At a SunGard round table in London last week, a group of leading MiFID commentators agreed that despite the challenges, the potential benefits of the directive are significant.

The Markets in Financial Instruments Directive (MiFID) is "one of the most important reforms being envisaged in the European financial markets" says Alberto Giovannini, chief executive officer of Italian asset management firm UNIFORTUNE.

Giovannini, who is also the author of the Giovannini Report, which identified 15 barriers to the harmonisation of Europe's clearing and settlement infrastructure, was speaking at a round table discussion on MiFID in London last week. He shared the stage with some of the leading commentators on the European Commission (EC) directive, brought together by SunGard. All agreed that MiFID would have significant repercussions for many players in the financial industry.

MiFID is a substantial revision of the EC's previous Investment Services Directive (ISD) and is due to come into effect on 1 November 2007. It aims to open up Europe's financial markets, removing, for example, practices in some parts of the region where all trades had to take place on an exchange. Common rules and definitions will be imposed to prevent countries putting in place expensive artificial barriers to cross-border trading.

Despite its extensive repercussions, Giovannini confessed he loved the directive, not least because his business "will not be impacted by it in a direct way", he joked. "As a user, I won't have to suffer the major headache of having to fire people or to figure out what software the firm needs to use."

THE PANEL

Alberto Giovannini,
chief executive officer,
UNIFORTUNE SGR SpA
Stephen Hanks,
economic advisor,
capital markets and
govenance team,
HM Treasury,
Anthony Belchambers,
chief executive,
Futures and Options Association
Dermot Turing,
partner in the financial services
and markets practice,
Clifford Chance
Robert Fuller,
IT director, strategy,
Dresdner Kleinwort Wasserstein
Colm Furlong,
equity specialist,
SunGard

"This reform will throw out of the window business models that financial institutions have made a lot of money out from their internal dealings in ways that perhaps have not been so fair in the past. Financial institutions will have to rethink how they make money and what services they offer to their clients."

Alberto Giovannini

Joking aside, Giovannini pointed up that those involved in the financial industry were always mindful of the overall community; with that in mind, MiFID is a very interesting and innovative reform that "potentially can bring a lot of benefits", he said.

Unlike the original ISD, said Giovannini, MiFID applies a concept of remote access – a passport for financial services – that "really works". The philosophy behind the directive is "unambiguously pro-competitive" opening up markets and eliminating concentration rules. For this reason, it is a major step forward in building Europe's single financial market and raises issues of democratic processes and strategy in the industry.

"This is not reform dictated by the need to adopt a certain technology or a certain technological model. It is something that says we have a lot of technology out there and we have certain needs in terms of making the market work - remote access, eliminating monopolies - but we must safeguard certain standards. I say the industry should build the technology needed with the available terabytes."

Because MiFID does not adopt a given way of doing things or a given system, it forces the creation of new systems and new ways of doing things, says Giovannini. "This is good, because it is more dynamic. This reform will throw out of the window business models that financial institutions have made a lot of money out from their internal dealings in ways that perhaps have not been so fair in the past. Financial institutions will have to rethink how they make money and what services they offer to their clients."

Existing business models may no longer be feasible as increasing demands for flawless execution are imposed on intermediaries. However, Giovannini said the "name of the game" would not be solely one of consolidation. "When we talk of these reforms, including those for clearing and settlement, we can conceive a pattern where specialisation may occur. I think there will be intermediate level institutions that will cater to small, specialised entities. At the end of the day, what we are all doing here is making it cheaper to access the financial markets."

Giovannini said market participants should not fear that consolidation would lead to larger players "taking over. Ideally, there will be a profound reshaping of financial intermediation, with plenty of room for small, specialised and high quality people who are able to offer something meaningful to their clients."

With regard to clearing and settlement, MiFID adopted "the very same concepts that have been developing in the discussions on improving clearing and settlement in Europe", said Giovannini. These concepts included the opening up of architecture and enabling remote access. "Everyone should be able to access remotely every segment of the value chain in a transaction. That is a very important concept, which is used to dismantle a structure, which at present is a patchwork of financial markets. We now have sanctioned national monopolies, which were originally in isolated national markets, conceived to force the pooling of liquidity. Clearly this does not make sense because clients don't want it."

In dismantling this patchwork, there would be "bumps along the way", said Giovannini. "I expect this process of dismantling national monopolies will be painful. Many people holding privileged positions in the industry will try to take advantage (very naturally, there is nothing illegal or unfair in this) of this to make their businesses more profitable or to expand them. But these business models will go out of the window, generating dislocation, strong arguments, head scratching and sleepless nights for many people. This will not be smooth."

