the Markets in Financial Instruments Directive

This bulletin directs investment firms' attention to the key business issues which they should be considering.

What does MiFID do?

MiFID is a complete rewrite of the Investment Services Directive (ISD). In areas already covered by the ISD, it introduces greater detail, clarity and prescription. It places greater emphasis on home state supervision. It also covers new areas of business, so derivatives of all forms, including commodity derivatives and contracts for difference, are included. Investment advice, previously an ancillary activity under ISD, becomes a core activity. The Directive is intended to have substantial pro-competition effects in all EU financial markets, although the greatest impact is likely in the equity markets where we could see significant structural changes. The new Directive thus has a substantial and pervasive effect on all financial businesses: even those regulated as credit institutions or insurance companies may find it impacts significant parts of their business too.

Who does it impact?
The table below shows the key impacted areas.

Business	Highest impact areas
Investment banks/broker dealers	Pre-trade transparency, client classification
Portfolio managers	Client classification, best execution, outsourcing
Stockbrokers	Best execution
Private banks	Client information, suitability
Futures & options firms	Best execution, investment advice
Commodity derivatives traders	Best execution, organisational requirements

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Key impacts

The European dimension:
There is a shift in many areas of MiFID from host state to home state rules: provision of services cross border become exclusively the remit of the home supervisor. The activities of the whole group should be mapped to MiFID. This will often not follow the legal entity structure, but business processes.

Rules heralding MiFID have been introduced throughout Europe since the implementation of the ISD, for example in terms of compliance functions. MiFID's regulatory impact will vary from Member State to Member State. Subtle changes, however, could be more demanding from a business process perspective than significant ones.

Exchanges and markets:
MiFID abolishes the concentration rule, so national authorities can no longer require firms to route equity orders only to stock exchanges (in particular home exchanges). The original argument for the concentration rule was that it aided price formation and discovery, and helped build pools of liquidity – both of which are vital to achieving best execution for clients.

To redress the balance with the removal of the concentration rule, MiFID establishes new, detailed rules for pre-trade and post-trade transparency, together with transaction reporting rules. The Directive does not stipulate how these requirements should be met. Firms will need to note the market changes in deciding how to meet their own obligations. Will liquidity move? Will new trade reporting media become available?

Transaction reporting will be, in future, to the home state of the investment firm executing the transaction by the close of the next business day. The simple addition of market venue codes to post-trade and transaction reports may be difficult for legacy systems.

Systematic internalisers
In countries without the concentration rule, large firms regularly execute client orders in shares on own account rather than on an exchange. If they do this on a regular and systematic basis in liquid shares, they will be defined as 'systematic internalisers'. In future, they will be subject to the same pre- and post-trade transparency requirements for orders of standard market size or below as exchanges and multi-lateral trading facilities (MTF). Though only required to accept orders from their clients, they must achieve best execution for these clients and they may not unreasonably restrict the clients they accept. Thus, current internal crosses will be disclosed to the market in the future, aiding price formation.

Systematic internalisers have several options:

- incur the expense of retaining this new status,
- refuse to deal at or below market size,
- put all orders through the market, or
- establish themselves as a Multilateral Trading Facility.

A key consideration, apart from the costs associated with each option, will be the scale of benefits in attracting order flow and liquidity.

Best execution
MiFID both extends the scope of best execution to all assets covered by the Directive, and the range of clients and market participants who are entitled to best execution. There are carve-outs for particular types of firms, and clients can forego best execution. Best execution will prove problematic for the following reasons:

- A best execution policy will have to be agreed for each asset class for each client;
- Data will have to be captured to demonstrate that any transaction met the agreed policy (each transaction does not have to be 'best execution' on its own); and
- New market venues/pools of liquidity will have to be monitored. This landscape may shift over time. There will be increasing use of performance metrics.

In addition, although best execution is a well-known concept in liquid equities it is unfamiliar, and difficult to define, in other asset classes. For many - bonds, OTCs, etc. - achievement of best execution can range from difficult to doubtful. However, best execution is required by the Directive.

Client agreements
The Directive is prescriptive in this area. Agreements will have to include details of best execution policy. It is likely all agreements will have to be reviewed; it may be possible to amend current agreements via side letters.

Client classification
The Directive defines three classes of client – retail, professional and eligible counterparty – for which there will be different levels of protection, and cost. The opportunity for clients to opt in or out of different categories for specific types of transaction, or even for specific transactions, poses significant challenges for information systems. Investment firms may wish to re-segment their client base and map clients to their services differently.

This part of the Directive has a grandfathering clause, but its effect is not clear and may end up being less helpful than at first appears.

Governance
MiFID sets out requirements for internal audit, compliance functions and the management of risk, safeguarding client assets and managing conflicts of interest. For example, compliance officers will need to be appointed to 'permanent and independent' compliance functions to oversee adherence to MiFID rules. Conflicts management will cover all conflicts arising from specific activities, or the interaction between activities: conflicts' policies must be disclosed to clients.

Record-keeping
Key requirements are that records should allow the key stages of any transaction to be reconstructed at any time and that records should be kept for five years (or the duration of the client relationship whichever is longer). These could prove onerous in terms of data storage and retrieval. Explicit record-keeping requirements are set out in a number of areas - transaction data, client data, client agreements, client reports etc.- but there are also implicit requirements around policies.

Client information/suitability
The Directive sets out the information to be taken into account when

judging the suitability of an asset or product for a client. It also sets out the way judgements should be made.

