

# The Benefits, Opportunities and Challenges of MiFID

*Laurence White*

The adoption of the Markets in Financial Instruments Directive<sup>1</sup> (**'MiFID' or 'the Directive'**) Level 2 implementing measures<sup>2</sup> was the culmination of a lengthy European legislative process begun in November 2000.<sup>3</sup> Once the measures are fully transposed and implemented by the Member States, they will represent a step-change in the sophistication and flexibility of financial markets regulation in Europe, and will be the catalyst for significant and beneficial changes in market structure.

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<sup>1</sup> Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC [2004] OJ L145/1. As amended by Directive 2006/31/EC of the European Parliament and of the Council of 5 April 2006 amending directive 2004/39/EC on markets in financial instruments, as regards certain deadlines [2006] OJ L114/60. The latter Directive postponed the date on which the measures in MiFID would be applied to investment firms to 1 November 2007, but required Member States to have finalised transposition by 31 January 2007, thus giving firms a 9-month implementation period after finalisation of national measures.

<sup>2</sup> Commission Regulation (EC) No. 1287 of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards record-keeping obligations for investment firms, transaction reporting, market transparency, admission of financial instruments to trading, and defined terms for the purposes of that Directive [2006] OJ L241/1 (**'the Implementing Regulation'**) and Commission Directive 2006/73/EC of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms, and defined terms for the purposes of that Directive [2006] OJ L241/2, p. 26 (**'the Implementing Directive'**). These are referred to as 'Level 2 measures' as they form Level of the 4-level 'Lamfalussy process'. See the *Final Report of the Committee of Wise Men on the Regulation of European Securities Markets* (2001), available at [http://ec.europa.eu/internal\\_market/securities/lamfalussy/index\\_en.htm](http://ec.europa.eu/internal_market/securities/lamfalussy/index_en.htm) for more details.

<sup>3</sup> European Commission, Communication COM(2000)729: 'Upgrading the Investment Services Directive'.

MiFID as a whole is a ground-breaking package of measures and a cornerstone of the Financial Services Action Plan. It is intended to transform the landscape for the trading of securities and derivatives and to increase competition and efficiency throughout Europe's financial markets. It will both increase investors' level of protection and give them greater choice.

It is intended to drive down the cost of capital, generate growth and boost Europe's competitiveness,<sup>4</sup> thus contributing to the jobs and growth goals which form part of the Community's Lisbon Strategy.<sup>5</sup>

MiFID will remove obstacles to the use of the so-called 'single passport' by investment firms, foster competition and a level playing field between Europe's trading venues, and ensure a high level of protection for investors across Europe.

The rapid globalisation of financial markets is an opportunity which Europe cannot afford to miss. Europe is already emerging as a global leader in financial services and the MiFID measures will help Europe to stay competitive. In order to secure the full benefits of MiFID, the Member States must also cooperate by implementing the measures fully and on time.

## 1.1 ANTICIPATED BENEFITS OF MiFID

The main anticipated benefits of MiFID are increased competition, enhanced investor protection, greater transparency and more effective regulatory co-operation. There should also be significant deregulation as super-equivalent national measures are cut back and replaced by the simplified, principles-based approach of the rules contained in MiFID.

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<sup>4</sup> The integration of EU equity and corporate bond markets holds out the prospect of significant reduction in trading costs and the cost of equity/corporate bond finance. Research conducted by London Economics in 2002 suggests that the static efficiency benefits of establishing integrated, deep and liquid equity and corporate bond markets alone are likely to be significant – involving a permanent reduction in the cost of equity capital by 0.5%, triggering an increase in investment, employment (0.5%) and GDP (1.1%). See London Economics: 2002, *Quantification of the macro-economic impact of integration of EU financial markets*, at <http://tinyurl.com/ewhum>.