Giovannini expects MiFID will "tremendously accelerate" consolidation of the clearing and settlement infrastructure in Europe. While there are synergies between the legislative processes underlying both MiFID and clearing and settlement reform, Brussels had not explored these in sufficient depth, he said. Decision makers should consider the appropriate sequencing of decisions in order to "make the whole picture come out properly", he said.

Part of the picture, is of course, how MiFID will be implemented across Europe. Stephen Hanks, an economic adviser in the capital markets and governance Team, HM Treasury, told the audience that his organization was "relatively positive about MiFID. It is not a perfect piece of legislation – but legislation rarely is. There will be some areas of unnecessary costs, but the directive is about competition, about simplifying the regulatory regime for cross-border business. That should have a positive effect on financial services in Europe and on the cost of capital."

In pondering the all-important question of what will happen post-MiFID, Hanks admitted the Treasury had no answers. "The UK Government does not have a blueprint for how this is going to work. We see it as the industry making its own decisions. We will not push the industry in a particular direction," he said.

Such an approach may prove to be an advantage. Anthony Belchambers, chief executive, Futures and Options Association, said if the "regulatory bar" were set too high, the industry would move back into what he called "regulatory arbitrage". "I believe this Directive will enable people to have greater freedom to locate their business where they want because the whole of their regulatory structure will be driven out of one member state. Surveys by the Corporation of London consistently find that among the top three needs of firms are always flexible, intelligent regulations. This is important to bear in mind."

"MiFID won't stop when the ink is dry on the proposals – that is when it will begin. We are trying to change what we do in Europe in order to create a more efficient capital market and that will require us to change or modify our behaviour over time."

Robert Fuller

Hanks and other speakers referred to the protracted negotiations over the Level 2 official draft, which covers implementation technicalities. These are now expected to be published on 6 February, although they were originally expected in September 2005. "After these are published, the European Parliament will need at least three months to consider the proposals. The European Securities Committee also has to discuss the text of the draft. Potentially important changes to the text may be made over the next three to four months," he said.

When asked by a member of the audience why implementation of MiFID had not been done in a phased approach, Hanks said that because of the interconnection of issues involved in MiFID "it would be very difficult to work out which parts of the directive should be separated out for phased implementation."

During his presentation, Dermot Turing, partner in the financial services and markets practice of Clifford Chance in London, warned members of the audience that they should not rely on the UK being late in implementing the Directive. "The UK has an outstanding record in implementing European directives on time. You have to be ready for MiFID on 1 November 2007."

There remained disagreements on the implementing measures said Hanks, which fell into two sections – the architecture of the implementing measures and the substance of the measures. "One important issue is how much of the measures will be in directive and how much will be in regulations. It has practical effect and will impact on the extent to which the Directive will go live on 1 November 2007. If measures are in directives, they have to be turned into national laws and regulations; that is generally a slower process. If they are in regulations, they will be directly applicable from 1 November 2007. Moreover, if they are in regulations, they will give people the right to take action against firms on the basis of what it says in a regulation, and not on the basis of whatever words member states use when they turn directives into domestic laws and regulation."

Hanks pointed up that European Commissioner for Internal Market and Services, Charles McCreevy, has said he wants maximum harmonization in order to prevent member states adding their own obligations to MiFID. This is in order to avoid the scenario under the ISD where there was too much freedom to add to the directive and this thwarted the single market objectives of the directive.

Around six issues had been among the most difficult to solve in the negotiations on the implementing measures, said Hanks. For example, the UK did not like the provision covering outsourcing in the text of last September, which restricts companies outsourcing to providers in countries outside the EU. On the other hand, some other member states were

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Anthony Belchambers

very attached to this provision, said Hanks. “The UK has been trying to explore what room there is to try to make this provision more liberal.”

Another issue has been the definition of investment advice, with which the Committee of European Securities Regulators (CESR) had wrestled . “Does investment advice include generic advice, the giving of advice about buying shares, rather than buying a specific share? We have always taken the view that it shouldn't, that as in the UK, the only investment advice that should be regulated should be specific advice.”

The issue that caused the most controversy at Level 1 was the scope of the obligations placed on people trading shares away from exchanges and from other trading platforms, said Hanks. These pre-trade transparency obligations for systematic internalizers have also caused problems in the Level 2 discussions. Among the questions wrestled with were the definition of a systematic internalizer e and what shares would be caught within the scope of the provisions by being deemed to have a liquid market.