In particular, suitability must take into account the overall financial capacity of a client, including cash and debt, and must pay attention to the current asset allocation i.e. a product which is suitable on one occasion may not be so on the one hundredth purchase as the portfolio has become too concentrated.

In addition, the Directive introduces the concept of 'appropriateness'. If providing non-advisory services i.e. reception and transmission of orders, firms have to satisfy themselves that the client has the knowledge and experience necessary to understand the risks of the product or service involved.

Execution-only services can be provided for non-complex products if the client has specifically requested it. In this case, there is no appropriateness judgement and the client has to be told that. 'Non-complex' means, broadly, listed shares, UCITS, money market instruments etc.

Inducements

The Directive says that inducements are allowed only if they are not detrimental to the interests of the clients. It clarifies that, in the area of advice, commission may be paid if the objectivity of advice is not jeopardised. Proving lack of bias may introduce a difficult concept to the already problematic areas of commission unbundling in the wholesale markets, and personal advice in the retail.

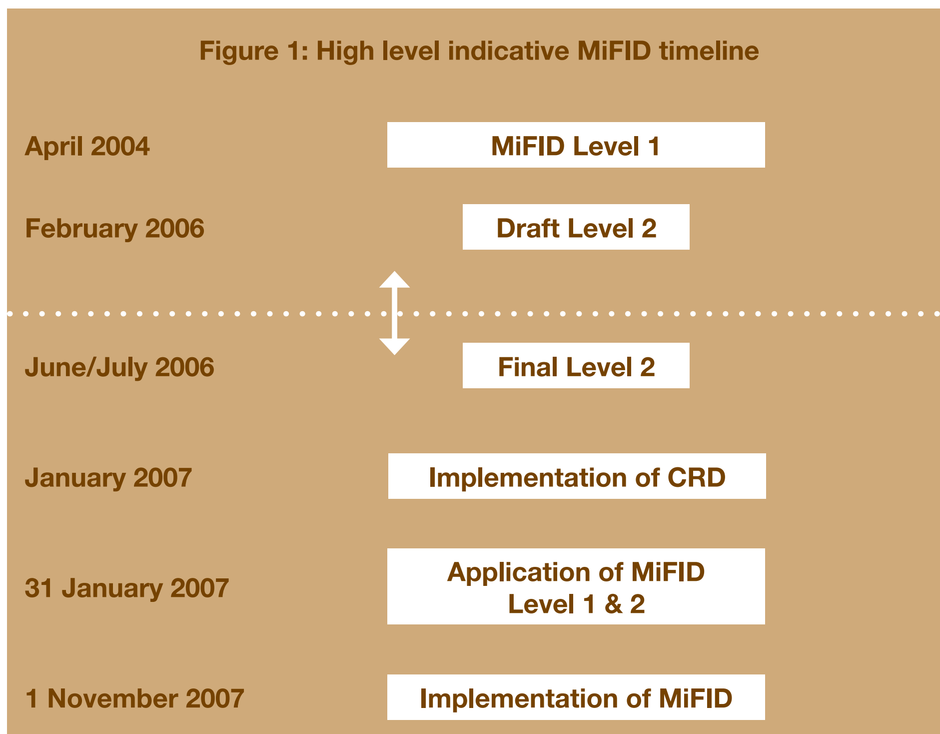
Outsourcing

The outsourcing requirements follow international good practice standards but outsourcing to a non-EEA entity will require special steps to be taken.

Where are we now?

The Framework Directive (Directive 2004/39/EC) became law almost two years ago and is due to be implemented by 1 November 2007. It is a new style 'Lamfalussy' Directive where technical detail is added to the framework through further legislation at 'Level 2'. The proposed Level 2 text was published in February 2006 and should be adopted by the summer. Further changes may appear before then.

Figure 1: High level indicative MiFID timeline



Regulators around Europe are beginning to consult on implementation of the Directive but the timetable is extremely tight.

Some regulators will find transposition particularly difficult. Many Level 2 market-related rules are set in the form of an EU Regulation. Once adopted, it becomes automatically binding – regulators cannot alter a word. Other parts of Level 2 are set out as a Directive which requires transposition into national law.

MiFID though is 'maximum harmonisation', aiming to prevent 'gold plating' or 'super-equivalence' in EU Member States. The ability of regulators to retain or add additional requirements is tightly curtailed by Article 4 of the Level 2 Directive. If this article remains, regulators will have little flexibility in transition. They might only plead retention of any additional rules with Brussels on the grounds of specific risks to investor protection or to market integrity in their jurisdiction which are not fully addressed by the directive.

Action points to consider

- The available texts are in sufficient detail and stable enough to allow project plans to be drawn up even though the final text is not yet available.
- The main aim at this stage should be to assess the impact on policies, processes, organisation and systems so that the work required to undertake the changes can be planned well in advance to ensure appropriate resources will be available when necessary. Although the end date is November 2007 any systems changes will need to allow for testing and parallel running.
- MiFID is a business issue. A senior executive should 'own' the project and should ensure that all relevant business units, as well as support functions, are involved.
- For some firms, investment banks and private banks in particular, substantial strategic change to their business models may be possible or necessary to gain strategic advantage.
- Expert project management is vital given the pervasiveness of MiFID across businesses.
- The actions of related third parties will have to be constantly monitored. Changes in practice outside the firm may force reconsideration of current plans.
- Mapping the total business to MiFID is crucial, particularly if there is a European or global element.

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