<sup>5</sup> The Lisbon Strategy was adopted in March 2000 and aims to make the EU the most dynamic and competitive economy by 2010. For more information see [http://ec.europa.eu/growthandjobs/index\\_en.htm](http://ec.europa.eu/growthandjobs/index_en.htm).

### 1.1.1 Increased competition

MiFID is expected to significantly increase competition, both across borders and among trading venues and intermediaries.

Firstly, in relation to intermediaries, it will do this by substantially updating the ‘single passport’ for investment firms, allowing them to operate across Europe on the basis of an effective single authorisation, across a wider range of financial instruments and investment activities. For the first time, investment advice and commodity derivatives business will be covered by the passport, for example.

The ‘single passport’ will mean that a firm needs only to answer to one regulator for most of its compliance questions. Organisational requirements including, importantly, risk management and conflicts of interest, and all services provided on a cross-border basis will be subject to home state control. The host state regulator will have a limited role in supervising branches in its territory,<sup>6</sup> but that will be all.

This represents a significant advance on the Investment Services Directive,<sup>7</sup> where host state regulators retain significant potential regulatory authority over incoming services and branches.<sup>8</sup>

As a result of stimulating cross-border competition, intermediaries can be expected to come under pressure to match incoming firms’ offers, cost structures and support services. This would diversify the range of products, services and markets that investors and issuers can access.

Secondly, and perhaps more profoundly, MiFID will lead to a step-change in competition between investment firms, stock Exchanges and other trading venues for the right to host transactions in shares.

Trading in shares will no longer be the prerogative of the local stock exchange as it is currently in a number of Member States.<sup>9</sup> Share trading will be able to be done on the stock exchange as before, but also on a Multilateral trading facility (‘MTF’), a voice broker, a so-called ‘systematic internaliser’, or via a bilateral OTC transaction.

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<sup>6</sup> Article 32(7) of MiFID.

<sup>7</sup> Council Directive 93/22/EEC of 10 May 1993 on investment services in the securities field [1993] OJ L141/27, as amended.

<sup>8</sup> See Article 11(2) in particular.

<sup>9</sup> See Article 14(3) of the Investment Services Directive. This enables Member States who chose to do so to impose the so-called ‘concentration rule’, requiring certain transactions in shares to be executed on a regulated market. This has the effect of limiting competition between other trading venues and the local bourse in a number of jurisdictions.

This should put significant pressure on Exchanges to improve their offering by reducing costs and offering a broader range of services. This in turn should lead to improved standards of service to investors, leading to more investors using capital markets, and therefore to deeper and more liquid markets. Where an exchange's market does become open to competition from another trading venue, spreads can be expected to narrow and the composite depth of the order books taken as a whole to be significantly enhanced. Ultimately, these effects should benefit issuers by lowering the cost of capital.

### **1.1.2 Enhanced investor protection**

Existing investor protection rules vary widely within the wide latitude granted by the Investment Services Directive.<sup>10</sup> Under MiFID, investor protection rules will be harmonised at a high level, so that investors can feel confident in using the services of investment firms wherever they are in Europe and wherever the investment firms come from in Europe.

Clearly, there would never have been political agreement on a stronger passport without strong and consistent investor protection rules being agreed across the Community. This gives both investors and regulators the comfort that foreign firms will not be able to exploit vulnerable consumers.

For the first time, there will be consistent European rules covering the core investor protection topics: 'Best Execution', information to clients, order handling, suitability, investment advice, inducements and conflicts of interest.

While all these changes are equally worthy of mention, perhaps the most important, from the competition perspective, is the introduction of the 'Best Execution' rule. This rule will oblige intermediaries to direct orders to those execution venues offering the best overall result for their clients, according to a range of factors and criteria which will be set out in the intermediaries' own execution policies. (For retail orders, the Directive requires price to be given priority, in the absence of specific instruction otherwise.)<sup>11</sup> Brokers will be obliged to include, in the list of venues they make use of, all those venues which consistently offer the best overall result. In this way, the Directive

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<sup>10</sup> See Article 11.

