

Algo Trading Forum

Mifid 2 RTS 6 Annual Self- Assessment



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iCOOC Forum: Algorithmic Trading

The management of risks surrounding the use of Algo Trading by banking corporations is a complex process, and in many places the industry has self-identified this process to be resource intensive, overly complex and granular, and thus inefficient. The process encapsulates three major testing phases.

First, organisations are required to complete a self-assessment programme to analyse the compliance against the regulatory requirements and operational risks of their active algorithms. This is followed by a validation phase where the self-assessment is then itself evaluated, and this falls under the purview of the business' risk management function. This validation is then audited to ensure validity, and to ensure that any areas which have been found to be non-compliant have had viable action plans assigned to them to address this.

Self-Assessment

Organisations have approached the self-assessment phase of the RTS 6 regulations in different ways but have in many cases fallen short of finding the best working balance between hyper detail orientation and laxity. Some corporations break down the 28 articles contained within the RTS 6 framework into sub articles and then each sub article into bullet points, each of which then forms a testing point for their team.

This has been noted as an extremely thorough, yet in many ways overly granular approach that acts as a drain on resources, especially when it must be repeated on an annual basis. This is especially true of firms which have a large suite of algorithms, making the testing process an enormous task tying up very considerable man-hours.

Even for those firms which do not break down the RTS 6 regulations so finely, the assessment process takes a considerable amount of time, with one participant reporting that the process of addressing the issues found in the report alone, without considering the time taken to create the report and the validation and audit afterwards, can take 4-6 months. In order to address this, a request was made to the regulator to allow for a bi-annual rather than an annual review cycle, to allow firms more time to address the challenges regularly posed by each assessment. There has as yet been no response from the regulator on this point, and it was suggested that in order to move forward it might be beneficial to draft a paper to give to the regulator to push for their decision on this.

This suggestion carried widespread approval from the industry representatives present on the forum, particularly in the light of the fact that, once the controls were implemented and adopted for RTS 6 to deal with the algorithms, there was limited change to them over time, and the testing process should reflect this.

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Validation

The validation process also threw up a number of industry-wide concerns as to how to maximise its efficiency. The validation stage requires interplay between the 1st line risk management function, who will typically have completed the initial self-assessment, and the 2nd line, whose responsibility it is to draw up the validation.

Often this leads to disagreement, and validation reports take a considerable degree of negotiation and back-and-forth between the two lines before they are signed off. It is therefore important to note that the purpose of the validation is to check and challenge the 1st line's conclusions and ensure they have covered all the necessary points.

Therefore, unless there is a particularly egregious problem within the self-assessment report, there is little need for major revisions to be posited by the second line.

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The second line can also become hyper-focused on the detail of the report, to a greater degree than is called for in the RTS 6 requirements, which state that the level of enquiry should be 'proportionate'.

The back and forth created by requests for increasingly detailed evidence from the 1st line to substantiate their assessment can therefore become counter-productive if taken too far. Given the role that the compliance function plays in relation to the regulator, it has also been posited as beneficial to bring them into the process early on, and to help oversee the interplay between 1st and 2nd lines that occurs as part of the validation stage.

The validation process relies on sample-based testing due to the large number of controls, to drill down on specific areas where controls require more extensive testing, and to gain an idea of the wider picture of the control suite without exhaustive and unnecessary hyper-focus.

Other organisations have already built in risk and compliance to their control framework to allow for the validation process, relying on a risk-based view, taking into account where 2nd or 3rd line assurance testing has already taken place to avoid the duplication of effort and increase efficiency.

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Audit

Retesting of controls during the Audit phase is a significant duplication of effort and a key problem facing many organisations undergoing these processes. In addition to the possibility of duplication occurring as a part of the validation stage, it can also occur frequently in the audit phase.

The role of the audit prescribed by the regulator is to ensure the process undertaken in the self-assessment and the validation stages is sound. Despite this, the audit phase in some organisations includes retesting, and this overlaps with the work done by the second line in the validation phase.

There can also be further duplications of effort where different audit teams operating within the same organisation, perhaps for different regions, overlap their efforts and hence waste human capital resources. Hence it is key that boundaries are clear within a given firm, and each step of the regulatory chain knows what it is responsible for testing and evaluating and sticks to it.

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