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Introduction

MiFID was formally adopted by the EU legislator on 30 April 2004, but until now, a systematic overview and discussion of the impact of the directive and its different provisions has not existed. The European Directive 2004/39/EC, better known as the Market in Financial Instruments Directive (MiFID), is nothing short of a revolution. This directive represents the cornerstone of the Commission's Financial Services Action Plan and was recently transposed into national law and implemented by investment services providers.

MiFID will fundamentally alter the structure of European securities markets, in a way that possibly not many other pieces of EU financial services legislation have so far done. Much of the available analysis surrounding MiFID has focused on compliance, on building the supporting IT infrastructure and on upgrading procedures within financial institutions. Yet the regulatory impact of MiFID extends far beyond short-term implementation for investment firms. The unprecedented scope of harmonization of securities markets legislation and the resulting open architecture ushered in by MiFID, especially in trade execution and reporting, will cause a profound upheaval within existing market structures.

MiFID is indeed revolutionary; its role and impact can be considered ground-breaking from the competitive, economic and legislative points of view. MiFID came into force in the EU and European Economic Area (EEA) countries on 1 November 2007, but as there were serious delays at the level of the member states and firms in adapting to this, a full appreciation of the changes brought about by this process can still be expected to take some time.

MiFID is revolutionary from the competitive point of view, as it dramatically changes the conditions for operators in capital markets. It abolishes the monopoly of exchanges and allows systematic internalizers and Multilateral Trading Facilities (MTFs) as trade execution venues. On the other hand, it radically upgrades the operating conditions for service providers in capital markets, through 'best execution', client suitability

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and appropriateness, and conflict of interest criteria. The combination of market opening measures and tightening of conduct of business rules will have profound implications for the structure of European capital markets, the competitive position of investment services providers, the design of investment products and the attitude of investors.

The seismic shifts brought about by MiFID will also have long-lasting implications for the strength of financial services sectors in EU countries, leading to a re-positioning of European financial centres. The huge delays which many member states experienced in transposing the directive in time have led some to argue that the 'variable geometry' concept, used to refer to the different degrees of institutionalized cooperation which exist between EU member states, could also be applied to MiFID. The diversity in preparedness of member states will exacerbate differences between financial centres in the EU, and strengthen the well organized, leading to a consolidation of EU financial centres.

MiFID is revolutionary from a legislative point of view, too, as it is the first EU financial services directive to make ample use of the provisions for secondary legislation, initiated under the 'Lamfalussy' approach. The MiFID directive allows for implementing measures for a whole set of provisions in the directive, by which legislators can agree on swift adaptations to the basic rules. MiFID also introduces a series of new concepts in much detail in EU law, which either did not exist at EU level or were not previously spelled out. Concepts such as 'best execution', conflicts of interest, and client suitability will fundamentally alter the way of doing financial business in the EU. These requirements will not remain limited to the area of investment firms, but will become standard principles for all retail investment products and investment services providers.

The implementation of MiFID was largely overshadowed by the financial crisis. Yet MiFID could be seen to be well adapted to the post-crisis regulatory landscape. Detailed regulation of concepts such as best-execution, know your customer rules and conflict of interest provisions was forward looking and is what is needed to convince investors that regulators were attuned to market developments. Its correct and strong implementation is what supervisors need to ensure to bring them back to the markets. With the large possibilities for adaptation to market developments in secondary legislation, MiFID can also sustain pressure of the times.

This book is intended as a handbook for practitioners, markets operators, financial services industry professionals, regulators, investors and students. It gives an in-depth understanding of this new EU directive in

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its multifaceted implications for the different business lines in financial markets. The individual chapters are designed to be read either independently or in combination.

Chapter 1 paints a portrait of the likely EU securities market landscape post-MiFiD. Much of the available analysis on MiFID has focused on short-term adjustment and compliance costs. Yet MiFID represents a revolution in European securities markets that is likely to lead to deep and long-lasting structural changes. The analysis in this chapter concentrates on ten predictions that the authors make about the likely impact of MiFID on market structures, and the likely strategic responses of financial services firms.

The second chapter traces the origins of MiFID, starting with the review of the 1993 Investment Services Directive (ISD), the formal Commission proposals for an ISD II (November 2002) and the decision-making process within the European institutions. It gives a broad overview of the structure of the text and discusses the most important principles.