<sup>11</sup> Article 44(3) of the Implementing Directive.

aims to increase competition between trading venues, by effectively obliging brokers to seek out the best deals for their clients, even if they are not to be found on incumbent Exchanges.<sup>12</sup>

Another notable development is the articulation of a comprehensive framework for the identification, management and disclosure of conflicts of interest. Investment firms will need to have well-documented policies and procedures relating to conflicts of interest, and to disclose details of those procedures to their clients. There are special rules for the provision of investment research, which has been the focus of intensive regulatory action in recent years, but the general rules apply to conflicts of interest across the board.<sup>13</sup>

### 1.1.3 Increased transparency

Another significant change wrought by MiFID is increased levels of pre- and post-trade transparency for transactions in shares that are admitted to trading on regulated markets.

The Directive tackles the topic of transparency for such transactions in two broad ways:

- in relation to pre-trade transparency, regulated markets and MTF's are required to make information publicly available about orders and quotes on their systems, while firms that internalise customer orders on a systematic, organised and frequent basis (**'systematic internalisers'**) in relation to 'liquid shares' as defined are required to make publicly available quotes in those shares;
- in relation to post-trade transparency, regulated markets, MTF's and investment firms are required to make publicly available information about completed transactions. Large transactions are subject to a series of delays depending on the size of the transaction.

The elaboration of a uniform level of mandated transparency across different transaction venues was essential in reaching political agreement to abolish the 'concentration rule'. Otherwise, significant trading volumes might migrate from regulated markets to untransparent venues for reasons purely of regulatory arbitrage, leaving open, transparent markets unfairly exposed.

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<sup>12</sup> Article 21 of MiFID and Chapter III, Section 5 of the Implementing Directive.

<sup>13</sup> Article 13(3) of MiFID and Chapter II, Section 4 of the Implementing Directive.

A second rationale for a high and uniform level of transparency is to prevent the fragmentation of liquidity into different liquidity pools, as a result of competition, from adversely affecting the price formation process. By requiring information about all comparable transactions to be made public by different actors in a form that ‘facilitate[s] the consolidation of the data with similar data from other sources’,<sup>14</sup> MiFID provides the building-blocks for market-led solutions to the problem of consolidating market data from a variety of trading venues.

Therefore, it can be expected that investors and their intermediaries will be able to subscribe to services which can display to them the share prices applicable across the whole market, not just those hosted on particular trading venues. This will enable investors to get better prices, and prices which more fairly reflect what is going on in the wider marketplace.

#### **1.1.4 More effective regulatory co-operation**

MiFID contains several technical innovations allowing for much more coherent supervision of pan-European financial markets. Transaction reports on a whole range of financial instruments will be channeled to the relevant supervisor of the overall market as well as to the local regulator of the trader.<sup>15</sup> Co-operation and information-sharing will likewise be enhanced across a range of topics.

#### **1.1.5 Deregulation and the principles-based approach**

Another significant MiFID impact will be deregulation. The rules that MiFID contains are for the most part principles-based. This means, for example, that they put the onus on firms to comply with high-level principles and only supplement those high-level principles with more detailed rules where absolutely necessary. For example, in relation to the obligation to act honestly, fairly and professionally laid down in Article 19 of MiFID,<sup>16</sup> more detail is prescribed but only on the topics of inducements<sup>17</sup> and the obligations of investment firms carrying

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<sup>14</sup> Article 32(b) of the Implementing Regulation.

<sup>15</sup> Article 25(3) of MiFID.

<sup>16</sup> Article 19(1) of MiFID.

<sup>17</sup> Article 26 of the Implementing Directive.

out portfolio management and reception and transmission of orders,<sup>18</sup> analogous to ‘Best Execution’ obligations.

