several. To ensure best execution, companies have to implement smart routing systems. They'll also need the systems to scale to accommodate large volumes of market tick data. The natural tendency for most companies is to make incremental fixes to meet deadlines. However, the risk is that “band-aid” fixes will not be able to keep pace with the increase in data volumes. The current applications may have to be replaced with next generation solutions, involving streaming data technology advancements, in the near future.

Companies should view this as a strategic opportunity to evaluate such solutions, concurrent with the implementation of tactical fixes. This will ease future transition to a more robust and scalable architecture. On this front, Infosys is leveraging its partnership with vendors specializing in streaming technology to develop components and create pre-built rules pertaining to the regulations, on top of the core processing engines. Our clients can benefit, not only from a more robust infrastructure but also from faster implementation as they leverage the pre-built components and rules.

Post-Trade Compliance Solution:

The regulations require companies to maintain an order book for every transaction. This is to prove to their clients and the regulatory bodies that they had indeed performed the best execution for a given order. This is probably an area that companies find most daunting and are least prepared. Current relational database technologies cannot store large volumes of tick data or process them in sub-seconds.

Here, Infosys is of the view that companies should treat post-trade compliance as a competitive lever. Once the data store of market tick data, order and executed trades is built with the right technology, it can also be used to validate trading strategies. We realize that the key to a successful solution is an efficient data management technology that can store large amounts of tick data and retrieve it in milliseconds. As in the earlier case, Infosys is leveraging its alliance partners specializing in streaming data engines and developing a trading compliance and strategy validation solution to address the above challenge.

Systems Testing Solution:

A big challenge all companies will face will be in ensuring that the systems they built have the right rules. Currently, there is a lack of appropriate testing solutions and infrastructure in the market for applications using real-time data. Infosys is leveraging its offshore development centers in China and India to develop a testing and certification solution that will validate real-time applications. The solution will simulate real-time streaming market data and help users define events and scenarios to test whether orders are indeed being executed as they ought to be.

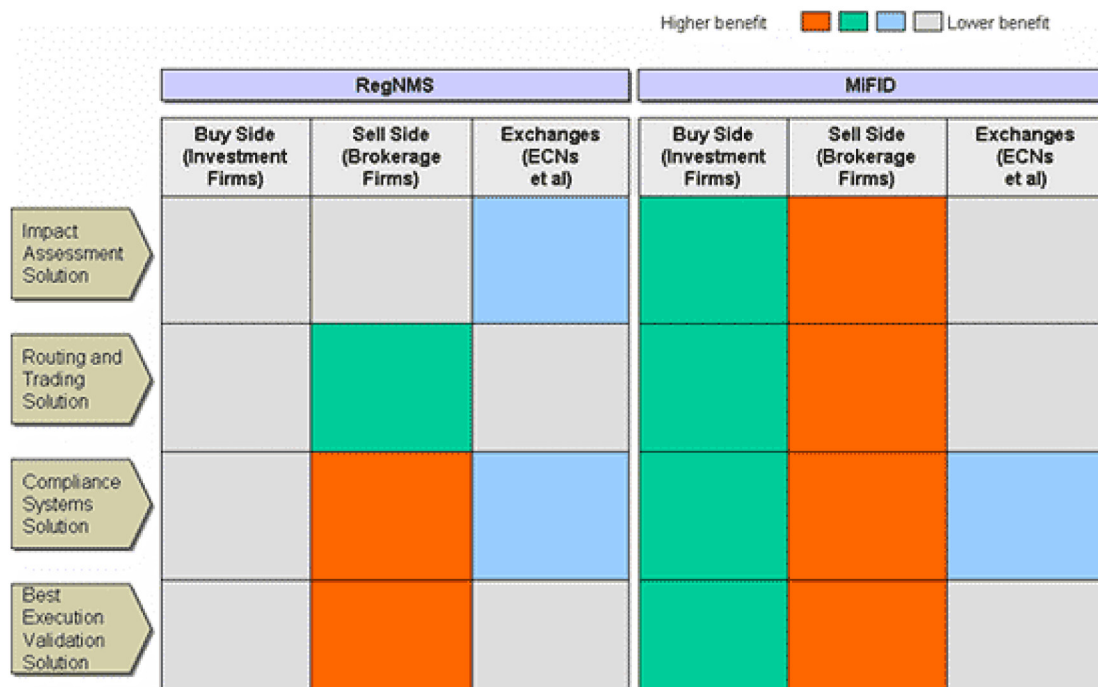


Figure 1: Infosys solutions and how companies can benefit

Conclusion

The Infosys Banking and Capital Markets Practice will be happy to share further details on how to prepare for RegNMS/MiFID, and more importantly, how to strategically leverage the opportunity for competitive advantage.

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