Chapter 1

Introduction[1]

Matthew Elderfield
Head of Department
Major Retail Firms Division
Financial Services Authority
and
Chief Executive Officer designate
Bermuda Monetary Authority

1.1 Background

1.1.1 *The Lisbon Agenda and the Financial Services Action Plan*

When EU leaders met in Lisbon for a special meeting on 23–24 March 2000, they had an ambitious agenda. Keen to capitalise on the recent creation of the euro, to push ahead with the single market and to address flagging competitiveness, a consensus had emerged over the need for a renewed European economic programme. The goal was no less than creating "the most dynamic and competitive knowledge-based economy in the world by 2010". This would be achieved through a series of measures addressing employment, innovation, enterprise, liberalisation and the environment. The Lisbon Agenda was born.

The summit considered a range of measures that had been prepared by the Commission and Member States. Amongst these was a proposal concerning the EU's financial markets: completing the single market in financial services was considered essential to the success of the Lisbon Agenda and improving EU competitiveness. Member States therefore made a firm commitment to implement a programme proposed by the Commission. They set themselves an

[1] This chapter has been written by the author in his personal capacity and does not necessarily represent the views of, and has not in any way been endorsed by, the Financial Services Authority.

ambitious goal: adoption by 2005. Some of the principal elements of the plan were briefly noted at the summit, but amending the Investment Services Directive ("ISD") or creating a Markets in Financial Instruments Directive ("MiFID") did not explicitly receive a mention. Nevertheless, the overall plan had received strong endorsement at the most senior levels of the European Union.

The Financial Services Action Plan ("FSAP") adopted at Lisbon had been developed earlier by the European Commission following consultation with industry experts and finance ministries. On 11 May 1999 the Commission had published a critical document, "Implementing the Framework for Financial Services: Action Plan". This ambitious programme included a host of recommendations to revise existing EU financial services legislation or to develop new directives. The plan also included a cautious comment about the need to "upgrade" the existing Investment Services Directive. There had been a lack of consensus amongst industry and government officials as to whether this key EU directive actually required full-scale revision or whether it might be possible to either make modest amendments or reach consensus between Member States as to how to implement the existing text. As a result, the relatively low-key commitment to "upgrade" the ISD was included in the FSAP.

From this small seed, the Markets in Financial Instruments Directive was born. Over the following years, the commitment to the FSAP at Lisbon gave the programme an unstoppable momentum. In the meantime, the reference to "upgrading" the ISD gradually evolved into a commitment to amend the existing directive and then fundamentally re-write it. "Upgrading the ISD", became "amending the ISD" to "ISD II" and eventually emerged as MiFID.

1.1.2 The Lamfalussy process

MiFID was not only born out of the FSAP. The Directive was one of the first pieces of legislation to be adopted under the so-called Lamfalussy process. In parallel to the adoption of the FSAP, Member States had struggled with how to streamline financial legislative processes in Europe and improve supervisory cooperation. Baron Alexandre Lamfalussy, the former president of the European Monetary Institute (the predecessor to the European Central Bank), was appointed to head a committee of "wise men" to study these concerns and proposed a new system of decision making and cooperation.

The Lamfalussy approach envisaged a four-level process. At level one, the European Council and Parliament would adopt "framework legislation" based on proposals from the European Commission. These measures would, in theory, be high-level flexible provisions that would not require constant revision. At level 2 would sit "implementing measures", more detailed directives or regulations adopted through fast-track legislative procedures known in EU jargon as comitology. Approval of these measures would be by a committee of Member States chaired by the Commission rather than the full legislative process. At level three, committees of supervisory authorities would work in close cooperation to develop convergence of supervisory practice. These level three committees would also be consulted by the Commission in the preparation of level 2 implementing measures. In the securities field, the level three committee formed was the Committee of European Securities Regulators ("CESR"). Finally, at level four would be enforcement of these various EU measures.

MiFID was developed under this new Lamfalussy procedure. From 2001 to 2004 MiFID progressed through the level 1 Lamfalussy process. Following difficult and sometimes controversial negotiations (*see* 1.2 below), MiFID was adopted as a level 1 directive on 30 April 2004. (Publication was rushed out on this date, the day before the accession of the new East and Central European Member States. If publication had been a day later, MiFID would have had to be translated into the languages of all the new members and the EU authorities were keen to avoid this cost.) The subsequent level 2 process, equally difficult and challenging, was completed on 2 September 2006 with the publication of the Implementing directive and regulations. National transposition of the directive was required by Member States by 31 January 2007, with the level 1 and 2 measures coming into force on 1 November 2007.

This Guide provides details about the level 1 and 2 provisions of MiFID. It is designed to provide an overview of the key provisions of MiFID to help practitioners in the financial services industry navigate these complex and interlocking pieces of legislation. From its humble origins in the FSAP and the Lisbon summit, MiFID has emerged as perhaps the most important piece of legislation in the action plan and certainly the most controversial. The compliance costs of MiFID are very significant for firms caught within its scope and the benefits are uncertain and debatable. This Guide is designed to set out clearly and concisely the key provisions of MiFID to help firms understand, comply with and perhaps benefit from MiFID. A table describing the key pieces of legislation referred to throughout the text may be found at page xv.

