

{Getting to Grips with MIFID}

{INTRO BY HOST}

It has been described as the most far-reaching reform of any major financial market ever undertaken. MiFID – the Markets in Financial Instruments Directive – is a critical component of the European Commission’s Financial Services Action Plan. But what lies behind the Directive, and how will it affect asset managers and their clients? Penelope Biggs, who leads worldwide business development for Northern Trust’s Corporate & Institutional Services division, examines the scope, costs and opportunities that MiFID may bring the European financial services industry.

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When the European Commission announced final adoption of MiFID by the European Union’s Council of Ministers in 2004, there was no disguising an almost palpable sense of relief. The erstwhile Internal Market Commissioner, Frits Bolkestein commented that “All of us have worked hard on this Directive, as on others, to overcome differences of view.” He continued by saying “It has sometimes been a hard road. Everyone has had to give ground for the greater good – and make no mistake, agreement on this measure will ultimately benefit all Member States by allowing reputable investment firms to work anywhere in the EU with a minimum of red tape while bolstering our defenses against dodgy operators.”

In fact, the Directive goes much further than merely offering protection against dodgy operators. MiFID will fundamentally change the way in which European securities markets operate. Most notable of these changes is allowing investment firms, banks and exchanges to provide their services across borders on the basis of their home country authorisation (*passporting*). In addition, it will allow banks and other investment firms to compete more directly with stock exchanges. These changes will bring about the end of the concentration rules that were enshrined in the Investment Services Directive, which MiFID will replace.

With these additional freedoms come inevitable responsibilities. For example, MiFID will impose more stringent reporting requirements, at both a pre-trade and post-trade level. MiFID will also require more formalised processes of client categorisation, as well as regularly updated policies on order execution.

Let's look at some of the highlights of MiFID

The European Commission says that MiFID will benefit investors, issuers and market participants by promoting efficient and competitive markets.

Amongst its many features, there are 5 key highlights of the Directive.

First, it will lead to further harmonisation, of national rules on the provision of investment services and the operation of exchanges, with the ultimate aim of creating a single European securities rule book.

Second, it will enhance investor protection, setting minimum standards for the mandate and the powers national regulators must have at their disposal, and establish effective mechanisms for real-time cooperation in investigating and pursuing breaches of the Directive.

Third, MiFID establishes the principle of a pre-trade transparency obligation whereby *internalisers* – meaning firms trading outside regulated markets – will be obliged to disclose the prices at which they will be willing to buy from and/or sell to their clients for transactions up to *standard market size*.

Fourth, it includes a set of protective measures for internalisers for when they are obliged to quote, so that they can provide this essential services to their customers without incurring undesirable risks.

Finally, MiFID will deliver a fair marketplace for retail investors, preventing financial institutions from discriminating between small investors. For example, by offering some of them undisclosed improvements to publicly quoted prices (*price improvement*).

So, let's look at the SCOPE of MiFID

There is still some confusion about the scope of the Directive, and which firms will be directly affected. Originally seen as a set of regulatory measures aimed at exchanges, investment banks and broker/dealers – the sell-side – it is now becoming clear that many asset managers will also need to implement changes to comply with MiFID. *But*, according to Octavio Marenzi of research and consulting firm Celent, the buy-side is not yet fully engaged. He states “Some asset managers do not think that they are investment firms. There is a level of complacency on the buy-side.”

Undoubtedly there is an element of “wait-and-see” about the buy-side’s approach to MiFID. In part, this may be explained by a belief that asset

managers do not fall under the definition of “investment firms,” but Mr. Marenzi says that this is *incorrect*. He states “Firms that regularly undertake portfolio management, or simply offer investment advice, are covered by the definition and are therefore subject to the Directive”.

Industry research suggests that, as yet, MiFID has not reached the top of the priority list for many asset managers. For example, in November 2005, Investit, a UK fund management consultancy, published research showing that a number of leading investment management firms did not consider MiFID to be a top three operational concern for 2006.

