

Introduction

MiFID: Convergence towards a Unified European Capital Markets Industry

... You don't join the European Commission to be popular ...

"It is coming and there is no escape: a nightmarish, alien creature capable of inflicting a terrible financial sting on all it touches. No, not the Day of the Triffids; this horror story is the Day of the MiFID".

Martin Dickson, *Financial Times*, 22nd July, 2005

If any topic has taken the financial industry by storm in recent times, it is certainly the one related to the Markets in Financial Instruments Directive: 2004/39/EC (MiFID), very often narrowed down to the notorious "Best Execution" obligation (or so-called Article 21), the prospect of European investment firms becoming systematic internalisers and, obviously, the ultimatum imposed on the sacrosanct concentration rule that currently prevails in most European domestic equity markets.

Press headlines on MiFID over the previous Summer demonstrate that the arrival of the Directive as a new step in the completion of the harmonisation of the European financial services landscape is not really welcome at the very least, according to the loudest voices heard.

In this industry probably over-dominated by service providers, communication is the sinew of war, and visible signs tend to confirm that lobbyists, financial industry trade associations, consultants, technology and service providers have done a much better job than the European Commission at raising awareness.

Of course, one could argue that instead of making industry participants aware, some may have gone a step further and played

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very loudly a dangerous “scare game” threatening the collapse of the entire capital markets industry, or predicting that most boutiques and small- to mid-size institutions would soon be *pushing up the daisies*, which in French language very poetically translates into *manger les pissenlits par la racine*.

Whatever the true motivations of these speakers are, it sounds perfectly clear that the dominant message consistently remains that MiFID is yet another heavy European piece of regulation and that this new development is once more constraining an industry tired of paying hard money for supporting the regulatory red tape.

The five main criticisms of the new Directive that can be heard in the press and in industry meetings are given below:

- (1) unrealistic time-frame and ever-changing implementation deadlines (some sarcastic commentators even claiming the Directive was initiated in 1999 ... *last century*);
- (2) best execution is and will remain a myth with no better foundation than good intentions;
- (3) the costs of transparency and reporting requirements will push most firms out of business;
- (4) wholesale rules are applied to retail markets;
- (5) no cost-benefit analysis was carried out before publishing the Directive, which is setting binding rules whose effects cannot be anticipated.

To be fair to the Directive’s detractors, these five statements may well convey a reasonable amount of truth. Most commentators even add that there is usually no smoke without some fire, so how can the industry embrace a change that is so badly framed?

What is, however, much less visible in the headlines for obvious editorial reasons is the other side of the coin and the possible benefits the industry, but more importantly the clients – professionals or retail – can gain from the Directive.

The realities of today’s capital markets are significantly different from those witnessed in 1993 when the first Investment Services Directive (93/22/EEC) was put in place, attempting to harmonise securities markets across Europe. More sophisticated instruments such as certificates, simple and sophisticated derivatives both in

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the fixed income and the equity universes, warrants and exchange-traded funds (ETFs) but also hard and soft commodities, credit derivatives and energy, and even carbon emission rights, have been developing tremendously over the last decade and are now part of every security firm's portfolio of services.

Technology and the Internet have dramatically changed the way market participants trade on or off exchange; alternative trading systems (matching, auctions, or algorithms) have emerged and offer new trading opportunities available to everyone whatever the location around the globe.

Investors are gaining confidence in more sophisticated investment strategies, allowing them to benefit from the endless innovations academics and practitioners bring to the table in order to improve the way assets are managed and to better perform, to better match liabilities or to better control risks.

But trading across Europe in 2006 is still not a simple matter. Absence of harmonisation of trading systems, regulatory regimes, and clearing and settlement channels remains a hurdle for any single financial institution's back office. With more than 50 active markets in Europe (and nine registered exchanges in the US), it is clear that the European capital markets still offer a significant potential for integration. The 25 local regulatory regimes lacking a high level of harmonisation are unlikely to be able to support long-awaited integration, providing a very good ground for the MiFID initiative.

Because MiFID is a revolution, because significant changes in the industry are more than needed to prepare European countries to compete in what has been one of the earliest examples of a global industry, and because conservatism and refusal to change are the foremost signs of a certain defeat, it is critical to devote some time to understanding the Directive and its real implications for all market participants.

MiFID is certainly one of the most ambitious initiatives European firms have ever encountered, on the one hand because of its wide coverage, from money managers, advisers, intermediaries, exchanges, service providers, and on the other hand because it affects so many dimensions of capital markets such as code of conduct, operational requirements, transparency and reporting, and client handling rules.

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Does MiFID constitute the 21st century “Big Bang” that most commentators predict? Will it turn out to be the financial industry earthquake that we have been awaiting for decades? In order to make progress in responding to these questions, this book attempts to document, explain and interpret the Directive and tries to better understand the possible outcome of this revolutionary piece of regulation.

This book has no ambition of providing responses to all questions investment firms may legitimately ask about the consequences of the regulation on their business, nor does it intend to cover every single aspect of the 73 articles of the Directive, but it will try to shed some light on the most significant aspects of the newly introduced regime.