The Guide has been prepared by a range of leading regulators, lawyers and industry practitioners who have followed MiFID's development closely. In many cases, the authors were intimately involved with the negotiation of MiFID level 1 or level 2 texts from the government or industry. While the views represented here are of the authors in a personal capacity, they are clearly informed by their close involvement with the formative stages of MiFID as it evolved out of the old Investment Services Directive. Section 1.2 below describes the origins of MiFID in the ISD.

1.2 The Investment Services Directive and the MiFID level 1 negotiations

MiFID replaces its predecessor directive the Investment Services Directive,[2] and the key issues tackled in MiFID can be traced back to that directive. The ISD was one of a raft of financial services directives adopted as part of an early 1990s initiative to develop the EU single market. At the time, it too was marked by controversy and had a difficult passage of negotiation between Member States.

1.2.1 ISD passporting provisions

The ISD was one of a number of "passporting" directives designed to promote cross-border business in the single market. The ISD concerned firms conducting business in a specified list of financial

[2] The ISD was adopted in 1993 and came into force in 1996.

services principally related to securities business. Banking business, for example, had its own passporting directive. Those firms subject to the scope of the ISD were granted the right to undertake business in any of the EU Member States, the so-called "passport," but need only be authorised by their home Member State.[3]

The fact that firms need only be authorised once by their home state but could operate across the EU in various other jurisdictions (host states) was considered to be a significant liberalising step. However, the benefits of MiFID were muted from the start. This was because host Member States were still permitted to apply local conduct of business rules on operations in their jurisdictions, provisions which were extensively applied. The single home authorisation had limited benefit if a firm had to adopt all local host conduct of business rules. These rules could impose a significant burden on doing cross-border business, requiring firms to maintain compliance with a patchwork of local standards. In some cases, these local rules acted as covert barriers to cross-border activity and favoured the local financial services industry.

This weakness in the ISD was a source of concern to industry groups and to the Commission when it drew up the FSAP. Initially, it was hoped that a constructive interpretation of the ISD by the Commission might pave the way for Member States to disapply host rules, at least for wholesale counterparties, but this effort had little support from Member States. As a result, there was a growing sentiment that MiFID needed to be amended to eliminate the right of host country Member States to apply conduct of business rules.

1.2.2 ISD and MiFID conduct of business standards

In the discussions that preceded the formal introduction of an amendment to the ISD, however, it became clear that most Member States were unwilling to accept an end to host conduct of business rules unless these were replaced by stronger common EU standards. The quid pro quo for an effective passport would be conduct of business rules at an EU level, set out in the revised ISD. CESR had in fact been

[3] The passporting and scope arrangements of MiFID, which have their origins in these ISD provisions, are discussed in Chapter 2.

working on supervisory standards in the area of conduct of business and the Commission looked to this work as a basis for its proposals. High-level conduct of business standards would be enshrined in a revised ISD, with the detail promulgated in level 2 provisions based on advice from CESR.

This is indeed the basic structure of MiFID: a reinforced right of passporting is set out which restricts the ability of host countries to impose conduct of business rules, but in exchange a framework of common EU conduct of business standards are prescribed in the level 1 and 2 texts.[4]

While there was early, broad consensus on this overall framework amongst industry and Member States, from the outset there were strong differences on much of the detail. Local conduct of business standards of each Member State reflected the evolution of those local markets based on years of accumulated practice. Developing a common framework therefore proved difficult. Fundamental differences in philosophy had to be reconciled in the negotiations. Some Member States took a more prescriptive approach to the protection of retail consumers, favouring product regulation and limits on the ability of some services to be provided unless a full array of regulation was provided. Other countries sought to preserve room for caveat emptor and for non-advised sales based on clear disclosure of risks. For example, during the negotiations there were difficult discussions over the concept of execution-only services. This led to tortuously negotiated wording in this part of MiFID.

Differences existed in other areas, such as how to differentiate between retail and wholesale counterparties, in particular with respect to the treatment of corporate counterparties. The overall framework for best execution was also heavily contested. These issues were gradually resolved through compromise in the negotiations between 2000 and 2004. As a rule of thumb, where the level 1 test is particularly complicated and detailed, it reflects an area of deep policy disagreement that needed to be resolved by developing a long compromise text.

---

[4] The MiFID organisational and conduct of business standards are discussed in Chapters 3, 4, 5, 6 and 7.

1.2.3 ISD and MiFID market standards

The ISD also had important provisions governing the operation of stock and derivatives exchanges, known as regulated markets. The ISD provided similar passport rights allowing cross-border services, in the form of accepting membership of firms from different Member States to trade on the market in question.

The ISD set out certain minimum standards for the operation of regulated markets, most controversially in the area of transparency. Transparency has many meanings in financial regulation but in this context transparency refers to the publication of information about trades conducted on a regulated market. By publishing information on the price and size of trades, information asymmetries between market participants are eliminated or at least reduced. This assists the price formation process and tends to reduce bid-offer spreads, leading to more efficient allocation of capital.

In a forerunner of MiFID discussions, the ISD negotiations were bogged down for some time on the appropriate post-trade transparency requirements for regulated markets. Here too, a clash of different market traditions was the cause of problems. Member States with a tradition of exchanges operating central order books (where all buying and selling interests are combined in a central automated market) were more comfortable with levels of high post-trade transparency. However, in the UK the market-making system (whereby individual firms compete against each other by setting quotes and providing liquidity) depended on a degree of opacity, or at least delay in publication, so that market makers had sufficient time to lay off orders. In the end a compromise position was reached that proved to have little impact. And in the meantime, the UK market evolved into a hybrid system offering a central order book and market-making system side by side. The scene was set for more explosive discussions on transparency when the issue was reopened in MiFID.