The principles-based approach means that much emphasis is placed on a firm’s own policies on topics as diverse as risk management, internal audit, compliance, conflicts of interest, ‘Best Execution’, and order handling. MiFID does not prescribe in detail what these policies should contain, so long as these policies are appropriate to the firm’s own circumstances and characteristics, and to the overarching objectives of the Directive.

As a consequence, the level of detail contained in the MiFID measures is in some areas significantly less than is contained in existing national rules. The so-called ‘anti-gold-plating clause’<sup>19</sup> is aimed at stripping back layers of existing (and future) ‘super-equivalent’ regulation which go beyond the requirements of the Directive, unless they can be rigorously justified in terms of consumer protection or market integrity. Proper application of this clause can be expected to lead to significant deregulatory changes.

## 1.2 OPPORTUNITIES AND CHALLENGES

Market participants are faced with a choice: will they treat MiFID as just another compliance exercise, or will they think strategically about the new possibilities in the new competitive landscape?

There are first-mover advantages to those firms that are prepared to think about new business opportunities and not see MiFID simply as a matter for compliance professionals.

For firms, they will need to consider a range of business choices, including:

- whether to consider commencing or broadening their offering of services into other Member States;
- by what means and on what terms they will make available information about transactions they conclude; and
- whether to enter some of the competitive spaces opened up by MiFID, particularly competing with Exchanges and other trading venues for the provision of trading services.

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<sup>18</sup> Article 45 of the Implementing Directive.

<sup>19</sup> Article 4 of the Implementing Directive.

For Exchanges, the changes will be profound. In those jurisdictions that currently have a concentration rule, they will face competition from other trading venues (including systematic internalisers), or will be able to compete with the incumbents, for the first time. Competition from other Member States will be ramped-up significantly. So both defensive and offensive options will need to be considered.

For the first time, MTF's have a clear, unambiguous passport with which to do business on a cross-border or branch basis throughout Europe. This is because the activity of operating an MTF has been made an investment activity for the first time.<sup>20</sup> For the first time, commodities exchange and MTF's will be able to provide their services in other Member States without encountering regulatory barriers.

Those firms that are currently or potentially operating as systematic internalisers will need to consider their competitive position vis-à-vis stock Exchanges and other trading venues. While there is significant upside for firms that are newly able to internalise orders that would otherwise go to incumbent Exchanges, this kind of business will also attract quoting obligations, which are part of the enhanced transparency measures mentioned above. So such firms will need to consider whether the risks of this business are worthwhile in light of the potential profits, and whether they can carry on similar business in a different way, such as on-exchange market makers or by providing execution facilities as MTF's.

### 1.3 CONCLUSION

MiFID has meant a lot of hard work for a lot of people.

High praise is particularly due to those stakeholders who responded with detailed and constructive comments to the numerous consultations during the legislative process. The process shows that industry and consumers, the European Parliament, European Commission regulators and Member States are able to work together in a sensible and pragmatic way in order to achieve the right result for Europe's financial markets and Europe's investors. As a result, Europe is the winner. And it shows that the Lamfalussy procedure – under which the two-level MiFID has been developed – works.

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<sup>20</sup> Section A(8) of Annex I to MiFID.

The rapid globalisation of financial markets is an opportunity for Europe. MiFID means we are well placed to stay ahead. Our financial markets are in good shape. They are growing strongly and are set to grow even faster in future as the Union enlarges further, the middle classes expand in numbers, the population ages, and people increasingly take responsibility for their own pension provision. MiFID will be an important part of this ongoing story.

We in the Commission services have been pleasantly surprised by the range, depth and quality of guidance on MiFID available for market participants – in the form of briefing notes, conferences, podcasts<sup>21</sup> and even online television materials.<sup>22</sup> We expect that this book will uphold and even exceed those high standards.

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<sup>21</sup> For example, The MiFID podcast at [www.mifidpodcast.com](http://www.mifidpodcast.com).

<sup>22</sup> For example, TheBankingChannel at <http://www.thebankingchannel.tv/cgi-bin/view.cgi>.