But industry specialists are urging the buy-side to become more engaged in the planning process. Simon Bennett, a managing principal at Capco, the financial services consultancy, says that managers need to start thinking about the different types of challenges they will face when MiFID takes effect. He states “The buy-side is looking at a range of issues, related to compliance, awareness and business development”.

Bennett points out that processes and procedures will need to change. He says “Asset managers will be required to implement new daily pre-trade and post-trade reporting routines, as well as incorporating much more client-related data on trade confirmations.” He continues “They will also have to introduce formal processes for reviewing the order execution policies of each of their trading counterparties, including a breakdown of charges. Price discovery will be a major challenge, as one of the unintended consequences of MiFID will be to fragment liquidity, potentially leading to higher costs”.

But, let’s look at the COSTS associated with MiFID.

The cost of MiFID is a key issue for all market participants. Research carried out last year by Liquidnet Europe amongst its members – which are all buy-side firms – demonstrated the level of skepticism about the cost/benefit ratio of MiFID. More than half of the respondents said that, in their opinion, MiFID would create high cost and provide little benefit. Almost half the respondents said their firm does not plan to spend any money to meet the MiFID requirements. In response to whether traders thought that MiFID will be an improvement or a detriment to the buy-side, 39 percent said it would be an improvement, 33 percent said it would be a detriment and 28 percent said they believed there would be no change.

With some estimates of the total implementation cost to the industry as high as 1 billion Euro, there are concerns that the European Commission has not delivered a fully cost-justified Directive. These doubts have not only been expressed by financial institutions. National regulators have also questioned the long-term benefits of the Directive. In a speech in 2005, the chairman of the UK's Financial Services Authority, Sir Callum McCarthy, voiced his misgivings about MiFID. McCarthy said "An example of concern for many firms currently is MiFID. It is deeply unsatisfactory that UK financial services firms face major changes, with the associated costs, for an initiative which has been subject to no comprehensive EU cost-benefit analysis to assess the specific contribution it might make to unlocking the prize of a more integrated European capital market. That kind of approach to policy-making cannot be sensible".

Sir Callum added that investment firms operating in the UK face a heavy bill for the new Directive. He stated "It is already clear that the MiFID changes will impose significant costs on the UK market, including for example, through systems changes and IT upgrades. Industry is understandably concerned about the potential scale of these costs – and I share those worries. It is far from clear that the benefits to the UK will outweigh the costs".

Finally, I will review the OPPORTUNITIES MiFID presents us.

Although the current Internal Market Commissioner, Charlie McCreevy, has subsequently committed to introduce a much more rigorous cost-benefit analysis on new proposals, there is no escape clause from MiFID. Whilst the lion's share of the work will fall to the sell-side, asset managers are by no means exempt from ensuring compliance. But Capco's Simon Bennett says that it is not all about additional compliance, data management and reporting procedures. Bennett states "The passporting aspect of MiFID could offer significant business development opportunities to asset managers. It could open up new distribution channels and reduce the pain and cost of doing cross-border business in Europe".

Steve Potter, head of the International Group for Northern Trust, says that following further recent communication by the European Commission, it appears that the time has come for action. Steve says "With all the delays and an occasional lack of clarity, it is understandable that some asset management firms have taken a slightly sceptical approach to MiFID. But it

is going to happen, and managers and the buy side in general need to be prepared for what we consider to be a significant market reform”.

Without doubt, implementing MiFID is going to cost the securities industry a lot of money – by some estimates, as much as 1 billion Euro – as well as taking up valuable technology and business resources. But the pay-off could be even more substantial, as cross-border markets are opened up and retail investors take *advantage* of the new freedoms and protections to broaden their investment horizons. With a well-planned resource allocation and implementation process, asset managers could stand to gain substantially from the opportunities that MiFID offers.

{EXIT BY HOST}

Thank you Penelope. For more information on MiFID and to read the full white paper on this subject please visit Northerntrust.com/europe.

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