The trigger for demands for tougher transparency provisions in MiFID arose because of plans to dismantle an existing provision in the ISD, the so-called "concentration rule". This was an optional provision, but it was used by many Member States. It essentially allowed Member States to require that all share dealing in their country, ostensibly only for retail orders, had to be conducted on the regulated market and could not be negotiated bilaterally between firms. The theory behind this was that by concentrating as much buying and selling activity as possible on-exchange, the enhanced liquidity improved the price formation process.

However, the concentration rule was deeply unpopular, principally amongst investment banks, and was widely viewed as anti-competitive. Investment banks pointed to the UK as having efficient price formation without concentrated trading and argued that ending the rule would allow greater competition between different mechanisms for trading, providing greater choice and lower costs for investors.

This difference of view formed another of the major sources of controversy in MiFID negotiations. The Commission's proposal for a directive clearly eliminated the concentration rule. Member States favouring the rule accepted that it was time to go, but demanded a quid pro quo: enhanced transparency. In this case, improved post-trade transparency would not be enough, but pre-trade transparency would be required for investment firms that competed with exchanges. The argument was that information about bids and offers should be published, not just about completed trades, to protect against market fragmentation. Market fragmentation versus market competition were the respective rallying cries. At the eleventh hour, as the Commission's proposed directive was sent to Member States to start negotiation, a pre-trade transparency clause was added: the systematic internaliser provision. The provision proved highly controversial and was subject to negotiation right to the end of MiFID. But in the end a form of pre-trade transparency remained as the price for ending the concentration rule.[5]

1.3 The level 2 MiFID negotiations

The level 1 text that was finally adopted in 2004 was the result of long and difficult negotiations. However, the framework directive

[5] The MiFID transparency standards, including those for systematic internalisers, are discussed in Chapter 8. The Directive's related provisions for regulated markets and multilateral trading facilities are described in Chapter 9.

remained to be supplemented with the relevant level 2 provisions. The Commission invited CESR to provide advice on a range of level 2 provisions. In some cases the level 1 text had expressly made provision for level 2 material. In other cases the Commission sought clarification of aspects of the Directive of its own accord.

As envisaged by the Lamfalussy process, the level 2 negotiations added a layer of further detail and clarification to the framework directive. These discussions proved equally difficult. Areas of ambiguity in the level 1 text which had been papered over for the sake of agreement, now needed to be explored again in further detail and made operational. The specific scope of the systematic internaliser pre-trade transparency provisions needed to be agreed. On the conduct of business side, the high-level framework standards needed to be elaborated in detail. Sensitivities arose, for example, as to the extent to which the provisions could be flexible so they could be adapted to different sizes and types of business. The calibration of the client classification rules were also subject to extensive negotiation at level 2, and the resolution of the scope of the over-the-counter ("OTC") commodity derivatives provisions were effectively resolved at level 2, rather than in the primary legislation.[6]

A number of overriding issues started to emerge during the level 2 process which were a source of concern especially to industry representatives. Principal amongst these was the length and detail of the level 2 provisions. Concerns mounted that the level 2 measures were too extensive and too prescriptive in nature. This was perhaps inherent in the Lamfalussy process and also due to the nature of the negotiations, as Member States remained keen to ensure that key aspects of their domestic conduct of business rules were reflected in the level 2 provisions. Again, where an issue proved controversial this tended to lead to lengthier requirements. In some cases the industry itself would argue for more detail to avoid ambiguity or address a perceived flaw in a provision. The result is indeed a very lengthy and detailed level 2 text.

As the level 2 discussions progressed, focus turned to the legal form of the eventual provisions. After much debate it was decided that the

[6] The Directive's commodity derivatives provisions are discussed in Chapter 10.

level 2 measures would take two forms. First, some of the level 2 measures would be promulgated by way of a regulation. These are provisions which have direct effect in Member States and do not need to be transposed into national law. A second set of measures would be provided by way of a directive (confusingly directives can exist at level 1 or level 2); in this case national implementing measures are required to give effect to the standards. MiFID was the first major piece of EU financial services legislation to make extensive use of regulations. The use of this instrument meant that Member States and industry representatives had a much stronger incentive to make sure that the text of the regulation was exactly as they wanted it and contained all relevant provisions, as it would have direct effect on firms and consumers and could not be amended in national law.

The debate on the relative merits of level 2 directives or regulations was caught up in a second issue: whether MiFID was a "maximum harmonisation" directive and therefore whether Member States were permitted to impose additional, so-called "superequivalent" rules. Broadly speaking, under a maximum harmonisation provision in EU law, Member States are prohibited from setting any additional standards or rules in the particular area. In other words, the EU law alone sets relevant standards. The aim of such a provision is to prevent Member States from adopting additional onerous requirements which might undermine the aim of the legislation and create barriers to cross-border activity.

In the case of MiFID, some provisions are on a maximum harmonisation basis and some are not. This depends on the exact wording of the provision in the level 1 or level 2 text. For example, the powers provided for competent authorities in article 50 are clearly minimum harmonisation provisions, as supervisors have greater powers provided by national legislation and other directives. In contrast, the article 24 standards on eligible counterparties are maximum harmonisation provisions, with Member States prohibited from imposing additional requirements.