Chapter 3 focuses on the new conduct of business regime introduced by MiFID, which set forth new powerful investor protection tools in the suitability and the appropriateness assessments, aiming at guarding the investors' interests. These devices, however, have been perceived as a threat by the industry, as they represent not only an additional compliance burden, but even a tricky teaser to be better solved in time before the entry into force of the directive. Suitability and appropriateness, in fact, have the potential to lead to an unpleasant situation for the industry: if not clearly understood in their distinctive scope and purpose, they may turn themselves into 'terrible twins', whose features risk overlapping. Even though suitability and appropriateness share the same goal of enhancing investor protection, they are subject to two different regimes, applicable when the situations described in the chapter occur.

Chapter 4 sheds light on the complex 'best execution' requirements introduced by MiFID. Interestingly, very few member states had formalised best execution provisions in place before. At most, some had vaguely defined fiduciary duty obligations. Best execution not only implies that firms have adopted and published a policy that takes into account several intertwined criteria, that they get a specific consent from the clients to the policy itself and that they review it annually, but also that they have adapted their IT systems to ensure that orders are executed in accordance to what is stated in the written policy and that the latter is constantly effective. This may force firms to outsource certain activities, as they may not be able to provide best execution in-house. Hence, MiFID

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is in this sense not only a burden for smaller firms, but also a threat for large integrated financial services groups.

Another change brought about by MiFID, the opening up of the market for equity market data, raises the question of whether data will be sufficiently consolidated and of high enough quality post-MiFID, or whether it will become too fragmented, thereby hindering price transparency and the implementation of best execution policies. **Chapter 5** discusses the market for financial market data, the provisions of MiFID and the implementing measures regarding financial data and data consolidation. It compares the approaches taken by the Committee of European Securities Regulators (CESR), the UK Financial Services Authority (FSA) and the US authorities on the organization of the market for market data. It concludes that markets should be capable of adapting and that additional licensing requirements, such as those proposed by the FSA, are in fact premature and act as a barrier to the single market. Nor would a US-style monopoly consolidator be needed in this case.

Chapter 6 addresses the issue of conflicts of interest as a tool to promote investors' protection and to enhance market integrity. It is based on the assumption that conflicts of interest are ubiquitous in the financial services industry, but this does not mean that regulators are prepared to accept conflicts as an unavoidable fact of life. The chapter focuses mainly on the MiFID provisions on investment research.

Strongly linked to the previous chapter, **Chapter 7** looks at the MiFID rules on inducements. It argues that while the policy objectives underpinning the rules are valid and necessary, the instruments regulators have chosen for achieving those objectives are in need of fine-tuning, and especially clarification, if the objectives are to be met without inflicting collateral damage on the European fund industry.

Chapter 8 addresses the interaction between the MiFID and the Undertakings for Collective Investments in Transferable Securities (UCITS) regime, identifying two main areas where MiFID impacts most on the asset management business: best execution, on the one side, and conflicts of interest and inducements, on the other. As UCITS are mostly distributed by institutions subject to MiFID, these new rules will have a far-reaching impact on the organization of the fund management business. MiFID, on the other hand, may also provide a platform for the distribution of non-harmonized funds. However, the national application of these provisions may differ, which calls for a consistent interpretation.

Chapter 9 aims at contributing to the ongoing policy debate on MiFID art. 65.1, which tasks the Commission with conducting a study to report

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on whether the trade transparency requirements that currently apply to share trading ought to be extended to non-equity markets. It presents the pros and cons of introducing greater transparency into non-equity markets, especially bonds. The chapter highlights the insufficient level of data available to market participants and regulators on volumes and aggregate bond market activity, as well as the lack of appropriate information made available to retail investors, suggesting that dealers may have little time to come up with a solution, and that an industry code of conduct may be an appropriate avenue – and one preferable to legislative initiatives – for introducing more transparency uniformly (within each fixed income asset class) across the EU.

Chapter 10 on the supervisory architecture introduced by MiFID sheds light on the technical issue of allocation of responsibilities between the competent authorities of the home and the host member state in the cross-border provision of financial services. The chapter also analyses the role played and to be played by CESR in the overall supervisory convergence.

Chapter 11 explores the transatlantic context, investigating whether MiFID and the US Regulation National Marketing System (Reg NMS) could be accepted as equivalents by regulators on both sides of the Atlantic. Apart from many similarities, the most important one being that the main purpose of both measures is to enforce best execution in equity trading, there are many differences as well in the definition of best execution, the structures of the markets, and the role and powers of supervisory authorities. The chapter calls upon the European Commission to make a detailed comparison between both measures and to take the opportunity to negotiate a mutual recognition agreement with the US.

The book ends with a general bibliography and a glossary. Specific references are kept at the end of each chapter.