The way that the provisions in the conduct of business (COB) area treat retail and professional investors was also causing controversy, said Hanks. “The directive makes a distinction between retail investors, professional investors and eligible counterparties. In Level 2, we have been trying to work out what measures apply to which group. From a UK point of view, we'd like a light touch for professional investors.” Some other member states wanted measures to protect retail investors to apply to professional investors as well, said Hanks.

Another issue around COB is the extent to which contracts between investment firms and their clients are regulated. “Some members states think the directive should mandate a signed contract and a minimum content of those contracts. We and some other member states are reluctant to go down this route. We believe it is not helpful to regulate, very specifically, the way people interact on a contractual basis.”

Clifford Chance's Turing took up discussion of the COB measures. “A huge hole in the ISD was the problem of COB rules. Member states preserved their personal jurisdictions over these. In the current regime, you have to comply with local rulebooks in all EU member states.”

Under MiFID, firms would be able to access customers all across Europe from London using only one FSA rulebook, said Turing. “That has to be better than the present situation. However, if you are

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Stephen Hanks

accessing customers from branches, you will have to comply with the branch member state."

The "flip side" to the coin on COB rules was from the customers' perspective, said Turing. Customers could be bombarded with investment offerings from 24 member states, including their local banks. As a result, there could be 25 different standards of business conduct because of the new, harmonized single passport regime. "That is why there is all this argy bargy that Stephen described about the Level Two measures. If you are going to try to make it work and protect those customers you need a reasonably harmonised approach to COB rules. Everybody in all member states has to change to move on to new harmonised rulebook; you can't have a single market without harmonised rules."

Many of the measures within MiFID would be significant IT projects, said Turing, but their impact would percolate throughout all areas of the business. "People will need to impose systems and controls across their entire business."

The FOA's Belchambers pointed up that while the financial industry was keen to develop harmonized rules to do pan-European business, it was important to tackle the underlying question of where the level of harmonization would be set. "Unless it is tempered by proportionality, market sensitivity and differentiation, it is not going to amount to very much."

The FOA, said Belchambers, had a real problem with the idea of applying high cost banking rules to commodity dealing corporates who don't do banking business. "The original thinking of the EC was that if these rules are good for one market or one provider, they have to be good for everyone. There has been a real battleground to claw back differentiation from that regulatory culture. I welcome harmonization, but we have to be careful about wrapping our arms around it too much."

In terms of the business impact of MiFID, Belchambers said while exchanges would undoubtedly face greater competition from firms dealing OTC off their own books and from low-cost platforms, the concept of best execution may well bring business back to exchanges. "The drive for best execution in the big-ticket business will drive people to go where the liquidity is. This will result in market driven, rather than regulatory driven, consolidation."

In the OTC market, firms would face disintermediation, he said. "There used to be a very big trough and people knew their place in the market and dipped in. Under MiFID, the trough will be shorter and there will be a lot of elbowing to get your snout in. The only way to do that will be to disintermediate your competitors." As a consequence, some of the smaller exchanges would disappear as the hunt for liquidity intensified, he said.

Belchambers devoted most of his presentation to the work being undertaken by MiFID Connect, a group of nine trade associations, which between them capture 90% of all UK financial services business. The group aims to establish a practical, cost-efficient and market-sensitive policy towards implementation of MiFID in the wholesale and retail financial services sectors. Member associations include the FOA, the Association of British Insurers, the Association of Private Client Investment Managers and Stockbrokers, the British Bankers' Association and the Building Societies Association.

"MiFID will have such a major impact on the market and firms we must make sure it has a significant industry imprint on it. The only way of doing that is to come together in a collegiate way, which is what MiFID Connect is about," said Belchambers.

Asked by an audience member if MiFID Connect would engage with non-UK associations, Belchambers said the organization would do so "instinctively" if UK firms liked what the organization was doing and wanted to roll out the measures.

Belchambers said it was important that the industry did not have to face "change for change's sake" and he stressed again the need for proper differentiation in MiFID's measures. "We have identified at least 15 areas of high risk to firms in MiFID implementation. These include conflicts of interest, management outsourcing, disclosure, suitability, best execution, order handling, transaction reporting and record keeping. We want to produce industry guidance to cover all of these areas."

MiFID Connect is receiving help from another organization set up to make sense of MiFID, the JWG-IT, of which Belchambers' fellow panellist, Robert Fuller is co-chair. JWG-IT acts as the IT sub group for the MiFID Joint Working Group which was set up by FIX Protocol Ltd, ISITC Europe, the Reference Data User Group and SIIA/FISD to evaluate the European MiFID legislation and its affect and cost across Europe.