During the level 2 discussions, there was concern amongst many Member States that the Commission, which authors the level 2 material, would prescribe maximum harmonisation too widely. National supervisors wanted to have some scope to preserve local rules in addition to those set out in MiFID. However, the Commission, supported by some in industry, wanted to limit the scope for such additional standards. The final level 2 provisions reflect the various compromises that were wrung out for each individual area.

Eventually, the Implementing directive takes a broadly maximum harmonisation approach underpinned by article 4. This article requires Member States to fully justify adoption of any superequivalent standards. Any such national rules must be objectively justified and proportionate, and be designed to address investor protection or market integrity risks not adequately addressed by MiFID. Such risks must be of particular importance to that country or have arisen after MiFID was implemented. As the national implementation process was still underway at the time of writing, it was unclear the extent to which Member States would attempt to make use of this provision – and whether they might be subject to challenge by parties who feel that superequivalent standards are not justified. Thus, the impact of this provision will be felt in national implementing legislation and is therefore properly outside the scope of this Guide. However, this is an important element of background to MiFID and helps to explain the way that the level 2 measures evolved. This was, for instance, another driving force for more detail. As some Member States became concerned that their scope for additional local rules was being cut off, it created an incentive to ensure that any issues of concern were covered explicitly in the level 2 text.

1.4 A Practitioners Guide to MiFID: an overview

1.4.1 Scope, authorisation and passporting rights

The foundation of MiFID is formed by those provisions which describe the scope of the Directive: those activities, instruments and therefore firms that are bound by MiFID. These measures, along with the provisions setting out passporting rights, are described in Chapter 2 of this Guide. Chapter 2 discusses the fundamental question: what is an investment firm? It explains that a firm is caught within the scope of MiFID if it engages in one or more of a number of defined investment services and activities. Many of these continue forward from the existing ISD and are the principal activities of broker-dealers, such a reception and transmission of orders, execution of orders, dealing on own account, portfolio management and underwriting.

However, MiFID makes a number of important changes to the scope of the ISD, as Chapter 2 describes. For the first time, investment advice is included as a core activity within the Directive. Also, the activity of providing a multilateral trading facility is defined for the first time. In addition, commodity and non-financial derivatives are, in some circumstances, brought within scope. However, at the same time as the scope of the Directive is expanded, MiFID provides a number of complicated exemptions for certain types of firm structured in particular ways. The author of Chapter 2 carefully navigates through these provisions, and also helpfully explains how they interact with the UK's domestic financial services scoping legislation, the Regulated Activities Order ("RAO").

From authorisation as an investment firm, now redefined by MiFID, comes the benefit of passporting. Chapter 2 explains how the Directive's passporting standards provide freedom to conduct cross-border activity subject to home state rules. However, it also explores the more complicated passporting framework for branches, where the split between home and host states is less clear, as well as describing the procedures for passporting.

1.4.2 *Overview of organisational and conduct of business requirements*

MiFID can conceptually be split into two parts: those provisions concerning markets issues and those concerning organisational and conduct of business requirements for investment firms. Both are important, but the latter account for the bulk of the MiFID level 1 and 2 provisions. In this Guide, Chapters 8 and 9 describe the market provisions of MiFID, while Chapters 4, 5, 6 and 7 describe different aspects of the investment firm standards. Chapter 3 sets the scene for this latter set of provisions and provides an overview of the organisational and conduct of business requirements, including the client classification framework.

Chapter 3 starts by explaining how the MiFID conduct of business provisions are modified for different types of firm, such as thirdcountry investment firms, credit institutions and unit trust or investment management companies, as well as EU investment firms.

The chapter then sets out the client classification regime in MiFID. This determines which sorts of conduct of business standards, described in subsequent chapters, are applicable for different types of client. The basic concept of client, the distinction between retail and professional clients, the separate category of eligible counterparty and the circumstances under which clients may opt up or down between categories are all carefully explained. As noted above, these provisions proved sensitive in the level 2 negotiations and their complexity is viewed as one of the sources of implementation costs for firms, even in the UK where a similar regime already exists.

1.4.3 Organisational requirements

Chapter 4 describes MiFID's organisational requirements that apply to investment firms caught within the scope of the Directive. These are the core provisions concerning how a firm must run its business at all times rather than the conduct of business provisions which arise as and when services are provided to clients. The chapter describes the MiFID organisational requirements in a range of areas, starting with an analysis of the Directive's conflict of interest provisions.

MiFID accepts that firms will have conflicts of interest and that these cannot be eliminated. Rather, the approach is designed to identify and manage such conflicts. The chapter describes the Directive's standards in this area, the requirements for a conflicts policy and the related disclosure obligations to clients. In addition, there are specific provisions relating to conflict management with investment research (which had their origins in the regulatory concerns that surfaced in this area at the end of the dotcom bubble). The interaction of these standards with similar provisions in the Market Abuse Directive is helpfully explained.

MiFID also sets out high-level requirements for systems and controls in firms. These are elaborated in more detail for the compliance and risk management functions of investment firms, as explained in Chapter 4.

The Directive's outsourcing provisions are also described here: these clarify the obligations that remain with an investment firm when they outsource activities and place certain limits on the types of activities that can be outsourced to particular types of service providers.