The authors would like to express their thanks to the European Capital Markets Institute (ECMI), an independent non-profit making organization established in 1993, for having provided the context to write this book. Back in 1996 ECMI produced a standard work on Europe's capital markets and the ISD, entitled *The European Equity Markets*. With this book, we hope to set the standard for MiFID.

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The MiFID revolution

The Markets in Financial Instruments Directive (MiFID) has essentially been seen as a compliance and IT exercise for financial services firms. As a result, much of the analysis surrounding MiFID compliance and the development of business strategies for the new regulatory landscape has focused on upgrading internal procedures and building the supporting IT infrastructure.

The impact of MiFID extends far beyond mere compliance and IT alone, however. The unprecedented scope of harmonization of securities markets legislation and the resulting open architecture ushered in by MiFID, especially in trade execution and reporting, will cause a profound upheaval within existing market structures.

MiFID is nothing short of a revolution: it will see banks operating as exchanges for some activities, exchanges offering alternative execution services that more closely resemble the structure of OTC markets than traditional organized markets, and the decentralization of order execution among a panoply of venues in markets previously governed by concentration rules: *le monde à l'envers*. MiFID has a profound impact on the organization, day-to-day operations and business strategies not only of investment firms – which have tended to be the focus thus far – but also of exchanges, asset managers and other financial markets intermediaries, such as brokers, data consolidators and business solutions providers. Overall market design and functioning are likely to be heavily impacted, not least because the implementation of MiFID is not a static event necessitating only one-off sunk costs; rather, it requires firms to make constant dynamic readjustments to remain competitive.

In light of this reality, insufficient analysis has been devoted to the strategic implications of MiFID, even though these are far-reaching – even more so, we believe, than what Basel II represented for banks – because of the profound market restructuring that is expected. The accompanying uncertainties as to how market participants are to

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position themselves strategically in the new regulatory landscape and respond to newly emerging threats will shake up the status quo.

As with all revolutions, the shock to the status quo represents a profitable opportunity for those who are well prepared – and a death sentence for those who cannot adapt to the new environment. The well prepared are the actors who in the post-MiFID world will generate higher revenue streams, steal market share from the less well prepared, and begin to compete in areas lying outside their traditional scope of service provision – areas previously closed to them, or deemed to be unprofitable prior to MiFID. On the other hand, the less well prepared will have been startled, soon after November 2007, to find themselves competing in business lines against actors from whom they previously faced little or no competition, including actors whom they may not even have viewed as natural competitors prior to MiFID.

1. Ten key predictions on the impact of MiFID

MiFID accelerates some important ongoing changes in European financial markets that are driven primarily by technological improvements and enhanced competition in the provision of financial services arising from globalization. Greater recourse to electronic trading, the facilitation of straight-through processing, the continued disintermediation of brokering through direct market access and algorithms and the 'exchangization' of Over-The-Counter (OTC) markets are but a few examples of ongoing structural shifts in financial markets that are reinforced or precipitated by MiFID.

MiFID leads to a higher degree of harmonization for investment services and securities transactions in the EU, by extending the reach of services and products covered as compared to the Investment Services Directive (ISD), and by imposing more detailed performance rules on exchanges and investment firms. As such, it should lead to more integrated European capital markets, but will also have significant impacts on market structure and development.

MiFID directly touches four distinct groups of actors within the financial services industry: investment firms (which may have fairly different organizational models across countries); exchanges and quasi-exchanges (multilateral trading facilities (MTFs)); data vendors; and specialized IT firms and solution providers, such as third-party algorithm developers. It affects equity markets, commodity and

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derivatives markets, and to a lesser extent bond markets.[1] This represents a considerable upgrade as compared to the Investment Services Directive, which it replaces. The analysis therefore starts with a discussion of the main developments in European capital markets over the past decade and reviews the effects of the ISD. We next rehearse the key points of MiFID and discuss the issues raised by its implementation for the various markets affected. A final section offers a brief outlook for the future of European securities markets. While numerous papers have already been published on how to prepare for MiFID, there has been much less consistent analysis of its impact on the market and the industry.

