

MiFID - planning and implementation

Part 1

This is the first of two articles following the publication by the UK Financial Services Authority of its recent document on planning for the implementation of EU MiFID. This article looks at the major issues behind the implementation of the Directive. The second article will review some the specific areas, where technology investment may be required.

MiFID replaces the Investment Services Directive (ISD) which has been in place since 1993. The goal of MiFID is to ensure that investors and intermediaries can transact freely with clients in the European Economic Areas (which includes the addition of Norway, Switzerland and Liechtenstein) in addition to the EU Member States on the same terms and conditions as business transacted in their home country. Issuers should be able to tap a deeper and more liquid market, in which spreads and transaction costs and the cost of capital would be reduced.

The ISD defined 'home' and 'host' state regulators, and determined the conditions under which authorised investment firms and banks could provide specified services in other EU Member States on the basis of home country authorisation. Mutual recognition by national authorities enabled authorised firms to passport into other EU countries without re-authorisation, creating a single 'passport' for trading institutions across EU Member States. The scope of ISD covered dealing, arranging or managing financial instruments. But ISD permitted a concentration rule, forcing all share trading through a local regulated exchange, and post-trade clearing and settlement through favoured national market depositories (CSDs).

Achieving a single, liquid market is a very ambitious challenge. It can only be achieved with the political will in each member state complementing "market will." This has been manifest to date in the European Parliament and its Council of Ministers, who delegated much of the work involved in delivering this plan to the European Commission. Analysis conducted by the European Commission indicates the notional effects of establishing integrated, deep and liquid equity and corporate bond markets were likely to be significant, involving a permanent reduction in the cost of equity capital of 0.5%, including generating one-off increases in both employment (0.5%) and GDP (1.1%).

The European Commission requested the Committee of European Securities Regulators (CESR), an informal gathering of EU financial services regulators, through the national financial services regulators to produce the necessary regulations and directives. These would be implemented by the regulators in each EU Member State. In view of the current political malaise within the EU, illustrated by events such as the effective rejection of the EU Constitution and the generally agreed, current ineffectual, Presidency of the EU by the UK Prime Minister, there must be real doubt about the Political Will to achieve a successful outcome for MiFID.

While the FSA does not wish to offend its political masters by speculating on this very real risk to MiFID, its Chairman has already expressed some concerns about MiFID in a speech in October:

"MiFID is the most significant Directive so far to be developed under the Lamfalussy process, in which the Level 2 implementing measures are to be prepared and adopted following submission of advice by the relevant Level 3 committee – CESR. For MiFID. The Level 2 provision will be absolutely crucial in defining, for example, what activities should be subject to restrictions on outsourcing, and if so what restrictions? Or what information should be given to retail clients? Or how should derivatives be defined? the tightness of the timetable has precluded CESR from carrying out cost-benefit analysis of important implementation choices to the Commission back in April, and reflecting both the importance and the complexity of the issues involved, consideration of key Level 2 issues still continues within the European Securities Committee, which comprises the European finance ministries with the Commission in the chair... There will not be sight of the EU Commission's recommended package - reflecting lengthy debate in the European Securities Committee - much before the end of next November 2005. It could well be April next year before the Level 2 measures are adopted in final form. Given the wide scope of MiFID and the fact that all the players have been on something of a Lamfalussy learning curve, it is perhaps understandable that the process is proving so long drawn-out. But the unwelcome, and

indeed unsatisfactory result, is to put renewed pressure in the timetable.”

“There is a lack of any cost-benefit analysis. There have been no estimates of the costs and benefits of MiFID at the EU level. None was made for the original proposal, nor was any produced during the subsequent negotiations. This has been deeply unsatisfactory, and it is encouraging that the Commission and the Council have now clearly committed to undertake impact analysis from the earliest stage for future Directives. The FSA has a statutory obligation to produce a cost-benefit analysis of any new rules, including those, which they must introduce to implement Directive.”

“Discussions with firms indicate that, the initial implementation costs in the UK could be significant. We do not underestimate the dead weight cost of revamping existing, or introducing new systems, procedures and business or trading models, particularly given the understandable desire of firms to minimise their legal and compliance risk. Even in those areas, where MiFID does not hugely change substantive requirements prevailing in the UK, the changes to the detailed form of the standards can be costly to deliver. We recognise that many firms are concerned about the possible scale of MiFID’s costs- concerns, which we share. It is far from clear that the benefits will outweigh the costs for the UK.”

In substantive terms:

- MiFID expands the definitions of financial instruments to include other frequently traded instruments, including contracts for difference (CFDs), derivatives such as credit, commodity, weather and freight derivatives.
- MiFID also recognises and formalises the regulation of Multilateral Trading Facilities (MTFs) such as electronic communication networks (ECNs) and automated trading systems (ATSs), reflecting the growth of such activities since 1993 when ISD was implemented
- MiFID’s scope encompasses best execution, client agreements, client assets, client classification, compliance, conflicts of interest, derivatives (both on/off-exchange), execution only services, information disclosure, internal systems, outsourcing, pre- and post-trade transparency and record keeping.

As the scope of MiFID is so broad, the task facing regulated firms should not be understated in

implementing this Directive and the FSA has produced some guidelines and pointers for consideration in establishing plans:

- The efficiency and effectiveness of their arrangements for compliance and risk management.
- The general integrity of their systems and controls including internal audit and business continuity management.
- Their arrangements for identifying conflict of interest and the resilience of the organisational arrangements used to manage them—seemingly conjectured to a significant area for change in many firms.

The changes will apply to all firms providing services on a cross border basis from the UK, or using a branch to do so. They are likely to cover:

- Compliance arrangements including measures governing personal transactions
- Internal systems and controls particularly in relation to:
 - (i) business continuity
 - (ii) staff
 - (iii) risk assessment, management and mitigation
 - (iv) internal audit
 - (v) administrative and accounting procedures
 - (vi) IT systems and processing
- Outsourcing of “critical and important” functions and services.
- Record-keeping, particularly in relation to transactions undertaken for clients by firms.

Implementation of MiFID is being conducted with indecent haste under an ambitious timetable. The rationale behind the timetable is that it has not been explained satisfactorily by the Council of Ministers or the EU Commission. It must be conjectured that this is a political attempt to breathe life into the objectives of the Lisbon Agenda. At the start of this decade, Europe’s political leaders committed the EU to become by 2010 “the most dynamic and competitive knowledge-based economy in the world capable of sustainable economic growth with more and better jobs and greater social cohesion, and respect for the environment”. The underlying assumption was that flexible market-based financing and the pooling of liquidity would lead to more efficient markets,

continual growth, competitiveness and employment. Both the Lisbon and Stockholm European Councils saw integration of European financial markets as a key for European economic reform.

Delays in pan-European implementation are almost inevitable. There will almost certainly be substantial slippage in the timetable.

- Will the pace of implementation be dictated by the slowest regulatory regime to implement MiFID?
- What sanctions or incentives are there for national

regulatory regimes to meet the deadline?

- Will MiFID be as effective as the weakest link in term of national financial regulator?
- Will we see practical opportunities for regulatory arbitrage in terms of the way in which national financial regulatory regimes implement MiFID?

Financial regulation will provide an interesting and volatile spectacle for the remainder of the decade.

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