MiFID's organisational requirements also govern safekeeping of client assets. In addition to high-level standards covering matters such as reconciliation and segregation, the Directive includes more detailed provisions governing depositing of client assets and the circumstances under which a firm may use such client assets itself (such as securities lending).

Finally, Chapter 4 also explains the Directive's record-keeping provisions.

1.4.4 Fair dealing with clients

Chapter 5 summarises various aspects of the MiFID provisions on fair dealing with clients. It starts with a discussion of the important and over-arching general duty to act honestly, fairly and professionally in accordance with the best interests of the client. As the author explains, it is important to be mindful that this general obligation applies in addition to the specific provisions of MiFID, so firms need to take account of this duty even when an individual provision may be disapplied. Each of the elements of the general duty are analysed, along with MiFID's related provisions on inducements. These explain that it is a prohibition of the general duty to accept any inducements unless these are covered under a relevant exemption, such as those provided for accepting fees.

The chapter also describes the different types of due diligence obligations owed to clients. The most extensive requirements apply to portfolio management or provision of a personal recommendation, when the requirement to make a suitability determination arises. For other services, only an appropriateness determination is required. As the author notes, despite the apparent similarity in terminology, appropriateness only requires the firm to determine that a client has the capacity to understand the product, while suitability goes further and also involves an assessment that the transaction meets the client's investment needs and that he or she can bear the financial risks of the transaction.

In addition, MiFID provides an exemption from appropriateness requirements for execution-only business. This is limited to the reception and transmission or execution of orders on behalf of clients but, as the chapter explains, only in non-complex instruments, where the service is initiated by the client and subject to other restrictions.

1.4.5 Best execution

MiFID makes important changes to existing best execution standards and aspects of the implementation are still subject to considerable debate. Chapter 6 analyses the best execution issues in MiFID by tracing the origins of the UK's best execution regime and explaining how it applies to different types of dealing: agency execution, riskless principal execution, own account best execution and own account counterparty execution.

Under article 21 of MiFID, when executing orders firms now have a general obligation to obtain the best possible result for their clients, taking into account a range of factors. The author explains the interpretation of this principle and discusses the stages that a firm should go through to develop an order execution policy, which is required by the Directive. The standards raise a number of implementation complications. For example, there are carefully balanced provisions concerning the application to OTC instruments. Consideration is also needed of the extent to which the best price should be the focus of execution as opposed to other factors, such as speed, likelihood of execution or market impact.

During the run up to implementation, considerable debate has taken place in particular concerning the scope of the best execution provisions. While it is clear that dealing with eligible counterparties means the requirement is disapplied, the position of own account dealers transacting with non-eligible counterparties has been uncertain. This provoked considerable concern amongst market participants worried about the impact on quote-driven markets. The author explains the different options for resolving these tensions in the Directive and the most recent Commission thinking on how to interpret MiFID in this sensitive area.

The chapter also helpfully analyses another complicated dimension of the best execution provisions, namely their application to portfolio managers. Traditionally an area of some uncertainty, the Directive helps clarify the application of these standards to the chain of order execution from client to manager to executing broker. The author helpfully analyses the various permutations of portfolio manager activity under the different MiFID services and explains how best execution arises.

Finally, Chapter 6 covers the relatively straightforward client order-handling provisions of the Directive, such as the general principles governing timeliness of execution and the rules covering aggregation of orders. However, MiFID's rules on client limit order handling are described in Chapter 8 as they relate more to the Directive's transparency rules.

1.4.6 Information requirements

MiFID's information requirements are extensive and pose a significant implementation challenge. Chapter 7 discusses the overall requirement that information must be fair, clear and not misleading, explaining the interpretation of each of these terms, as well the general standards for marketing information and the presentation of information, including information about investment performance.

The Directive also includes extensive provisions governing the content, form and timing of the various types of information that must be provided to clients. These vary in some circumstances depending on the type of service being provided (such as portfolio management or custody). These are explained here, including the interaction with the Distance Marketing Directive.

MiFID also has detailed information requirements in a number of other areas. Certain types of information must be provided prior to dealing. Standards are also set for the content of client agreements. Finally, there are various provisions concerning periodic reporting to clients. Chapter 7 carefully reviews all of these obligations.

1.4.7 Transparency and transaction reporting standards

Chapter 8 is the first in this Guide to cover the "markets" provisions of MiFID. The chapter discusses the transparency obligations for equity trading set out in the Directive, which apply in various circumstances to investment firms as well as regulated markets and MTFs. As the chapter explains, and as was discussed at 1.2.3 above, the provisions on transparency arose from the wider debate on market structure as the concentration rule ended, which led to the view that transparency requirements should apply to bilateral dealing by firms as well as transactions conducted on regulated markets and MTFs.

Chapter 8 starts by describing the post-trade transparency requirements of the Directive. The similar requirements for regulated market and MTF trading are summarised and then contrasted with the provisions for bilateral trading between investment firms. MiFID also makes important changes to the way in which such information is published – the Directive introduces competition into the market for the publication of transparency data, previously the exclusive domain of the exchanges. However, this competition raises questions of data quality and aggregation, as the chapter explains.