"JWG-IT is looking at pan-European issues and we will help MiFID Connect to look at these issues," said Fuller, who is IT director, strategy, Dresdner Kleinwort Wasserstein. "Some estimates of the IT costs associated with MiFID indicate that implementation costs will be ten times what they think individual firms will make. It is a very difficult business decision to make if you want to spend the money needed for IT to stay in business."

When tackling MiFID implementation, firms should look beyond the text of the proposals, said Fuller. "MiFID won't stop when the ink is dry on the proposals – that is when it will begin. We are trying to change what we do in Europe in order to create a more efficient capital market and that will require us to change or modify our behaviour over time."

Because MiFID is a piece of European legislation, Europe had to work together on issues such as transaction reporting, common customer identification and common securities reference numbers, he said. "If we are to have a truly European piece of legislation, we need to have someone looking at concepts across European boundaries. There needs to be an acknowledgement of the cross-border nature of these issues. We don't want to have to install 28 different systems in 28 different countries; we all have customers in those 28 countries," he said.

Fuller said it was important to keep MiFID implementation as low cost as possible. "In the past there was enough money to pay for new ways of doing things; it didn't matter if you payed away $100m. But we can't afford to do that anymore if our margins are going to be only 10% of what they were before. This means you have to look at what the company holds dear in an IT sense and change the cost of these things, or you won't be competitive."

Despite the challenges, Fuller said the industry had a lot to gain if MiFID were implemented wisely and it could be used to make Europe and even bigger and more efficient market than it is now.

While MiFID presented many challenges, Colm Furlong, equity specialist, SunGard, struck something of an optimistic note. "The technology needs across all asset classes will change under MiFID, but we are not starting from scratch when discussing what technologies we need. There is a lot of expertise in the software business." MiFID converged with many of the major issues software firms had tackled over the past few years, he said.

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Technology had a key role to play in some of the key themes, said Furlong. SunGard was focusing, for example, on the systematic internalizers – sell side firms that become a market. "These firms have to act like a market, publishing prices on a continuous basis. From a technology view, these firms have to have the same technology as an exchange - a matching engine and the ability to distribute prices. More than that, they also need to know what is going on in other venues, based on best execution requirements. This makes it very complex."

SunGard approaches this issue by dropping the market technology into the order management system (OMS), in the centre of the business flow. "For systematic internalizers, the market matching technology is within the order routing rules and looks outwards as a hub to other external markets. We believe this is a very unique approach."

Internalization would not just be about putting a machine in place to watch orders coming in and hope they match, said Furlong. "Agency brokers won't make money out of internalization unless they make the market. They need trading desks and they need to provide liquidity. They will have to take positions and risks." All this requires advanced trading tools that will protect the internalizer.

Like Fuller, Furlong said the changes MiFID would bring in would be worth it, given the potential benefits. "We will get the kind of capital market we all want in Europe."

Many of the questions from the floor reflected firms' worries about the deadline and the answers reflected the frustration that the Level Two draft had yet to materialise. Belchambers pointed up that one of the reasons for the formation of MiFID Connect was to help firms deal with the implementation timetable. "Regulators often don't like the idea of phased transitions of long periods of implementation because firms will often leave it to the last

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minute. Don't forget we have a safe harbor of nine months, but if regulators and member states steal time, firms will be left with only a few months to implement the necessary changes."

Fuller agreed, adding that MiFID was not the only consideration. "We are also dealing with Sepa in the same time frame and from an IT point of view there is a concern about the clashes of these and the ability of firms to create that amount of change while remaining stable. There is no easy way, other than to press the EC when we have a European voice."

Would there be sanctions for member states that failed to implement the directive on time? Hanks said the formal procedure of infraction proceedings was a long and slow process but was the only one available, other than "harassment".
Turing raised the issue of enforcement against firms. It was important to know how sensitively the directive would be enforced, particularly whether firms would be disciplined if aspects of their planning had not gone to timetable.

Hanks added: "We have an obligation and an opportunity to implement this Directive on time. Equities trading as envisaged under the Directive is closer to the current state in London, so there will be slightly less change in the UK."

However, Turing said some measures would be new to London, such as those added layers regarding price disclosure, record keeping and transparency obligations. "I wonder if MiFID will have a positive impact on multilateral trading facilities or systematic internalizers. MiFID makes it more difficult because there are more obligations than before. London has been generally friendly for this activity to date and has welcomed people with alternative platforms – there has never been a rule that you can only trade on the stock exchange."

For Fuller, life is "full of surprises" and the most important issue was that CEOs and the IT part of financial institutions worked together to make decisions about European strategy. "People need to grab this with both hands to be a winner – otherwise they won't succeed." ●