



Miffed by MiFID?

Those who have not already come across it are going to hear more about a new expression in the ever growing lexicon of European regulatory language – MiFID (Markets in Financial Instruments Directive). MiFID is the European Directive designed to replace and update the Investment Services Directive (ISD), introduced in 1993 as part of the drive towards a single European market in financial services. Intended to bring about fundamental change, the implementation of MiFID will be a significant milestone, which is going to have a dramatic impact on the financial community.

MiFID started life as ISD 2 in 2000, when the European Commission proposed upgrading ISD. In the years that have followed, it has passed through the various stages of the European legislative process, to be adopted by the European Parliament and Council in April this year.

MiFID has not yet been implemented and will not come into force as domestic law in Member States until April 2006. Historically, once adopted, European Directives slide seamlessly into domestic law by a set date with little or no debate. However, this has changed for European Regulatory measures since the Council adopted the recommendations of the Committee of Wise Men, chaired by Baron Alexandre Lamfalussy in 2001. The Committee proposed a four level approach to regulatory measures. Level 1 (the European directive) should confine itself to broad general framework principles, level 2 implementation measures to be adopted by the Council and below that, levels 3 and 4 deal with cooperation and enforcement.

Where are we now?

Having adopted the level 1 principles in the Directive, the Commission has now called on Committee of European

Securities Regulators (CESR) to consult on level 2, the implementation measures, through a set of mandates given to it in January this year.

For those who have already encountered MiFID, it is probably as a result of the CESR consultation process, which was underway during the summer and which, unusually, included a public meeting in Paris in July (where the majority of participants apparently came from the UK). The deadline for submission was 17 September 2004, comment from exchanges, trade bodies and other interest groups came ahead of this deadline. The consultation on the mandates given in January is due to be completed for report back to the Commission by the end of January 2005. As part of the consultation process, a further consultation paper was due to be issued as *FOW* went to press and there may be a further public meeting in November.

At the end of June, the Commission gave CESR a further set of mandates to review and advise on. The timetable for this second set of mandates has a deadline for comment of mid-January, and a sign-off date at the end of April 2005. Speaking at a conference in September, Michael Folger, director of wholesale and prudential policy at Financial Services Authority, indicated that this was the date FSA had targeted to start work on its own implementation of the Directive, aiming at bringing forward a Consultation Paper in July 2005, in order to have rules adopted by February 2006.

What's all the fuss about?

MiFID is set to get an FSA three star rating because it goes beyond anything we have seen so far on the harmonisation of financial services throughout the European Union.

The high level objectives of the Directive are to:

- Clarify and expand the services that can be dealt on markets and between investment firms
- Broaden the range of services for which authorisation is required
- Reinforce the requirement that investment firms execute orders in a way that provides the best result for their client (best execution)
- Set in place new rules for handling clients' orders
- Set requirements for managing conflicts of interest
- Clarify standards for regulated markets and MTFs (Multilateral Trading Facilities)
- Enhance the principles of cooperation between competent authorities.

Some aspects of the Directive are specific, such as the extension of the range of services subject to European regulation and passporting. Once MiFID comes into force, investment advice will be covered, so that the large number of advisers in the UK and throughout Europe who avoid the regulatory capital implications of the Capital Adequacy Directive will no longer be able to do so. However, most aspects of the Directive are simply statements of high level objectives rather than specific requirements and it is only at the next level down (the CESR mandates) that the full implication of these objectives become clear.

CESR has divided its consultation on the various aspects of the Directive into three streams, each under the stewardship of one of three expert groups:

- Intermediaries issues looking at organisational requirements, conflicts of interest, conduct of business, order handling and best execution (chaired by FSA chairman, Callum McCarthy)
- Markets issues looking at admission to trading, pre and post trade transparency and post reporting

What exactly is MiFID and what is its purpose? With the ever-increasing number of financial regulations, how exactly does this legislation fit? Vincent Mercer* looks at the current state of play and ahead to what is on the horizon

(chaired by Jacob Kaptein from the Dutch securities regulator)

- Cooperation and enforcement issues looking at transaction reporting and exchange of information and cooperation between regulators (chaired by Michel Prada, president of the French securities regulator).

The Directive's proposals are extensive and include the following:

Intermediaries

Compliance

Article 13 proposes a common approach to compliance and systems of internal control. CESR proposes that every investment firm should have effective compliance policies, procedures and functions and that the compliance function should monitor the adequacy and effectiveness of internal policies and report to senior management. It also proposes the establishment of internal audit control and independent audit risk control functions.

Best execution

Article 21 proposes best execution for all but gives no indication of what this constitutes. CESR proposes a number of factors that a firm should take into account in forming its order execution policy.

Investment research

Articles 13 and 18 propose that investment firms should establish and enforce policies for identifying, preventing and managing conflicts of interest, particularly those firms involved in proprietary trading and portfolio management. CESR suggests that having these policies should produce a common approach.

Markets

Pre and post trade transparency

The Directive proposes that there should be coordination and harmonisation and real time distribution of

information relating to any investment across all the markets on which it is traded. It also proposes that there should be standardisation of bid and offer information and security identifiers. This will be subject to some exemptions. CESR has already indicated that this would include block trades. As part of this CESR is attempting to achieve harmonisation on trade crossing rules particularly rules on transparency for in house crosses.

Admission to markets

Article 40 of the Directive seeks to promote fair and orderly trading. The CESR consultation identifies the elements which an exchange or market should take into account in determining whether to admit any particular investment to trading.

Cooperation

Transaction reporting

Article 25 proposes harmonisation of transaction reporting, allowing the information gathered to be exchanged more easily between regulatory and market supervisory bodies.

Responsibility for coordinating information

Article 25 is one of the more troubling aspects of the Directive for exchanges and markets in that there will be a single point for the coordination of information relating to any particular investment. This will be the most liquid market. The CESR consultation includes consultation on the arrangements for detecting the most liquid market for any particular investment, starting from the proposition that it will be the market on which the investment was first admitted to trading.

Cooperation and exchange of information

Article 58, in response to the Directive, CESR proposes a series of arrangements for the making, handling and responding to requests for information between regulators.

The future

MiFID is an excellent illustration of the problems with the European legislative process – the realities of European harmonisation, mounting costs and difficulties with inflexible deadlines.

The Directive is being introduced on a timetable that has been set by politicians to harmonise practices throughout the European Union. However, the rationale for imposing uniformity is, I suspect, lost on many of us who might buy into equivalence taking account of the various national laws and cultures. At no stage have I seen any cost-benefit analysis of MiFID and the costs of implementing this Directive across Europe must be enormous.

The timetable for implementation of the Directive necessarily (and disappointingly) imposes a limit on the consultation that CESR can realistically undertake. This in turn must limit the amount of debate that can take place to settle inevitably competing national interests. It seems to be a case of aiming to get the Directive in place rather than aiming to get the Directive right.

While the European consultation process is improving with more transparency, the UK approach to its involvement in it is unchanged. Handling European legislation is left to civil servants and there is little or no public scrutiny. Unlike an increasing number of European countries, our Parliament has no mechanism for scrutinising European legislation. Yet again, we seem set to face further uncertainty, disruption and increased costs inspired by Europe.

It will be interesting to see how MiFID will come out of the CESR consultation and what it will look like in its final state. □

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