The MiFID pre-trade transparency provisions were the most controversial aspect of the level 1 negotiations and are described carefully in Chapter 8. The regulated market and MTF provisions are covered along with the complex rules for systematic internalisers. These latter provisions were designed to cover investment firms that were seen to be providing a trading service closely analogous to that of regulated markets and MTFs. The definition of systematic internaliser is analysed alongside a description of the various transparency obligations that arise for different types of shares in different circumstances. Closely related to these requirements are the Directive provisions for limit order handling, which are also covered in the chapter.

The Directive also imposes transaction reporting obligations on investment firms. This relates to the provision of information about the details of trading to regulatory authorities, in order to help them fight financial crime including market abuse. This information is more extensive than that published to the market and includes confidential details such as counterparty information. The chapter explains the particular types of information that must be transmitted and explains that the requirements apply more broadly than equity instruments. The Directive has complicated rules determining which competent authority should receive information about which particular security. This has imposed considerable systems demands on firms. The chapter explains these provisions and discusses the obligations on Member State authorities to share information.

1.4.8 Regulated markets and MTFs

While the ISD introduced the concept of a regulated market in EU law, MiFID includes much more extensive provisions concerning "exchanges". MiFID also includes a parallel regime for investment firms that provide similar exchange-like services, otherwise known as multilateral trading facilities. This approach was designed to avoid the risk of market fragmentation and create a level playing field between different types of trading facility. Chapter 9 describes the various requirements applicable for both regulated markets and MTFs, starting with a discussion of their similar definitions. This highlights that the scope of the definitions covers trading under the rules of these entities, as well as trading directly through their technical systems. This important provision permits current market structures to continue.

The chapter provides an analysis of the full range of authorisation and organisational requirements that apply to regulated markets and MTFs. The minimum standards for authorisation are discussed as well as the regime concerning persons seeking to exercise significant influence over a regulated market. Then the organisational standards are discussed in turn. These include standards relating to conflicts of interest, risk management, business continuity, rules and procedures for members, and finality of settlement. Regulated markets and MTFs must also have the capacity to effectively monitor trading activity on their facilities.

As Chapter 9 explains, the key difference between regulated markets and MTFs arises in the requirements concerning admission to trading. When a security is admitted to trading on a regulated market, this triggers a range of obligations under the Prospectus Directive, Market Abuse Directive and Transparency Obligations Directive. In contrast, admission to trading on an MTF is not subject to such standards. However, regulated markets are permitted to operate MTFs, which allows exchanges to provide market segments which are not subject to the full weight of EU standards (such as AIM in the case of the London Stock Exchange). MiFID itself applies various additional admissions to trading requirements, which also extend to non-equities, but Member States are permitted to impose superequivalent standards, thus preserving the more stringent UK listing regime.

Chapter 9 also explains how passporting works in the context of regulated markets by providing a right to offer access to facilities to members from across the EU provided certain conditions are met. The Directive also makes some tentative steps designed to encourage greater choice in clearing and settlement facilities for users of regulated markets. However, the chapter explains why these are largely theoretical and that a separate debate is underway on this issue in Brussels.

1.4.9 Commodity derivatives

Chapter 10 is a specialist discussion of the various MiFID provisions of most relevance to commodity derivative market participants and infrastructure providers. The chapter is provided due to the significant impact that the Directive imposes on these particular markets, previously outside the scope of the ISD. While some of the provisions are discussed elsewhere (most notably in Chapter 2 on scope), Chapter 10 is a useful starting point for readers who wish to review the impact of the Directive on these markets as a whole before exploring the detailed provisions in other chapters.

MiFID attempted to carefully scope the inclusion of commodity derivatives in order to focus the provisions on wholesale and professional firms and to take account of the particular corporate structure of typical commodity derivative participants. As the chapter explains, this is tackled by balancing a very broad definition of commodity derivative with a range of exemptions. The chapter explores the various aspects of the broad definition, including the difficult issues relating to physical settlement, and then explains how the definition is carved back with the various group, ancillary service and other exemptions that apply, each of which are analysed in turn.

The chapter also explores how this new regime sits alongside the existing scope of UK financial services regulation. The interaction with the UK Regulated Activities Order is discussed, showing that there may be circumstances where UK authorisation is required even if MiFID does not apply.

Finally, the chapter provides an overview of the provisions of MiFID which may have most bearing for commodity derivative market participants. The application of the counterparty classification and best execution regimes is highlighted as being of most importance and this is discussed, focusing on the particular challenges for the commodity derivative markets. (As noted above, these requirements are also reviewed in more detail in Chapters 3 and 6.)

MiFID also brings with it obligations under the Capital Requirements Directive, which has proven controversial for the commodity derivative markets. As Chapter 10 explains more generally, while MiFID brings opportunities to market participants by way of passporting, it also brings costs and challenges. As the authors note, firms are likely to want to explore their particular corporate structure in light of MiFID's definitions and exemptions in order to decide whether they wish to operate under the Directive.

1.5 Preparing for MiFID

The summary in 1.4 above and the more comprehensive analysis in the rest of the Guide highlight the complexity of MiFID and the scale of change required by firms. The chapters that follow discuss the standards in greater detail and provide valuable insights into how to prepare for the introduction of MiFID and for ongoing compliance with the level 1 and 2 requirements.

