Markets in Financial Instruments Directive (MiFID)

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'MiFID'?

"This is not some fearsome man-eating plant. It is simply Brussels shorthand for the Markets in Financial Instruments Directive." – Commissioner McCreevy

Introduction to MiFID

- Comprehensive regulatory regime governing financial trading and intermediation in Europe
- Comes into force 1 November
- Replaces Investment Services Directive (1993) which had:
  - Low level of harmonisation of conduct of business questions
  - Concentration rule permitted
- MiFID takes its place alongside other elements of Financial Services Action Plan
  - E.g. Prospectus Directive, Market Abuse Directive, [Issuer] Transparency Obligations Directive, Company Law reform, Audit and Accounting reform

MiFID Regulatory philosophy

- Principles-based approach
- High level of investor protection
- Limited reliance on disclosure – strong rules on inducements, conflicts, best execution
- Rules calibrated to firm, client characteristics
- Lighter-touch regulation of professional markets
- Limit 'gold-plating' to enable the passport to function well
- Where possible use Regulation not Directive

Lamfalussy – 4-Level Approach

Level 1: Broad framework principles in Directive/Regulation adopted through co-decision process (Council and European Parliament)

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Level 2: Implementing rules by COM, after consulting Committee of European Securities Regulators (CESR). Vote at European Securities Committee (ESC). Oversight by EP

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Level 3: Strengthened cooperation between national regulators to ensure convergent application (CESR)

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Level 4: Strengthened enforcement of Community law (Commission)

The key ‘deals’ of the MiFID

- Strengthened single ‘passport’ for investment firms means provision of investment services in 27 EU + 3 EEA States on the basis of a single authorisation & a high level of home state control
  - Quid pro quo: High standards of investor protection rules valid throughout the EU
- Abolition of concentration rule, i.e. providing for free competition between exchanges, MTFs and systematic internalisers for the trading of shares
  - Quid pro quo: Pre- and post-trade transparency for regulated markets, MTFs and systematic internalisers

Main requirements for firms

- Organisational
  - Including requirements relating to risk management, internal audit, compliance function
  - Limitations on personal dealing by employees and others
  - Outsourcing – limits on outsourcing of PM to third countries
  - Conflicts of interest – requirement to have a comprehensive policy for identifying, managing and disclosing conflicts

Firms requirements (2)

- Conduct of business
  - Information to clients to be fair, clear and not misleading
  - Investment advice and portfolio management must be <u>suitable</u> to the investor’s level of experience, risk appetite and investment objectives
  - Other services must be <u>appropriate</u>
    - Investor must be able to understand risks
    - Except a limited class of ‘non-complex’ products
  - Firms must deliver ‘best execution’ when executing orders on behalf of clients

Firms requirements (3)

- Conduct of business
  - Strong regulation of inducements
    - Payments to & from firms in relation to investment services must be justified and fully disclosed to clients
    - Disclosure of receipts not enough – must enhance quality of service to the client
  - Record-keeping measures
  - Mandatory written client agreement for retail clients

Firms requirements (4)

- Transaction reporting to local competent authorities of buy and sell transactions in all financial instruments admitted to trading on a regulated market
  - and sharing of data among competent authorities to ensure adequate supervision
  - Carve-outs from obligation for primary market transactions, securities financing, option exercises
  - For interest rate, FX and commodity derivatives, regulators have adopted an exchange-centric approach since there is no OTC trading of exchange-admitted instruments
    - Exchange provides feed to local regulators
    - Remote members can still report directly to their authorities
  - Some regulators apply rules to a broader range of instruments. E.g. FSA applies rules also to OTC-only instruments that are not admitted to trading on a regulated market

Transparency & exchanges

- Detailed transparency provisions apply to shares admitted to trading on regulated markets
  - Trading venues (regulated markets, MTFs and systematic internalisers)
  - Firms subject to post-trade obligations for OTC trades
  - Pre-trade exemptions available e.g. crossing networks
  - Delayed publication of post-trade information possible for large trades under a ‘sliding scale’
- Carve-outs for primary market transactions, stock lending & repo, options
- Reporting in ‘real time’ (within 3 minutes) except for portfolio trades and out of hours trades
- Requirements for organisation and conduct of regulated markets and MTFs

Intended impacts of MiFID

- A catalyst for significant innovation and market structure changes
- Increase competition between trading venues and cross-border
- Increase trading volumes and financial information flows
- Will make full electronic trading more attractive
- Create deeper, more liquid integrated capital markets
- Lower costs for issuers and investors

Market changes so far

- Very encouraging
- A range of new trading venues and services have already been announced
  - Trading: Project Turquoise, Chi-X, Equiduct, SmartPool, Plus Markets, etc…
  - Trade reporting to market/regulators: Project Boat, Omgeo, ICMA TRAX2, LSE, Reuters, Deutsche Börse, etc…
  - Other services for firms to assist in compliance/service delivery
- Existing exchange services upgraded (cheaper, faster)
- Consolidation among major exchanges
  - LSE-Borsa Italiana
  - NYSE-Euronext
  - Share register action at LSE and OMX involving Nasdaq, Dubai, Quatar…

EC impact analysis

- London Economics, 2002
  - Covered FSAP as a whole not just MiFID.
  - But MiFID is a cornerstone of financial integration
- Found that financial integration of EU-15 would lead to:
  - Reduction in cost of equity capital of around 50 bp
  - Reduction in cost of bond capital for non-financial issuers of 40bp
  - GDP increased by 1.1%
  - Total business investment up 6% and private consumption up 0.8%
  - Total employment up by 0.5%

MiFID Transposition readiness

- Not all Member States will have fully transposed by 1 November
  - Despite COM pressure via litigation (ECJ) and 'name and shame' efforts
- CESR statement on late transposition
  - Firms operating into late-transposing Member States must be allowed to operate freely
  - Firms based in late-transposing Member States
    - Will have a transitional passport under Art. 71 MiFID
      - Based on existing comparable regulatory regimes
    - Applies to firms that already have an ISD passport
    - Does not apply to newly harmonised services such as investment advice or commodity derivatives business
- We expect all Member States to have fully transposed by early 2008 at the latest

… and all who sail in her

Questions