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MiFID Revolution or Delayed Execution

CEPS Commentary
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Financial services firms will have to adapt to the strategic implications of MiFID in the coming months, or face gradual extinction. MiFID portends a true revolution in the European financial landscape, not only because of the profound changes it will trigger, but also because of the huge diversity in preparedness on the part of both member states and firms to implement its provisions. The abolition of the monopoly of exchanges and the introduction of best execution for service providers are fundamental challenges for the two main actors involved. And there will be no excuses for delays after November 1st, when the new rules will be irrevocably applicable.

The wake-up to the implications of MiFID was late, if not to say very late. Although the directive was adopted by the EU in April 2004, it has taken most member states and firms more than 3 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 22 member states for their dereliction –Ireland, Lithuania, Slovakia, Romania and the United Kingdom being the exceptions. Even fewer member states have implemented the implementing directive. In the meantime, large member states such as France, Germany, Italy and Spain have (almost) completed implementation.

No wonder firms are also late with their preparations. The latest Sungard MiFID Survey of financial institutions, which is probably the most comprehensive inquiry on the subject, published in July 2007, shows only a limited improvement in the preparedness of firms. In April, it indicated that only 40% of the firms were on track or ahead of schedule with their plans; in July, this was about 55%. But firms cannot be expected to be ready if their authorities are not. In some member countries, financial institutions have been regularly informed by their authorities for 2 years now about what it takes to plan for MiFID. In other big states, however, absolutely nothing was circulated until a few weeks ago. Despite these large discrepancies in preparedness, the deadline for application, 1 November 2007, will not change. This is already an important part of the revolution to come: MiFID will exacerbate differences between financial centres in the EU and strengthen the well prepared. But this does not predict much good for when MiFID will start to bite for the badly prepared.

One could reasonably ask about the reasons for these huge delays? It is interesting to note that member states managed to implement another complex piece of EU legislation that had to be transposed at about the same time, the Capital Requirements Directive implementing Basel II (80%, in fact, according to the EU Commission league tables), and firms seem to be prepared as well. The reason MiFID is such a hard nut to crack is most likely related to the radically new and complex concepts it introduces in much detail in European legislation – such as client classification, client order handling, best execution, conflict of interest, client suitability,

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inducements – the liberalisation of execution venues and the market for financial market data. These innovations form the most important part of the revolution to come.

No member states had best execution provisions in place ex ante. 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 criteria and that they review it annually, but also that they have adapted their IT systems to ensure that orders are effectively executed. This may force firms to outsource certain activities, as they would not be able to provide best execution in house. MiFID is in this sense not only a burden for smaller firms, but also a threat for large integrated financial services groups. In what is still one of the best impact analyses of MiFID, a study by JP Morgan expects that €19 billion (!) could be wiped off the market capitalisation of eight leading European wholesale banks as a result of MiFID because of increased competition (lower profits) and the costs of implementing the detailed client suitability arrangements, higher transparency and strict best-execution requirements. The loss of captive private banking volumes (i.e. private banking trades which are executed on the investment bank's internal platform) is expected to lead to a 20% decline in margins.

Best execution will not be limited to investment firms. It will permeate through the whole intermediation chain in financial markets. Although best execution as a general principle does not apply to eligible counterparties, such as institutional investors, Art. 24.2 sets forth a prominent derogation. By virtue of this derogation the entities classified as eligible counterparties are always entitled to request to be treated as clients whose business with the investment firm is subject to the best execution and client order handling provisions, meaning that the higher investor protection granted to retail and professional clients will apply. Hence, whenever the final beneficiary of the services provided by an eligible counterparty (i.e. an institutional investor according to the pre-MIFID regime) is a retail client, which it mostly is, the institutional investor itself will see it as his duty to demand best execution to be delivered by his market counterparties, and all this entails for these firms in increased transparency, detailed and unbundled cost statements to clients. Those who think that UCITS (investment funds) would escape from MiFID's reach are mistaken, as also EU Finance Ministers were alerted to possible regulatory arbitrage. In their May 2007 meeting, the EU Council of Ministers stressed that MiFID conduct-of-business rules apply to UCITS and that both directives should be implemented in a coherent way.

The impact of MiFID on exchanges has been more widely discussed, although the extent to which exchanges will be challenged by new platforms, such as Turquoise, is still an open question. The reaction of bourses to MiFID is apparent in some large restructurings in the sector, such as NYSE-Euronext, Nasdaq-OMX and LSE-Borsa Italiana. An exchange can survive MiFID in one of two ways: horizontally, by e.g. extending its critical mass in equity trading, as Euronext has done, or by strengthening its vertical integration, meaning controlling the whole back office chain, as several continental European exchanges have done, and now also LSE has recognised in the take-over of Borsa Italiana. Of the large European exchanges, LSE is probably the most exposed to the effects of MiFID, as it is dependent for close to 80% of its income on equity trading and the related market data, areas that are opened-up for competition under the new directive. In addition, LSE has the most liquid shared amongst the European exchanges, possessing one-quarter of the 894 liquid shares, according to CESR, on which trading may be internalised by European banks following the rules set in MiFID's art. 27, or which may be the most interesting chips to attract trading by competing trading platforms. The same applies to the data generated from these trades, in which Boat or others may be interested.

Whether Turquoise and others will pose a real threat to exchanges depends on the degree to which they manage to attract trades, and thus obtain a critical mass of trading in certain stocks. The broad definition of best execution in MiFID, taking into account a series of criteria, may

benefit these ventures, although the retail-isation of the interpretation of this concept may be a problem, reducing it to price and cost of the transactions. In addition, investment banks behind the initiative should be prepared for legal action from the exchanges on concerted practices, and from institutional investors whose portfolios they manage on conflicts of interest. We would maintain that it will be difficult to challenge the position of the incumbent exchanges, for systemic internalisers as well as for alternative platforms. The potential for internalisation will be limited, as the benefits will hardly outweigh the costs, as the JP Morgan study highlighted. For bank-driven MTFs, governance issues may be the most difficult to overcome.

Nevertheless, exchanges will need to be extremely vigilant in the coming months, and adapt their heterogeneous business structure to the imperatives of MiFID. They will first of all need to watch the pricing of trading and prepare for a loss of revenue in market data to specialised intermediaries, be alert to opportunities in services and IT, and restructure some of their business along European and sectoral rather than national lines. In the fields of market data, the development of specialised markets for small caps or high tech stocks, bonds and funds, opportunities exist to link up with other exchanges or to develop new markets.

Hence, MiFID is both a threat and an opportunity, a threat to lagging member states, to the incumbent exchanges, small financial institutions and large integrated groups, but also an opportunity to rethink the business structure and position oneself ahead of the competition, by developing new business lines. MiFID is also an opportunity for new entrants to compete in markets that were not (really) open before, such as market making and selling equity market data, and for niche players and systems developers to provide services to large integrated financial institutions. MiFID finally will be a big step forward for users, not only retail investors, but also institutional investors in the sense of better services, better prices and more transparency.

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