For a financial firm, preparing for the introduction of MiFID is a daunting prospect. In addition to the analysis in this Guide, there are various sources of assistance that can help navigate the material and highlight the key business areas and functions that are affected by MiFID. The UK Financial Service Authority has published a useful guide, "Planning for MiFID", on its website (www.fsa.gov.uk) which outlines the issues that firms should be thinking through as part of their implementation work. The FSA webpages also include a host of other useful material on MiFID (and the FSAP and Lamfalussy process) including links to key documents. An industry initiative, "MiFID Connect" (www.mifidconnect.com) provides similarly useful resources that helpfully supplement the material in this Guide.

Firms can expect supervisory authorities to take a keen interest in their work implementing MiFID. The rest of this section provides insight into how authorities may approach their review of MiFID compliance, at least from this author's perspective as a UK financial supervisor.

Typically for most organisations, supervisors would look to see evidence of a clearly organised implementation project, with strong governance and a well-articulated project plan. In order to ensure support from staff and adequate resources, it is important that business functions provide sponsorship and are involved in the implementation process, and compliance officers are not viewed as solely responsible for MiFID.

As a starting point, supervisory authorities will expect firms to have conducted a close analysis of the scope of MiFID and to have assessed which legal entities and types of business will be impacted by the Directive. This analysis may provide some opportunities for firms to reorganise or alter their activities in order to move within or without the scope of the legislation.

Determining whether a firm is within the scope of MiFID is not only relevant for the application of the Directive itself. MiFID is part of an interconnected corpus of EU directives: MiFID-scope firms or regulated markets may find themselves subject to the requirements of other directives. Most obvious of these is the obligation to apply the provisions of the Capital Requirements Directive.

Following this review of scope, firms will normally then conduct a gap analysis between their current compliance arrangements and the requirements of MiFID. This requires a close study of the provisions of the level 1 and 2 text, which this Guide will assist, as well as reviewing national implementing legislation. As evident from the above summary, there are a number of key areas that such a gap analysis would be expected to cover:

(a) appropriateness and execution-only procedures;
(b) best execution policies and procedures;
(c) client classification arrangements;
(d) client order handling arrangements;
(e) conflict of interest policies and procedures;
(f) compliance organisation and structure;
(g) disclosure requirements;
(h) marketing and financial promotion arrangements;
(i) suitability requirements;
(j) systems and controls;
(k) transaction reporting.

For firms active in equities trading, post-trade transparency standards need also be considered and, for systematic internalisers, pre-trade transparency requirements.

This is a high-level list only and is not designed to be comprehensive. The detail of MiFID will present particular challenges for different types of firms.

Against this framework, supervisors would typically expect to see a clear project plan to address any gaps with compliance in a timely manner. Despite the fact that the implementation date of MiFID was delayed until 1 November 2007, there is a degree of acceptance of the major implementation burden faced by firms and that it may prove impossible to address all of the standards in time. In this context, comfort may be provided by firms taking a risk-based approach. Are the key areas of compliance which pose greatest risk of consumer detriment being addressed first? More generally, is progress being tracked carefully, with the status of efforts highlighted on, say, a red-amber-green basis? Are delays escalated to senior management and additional resource made available if necessary?

While the focus on 1 November 2007 is important, it is sensible to take a wider perspective. Many best-practice firms undertake post-implementation reviews at some stage after their projects are complete, or conduct internal audit analyses of implementation work. Supervisors that take a pragmatic view of the implementation date may well undertake their own firm-specific or cross-industry reviews of compliance some months later, after the dust has settled. When supervisors find at this stage that firms have not made sufficient progress with implementation despite the flexibility shown with the implementation timetable, then a more robust response is possible. Finally, MiFID presents ongoing compliance challenges and supervisors will look to see that appropriate systems and controls are put in place for this.

This is indeed a daunting programme of work for a firm. The above is only a high-level guide as to how to ensure compliance with the requirements of MiFID. Best practice firms will of course seek to do more than this and try to take strategic advantage of MiFID. The obvious areas of analysis are the possibilities offered by greater passporting rights and the ability to eliminate structures, legal entities and other costs related to compliance with host conduct of business rules or to develop new cross-border activities based on home country standards. In the markets space, there is also the prospect of enhanced competition with regulated markets, and firms already appear to be taking advantage of this.

1.6 Impact of MiFID

What then will be the impact of MiFID and do the benefits measure up to the considerable costs? It is extremely difficult to assess this given the considerable uncertainties around the impact of the Directive. As the implementation date gets closer, the costs of MiFID certainly start to crystallise, but the benefits will not be clear for some time, depending on how firms and markets react to the liberalising provisions of the legislation.

Nevertheless, assessing the costs and benefits of MiFID is a crucial task. It is considered best practice in financial policy-making to conduct a rigorous analysis of market failure and then subject any suggested policy solutions to an equally rigorous cost-benefit analysis. The crafting of MiFID suffered from an absence of such a process. As the above discussion hopefully makes clear, the development of MiFID naturally followed from the concerns over the ISD in the context of the Lisbon Agenda and FSAP. However, there was no early stocktake of the costs and benefits of the "upgrading" of the ISD that eventually emerged as MiFID or of the specific provisions that are contained in MiFID.

The UK Financial Services Authority has conducted such a cost-benefit analysis, after the adoption of MiFID but before implementation, because it is obliged to do so under UK law. This analysis, published in November 2006 ("The overall impact of MiFID"), was prepared with the assistance of consultants Europe Economics.