In our view, MiFID will bring about the following fundamental changes:

1. As a result of high compliance costs and greater operational complexity, MiFID will lead to a further consolidation phase in the brokerage industry, although smaller firms will continue to have a niche, essentially because of the proximity to clients. MiFID will lead to a tighter competition between financial centres, as a result of the abolition of the monopoly of the status symbol of financial centres, the stock exchange, and because of large differences in the preparedness of member states and firms.
2. Although investment firms and MTFs are able to compete with exchanges on order execution as a result of the abolition of the concentration rule, exchanges are expected to remain the main source of liquidity and price formation for the time being, but they will be subject to more competition in their market data and settlement activities. Despite a misconception that they will only face more competition from market-makers in the trading function, exchanges will also face enhanced competition from other exchanges. On the post-trading side, exchanges will be impacted by the European Central Bank's (ECB's) Target 2 Securities initiative and the European Commission's Code of Conduct on Clearing and Settlement.
3. OTC markets are going to be more heavily regulated than in the past under MiFID, meaning that the heydays of market opacity and cosy execution arrangements between providers are over: the distance

[1] Under MiFID art. 65, national regulatory authorities are free to extend the strict MiFID pre- and post-trade information requirements to non-equity markets. Some already do so, such as those in Denmark, owing to the large retail investor presence in its mortgage bond market. See Chapter 9.

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between OTC markets and regulated markets will be narrowed as the former become more competitive, more transparent and more closely monitored.

4. A significant rise in algorithmic trading is almost a certainty. The need to rapidly search prices available on a variety of execution venues *ex-ante* and to verify the quality of execution *ex-post* will stimulate demand for business solutions such as algorithms. As execution venues proliferate, traders will rely more on smart order-routing systems to provide best execution.
5. Trading volumes should increase as a result of greater competition between execution venues and enhanced market transparency. More competition means lower transaction costs, which should feed into higher volumes. More transparency means more confidence in the quality of price discovery, enhancing market efficiency, which should also generate higher volumes. Greater transparency will contribute to the parcelization of block trades into a more continuous stream of orders, since it will increase the market impact of large trades.
6. Connectivity is a central feature of the post-MiFID trading landscape that will be characterized by the fragmentation of liquidity pools as trading is decentralized. Connectivity necessitates the acceleration of efforts to arrive at common standards to facilitate straight-through processing in an accelerated and more competitive trading environment, as well as to ensure seamless order transmission and data retrieval, across the spectrum of business lines in a decentralized trading environment.
7. A massive market for market data arises out of MiFID. In countries where the concentration rule was applied, the local stock exchange acted as the sole execution venue, meaning that market data revenues of equity trading essentially accrued to exchanges. The more execution venues there are, the greater is the need to gather data. MiFID's strict best execution and order-handling rules heavily increase the need for reliable analysis in both the pre- and post-trade periods to ascertain the venues that will most likely perform a successful execution pre-trade and the self-imposed quality of execution tests MiFID requires post-trade.
8. MiFID necessitates a response on the part of buy-side firms. Most analysis has focused on the impact of MiFID on sell-side institutions. The buy side will be faced with the challenge of ensuring efficient data management, as market data are likely to increase significantly

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post-MiFID. The challenge is to monitor the quality of execution buy-side firms obtain for their clients.

9. Although MiFID is much more detailed and harmonizing in scope than its predecessor and the European Commission has tried to restrict the loopholes in the Implementing Directive, 'goldplating' will continue, as suggested by the emergence of initial indications in this direction. In addition, contract law and consumer protection remain national. The European Commission thus faces a heavy policing role in the post-MiFID era to ensure correct implementation, tight enforcement and a level playing field.
10. Given the heavy conduct of business regime of MiFID, the search for less stringent regimes can be expected, but also new non-passportable national regimes may emerge. On the other hand, MiFID is so all-encompassing that its rules will spill over into related sectors, such as asset management under the UCITS regime. MiFID may well set the standard for the conduct of business regime for all forms of retail investment products, frustrating attempts to further harmonize product regimes in the EU.

2. Delayed implementation by the member states

Overall, the preparation by European authorities of the MiFID implementation went smoothly, but the problem lay with the member states. Although the directive was adopted by the EU in April 2004, it took most member states more than three years to be ready! Almost all member states failed to meet the deadline for transposing the text into national law, 1 February 2007. In June 2007, the European Commission sent warning letters to twenty-two member states for their dereliction – Ireland, Lithuania, Slovakia and Romania the being the exceptions. On the deadline of application of MiFID, 1 November 2007, at least 7 member states were not ready, representing 1/3 of the EU population (Italy, Spain, The Netherlands, Poland, Czech Republic, Hungary and Finland). By the end of January 2008, the Czech Republic, Hungary and Spain had still not implemented MiFID, which led the European Commission to refer the cases to the European Court of Justice.

Given this diversity in preparedness by the member states, it is no wonder that firms are also late with their preparations. In some member countries, financial institutions had been regularly informed by their authorities, from about two years ahead of the November 2007 deadline, what it was going to take to plan for MiFID. In other states, however,

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