It has to be said that, at the time of writing, Level 2 regulations have just been released in draft stage pending final adoption by the European Commission (which is expected in September 2006). Some aspects of the Level 2 draft proposals will be discussed and examined even though most of the analysis is made on the basis of the information that has been available for nearly two years within the Level One Directive 2004/39/EC of 21st April, 2004.

To quote the Internal Market and Services DG memo on MiFID frequently asked questions,¹ the information and analysis provided in this book is:

- ❑ *“of general nature only and is not intended to address the specific circumstances of any particular individual or entity;*
- ❑ *is not necessarily complete and does not systematically cover all the aspects;*
- ❑ *is made available for general information only and does not constitute professional or legal advice;*
- ❑ *in no way constitutes an interpretative document.”*

In order to cover the aspects we believe will most impact on the European Capital markets and the financial institutions that the Directive classifies under “Investment Firms”, we have structured this book in seven chapters such that each focuses on specific issues and questions of interest to the reader. Because each of these topics would benefit from a full analysis in a separate book, our analysis tends to summarise the main concepts and elements of the

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Directive and provides some level of interpretation of the impact on investment firms.

The seven chapters that constitute this book have been organised as follows:

- (1) MiFID: context of the Directive as part of the Financial Services Action Plan.
- (2) The development of multilateral trading facilities (MTFs) and electronic communication networks (ECNs) in the US and in Europe.
- (3) A pan European level playing field for execution services.
- (4) The likely impact of MiFID on market structures: will transparency guarantee efficient and fair markets?
- (5) Best execution: understanding the concept and key requirements.
- (6) Transaction cost analysis (TCA): a state of the industry and research.
- (7) A new framework for advanced TCA.

In the first chapter, we will review the existing regulatory landscape, understand where MiFID fits within the European regulatory modernisation programme as well as its *raison d'être* and document how the new regulation has been structured both in terms of regulatory process (the Lamfalussy procedure) and in terms of overall coverage (conduct of business requirements, organisational requirements, transaction reporting and transparency requirements). In this chapter we will discuss what the possible outcomes are for the most important dimensions of the Directive.

In the second chapter, we will analyse the past developments of the ECN/ATS market in the US, and how the industry has grown by fragmentation of liquidity pools and then dramatically consolidated around a small number of large players tightly linked to the historical exchanges. We will also describe Europe's current market structure so that the reader can assess how MiFID might impact on the competition landscape as far as execution is concerned.

In the third chapter we will define the newly introduced concepts (Systematic Internalisation and Multilateral Trading Facilities), review in more detail the specific pre- and post-trade requirements defined at the first level of the Directive, and try to fashion a hypothesis on what implications these new requirements may have on investment firms, depending on their nature.

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In the fourth chapter we will review the existing literature on market microstructure that assesses the likely impact of competition through fragmentation and increased transparency on the efficiency and fairness of equities markets. If competition is usually a strong driver for significant reduction in execution fees, the impact of fragmentation and transparency on total costs (including market impact and opportunity costs) is more complex and has to be carefully reviewed in the light of the forthcoming regulation.

In the fifth chapter we will shed some light on what is probably the most debated question raised by MiFID, that of the newly introduced obligation of best execution. Initiated as an obligation of result in a principle-based regulatory approach, the Best Execution obligation has been actively fought by industry representatives and is slowly turning into a more modest obligation of mean that remains complex and ambiguous if not over prescriptive. The objective of this chapter is to understand the concepts behind best execution, and to try to define what a best net price could be as part of a regulatory obligation and why this obligation is so important within the overall concept of MiFID.

In the sixth chapter we will go through a detailed review of what is considered a cornerstone of the Best Execution obligation, namely transaction cost analysis (TCA). TCA has significantly developed over the last five years and has become a strategic activity for most intermediaries willing to demonstrate the quality of their services and their added value. But TCA is also an area where the absence of conceptual and methodological consensus does not allow the industry to really convince their clients.

In order to constructively contribute to the development of MiFID within the industry, we then provide in the seventh chapter a draft framework for measuring transaction costs that, in our eyes, constitutes a major step towards better measuring and controlling the overall quality of execution. We obviously hope the industry will embrace this new approach, which could become a standard for assessing quality of execution and ensuring that the industry, even if not achieving best execution, is at least not letting its clients down too badly.

The full text of the Level 1 Directive, as well as a glossary of terms, is provided in the appendix at the end of this book. The

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Level 2 draft Directive and Regulation can be downloaded in full text on <http://europa.eu>

On the basis of these seven chapters the reader should gain a good understanding of the overall requirements of MiFID and the key areas of business that are likely to be impacted by the Directive. There is no doubt that more detailed analysis will develop over time on topics such as internalisation, reporting and transparency requirements, best execution, client handling and conduct of business. We hope that this first contribution will help the industry to react appropriately to the birth of this monster that, when all is said and done, must have been expected for some time, in order to build a truly European financial services industry.

- 1 Internal Market and Services DG memo MEMO/06/57 : "Frequently Asked Questions on MiFID : Draft Implementing 'level 2' measures", 06/02/2006 available on <http://europa.eu>