The FSA analysis is rightly heavily caveated and concludes that the benefits are highly dependent on the assumptions made about the impact that particular provisions will have on market behaviour. Under the central assumption in the paper, the FSA report concludes that quantifiable benefits of up to £200 million per year in direct benefits may arise in the UK as a result of MiFID. The analysis further suggests that, depending on the shape of these developments, further "second round" effects of another £240 million in benefits are possible in the UK. The analysis also notes that benefits outside the UK may be higher given the greater liberalising impact on other more restrictive markets.

Set against these tentative benefits, the FSA study reports significant costs. The analysis suggests one-off costs estimated in the region of £877 million to £1.17 billion[7] for firms and estimated ongoing costs of £88 million to £117 million.

As the FSA itself acknowledges, these numbers need to be treated with a great deal of caution. But they clearly mirror a perception in many quarters that MiFID has proved highly costly and may be of limited benefit. Why has this proved to be the case and where might benefits be seen?

At its simplest, a judgement on the success of MiFID depends on whether the passporting benefits of MiFID are viewed as outweighing the considerable transitional and ongoing costs arising from new common EU conduct of business rules.[8] Immediately, a fundamental

[7] The Directive has only limited transitional provisions. Allowing greater scope for grandfathering existing arrangements with clients might have brought these initial costs down considerably and helped to tip the cost-benefit more in favour of MiFID.

[8] It could also be argued that MiFID provided benefits by improving compliance standards through common EU conduct of business rules. This rests on the premise that existing national rules were deficient, and it is hard to see that as the case for most jurisdictions. However, for some Member States MiFID has led to a significant increase in investor protection standards.

problem is evident: the costs of the conduct of business provisions are by law applied to each and every EU firm subject to the scope of MiFID, but only some firms have the business model or ambition to conduct cross-border activity. Thus, there is an asymmetry between the number of firms subject to the costs of MiFID and those who will realistically hope to benefit from the passporting provision.

The limited benefit of passporting merits further thought. In many cases firms subject to MiFID simply do not conduct cross-border business or intend to do so. But in theory, the liberalising nature of MiFID provides an opportunity for such cross-border financial activity and could kick start businesses in this direction. However, in the retail financial services space, it is increasingly evident that there are other significant barriers to cross-border business apart from host conduct of business rules. Local general consumer rules, pension laws, tax provisions and other standards may inhibit such business. But perhaps more important, evidence to date has been that consumers prefer to deal with well-established local brand names that have a local, normally bricks and mortar, presence. This has inhibited the scope for cross-border retail financial selling. It seems instead that cross-border mergers between retail financial services firms are what is really needed to develop the single market.

If the picture on the retail side is of limited appetite or scope for passporting activity, the wholesale markets present a somewhat more encouraging picture. Here cross-border offering of services is much better established and the passporting provisions of MiFID will have afforded firms an opportunity to rationalise their compliance arrangements. Furthermore, as explained in Chapter 3, the introduction of an eligible counterparty regime beyond the UK to other Member States may help reduce trading costs for wholesale market participants.

Perhaps most beneficial may be MiFID's provisions in the markets space. The end of the concentration provision will expose regulated markets to increased competition in the form of both MTFs and systematic internalisers. Competition in the publication of price data has also been liberalised by MiFID. It is interesting to see that there are early signs of competition in both of these areas, as industry consortia seek to develop rival trading and publication mechanisms. Whether or not these initiatives are successful is still uncertain, but they will likely impose pricing pressure on existing regulated markets, driving down costs. In the meantime, MiFID may well have an influence on the shape of exchange consolidation in Europe, as the drawn-out mating process between European regulated markets comes to a close.

1.7 After MiFID

The level 1 and 2 legislation analysed in this Guide are of course not the last word on MiFID. The national implementing legislation of Member States will elaborate on the material discussed here and will no doubt be subject to revision in years to come. Given the complexity of MiFID and the volume of change being imposed and digested in short order, there will probably be a settling-in period followed by reflection and possibly amendment of implementing rules.

In the meantime, supervisory authorities will continue to work under level 3 of the Lamfalussy process on further convergence of practice in areas governed by MiFID. Discussions are ongoing in areas such as the practical application of the branching provisions, common data standards and transaction reporting, and interpreting MiFID's best-execution provisions. Continual monitoring of the work of the CESR is therefore advisable.

MiFID itself also includes a number of review clauses requiring analysis by the Commission. For example, studies are required of the merits of enhanced transparency requirements for financial instruments other than equities. There is already a rigorous debate underway, with considerable scepticism about the need for legislation, but with industry making tentative steps to improve post-trade bond transparency.

More generally, the impetus of the FSAP and the Lisbon Agenda has cooled. Prompted by cries of over-regulation, there is recognition of a need for a lengthy legislative pause and a period of "consolidation" after the considerable volume of financial services legislation adopted in recent years. Also, new disciplines of market failure and cost-benefit analyses have received wider acceptance at European levels, meaning that new initiatives are considered more carefully.

Thankfully then, it seems it will be some time before there is any appetite to reopen the controversial issues that are tackled in MiFID. In the meantime, the liberalising provisions of MiFID will have their opportunity to influence the future development of Europe's financial firms and markets. Only then will we see whether the costs of MiFID have been justified, and whether the vision so optimistically embraced in Lisbon is, in fact, realised.