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Markets in Financial Instruments Directive (MiFID): Frequently Asked Questions

(see IP/07/1625)

1. What is the "MiFID"?

The MiFID is the Markets in Financial Instruments Directive – or Directive 2004/39/EC. It replaces the Investment Services Directive (ISD) which was adopted in 1993. It was agreed unanimously by the Member States and by a strong Parliamentary majority. It is a cornerstone of the Commission's Financial Services Action Plan (FSAP). It sets out a comprehensive regulatory regime covering investment services and financial markets in Europe. It contains measures which will change and improve the organisation and functioning of investment firms, facilitate cross border trading and thereby encourage the integration of EU capital markets. Economists agree that financial integration will strengthen the EU economy significantly. At the same time, MiFID will ensure strong investor protection, with a comprehensive set of rules governing the relationship which investment firms have with their clients.

2. MiFID is a so-called "Lamfalussy" Directive. What does this mean?

It means that the MiFID is being adopted using a legislative approach known as the "Lamfalussy Process." This approach was devised by a Committee of Wise Men (chaired by Baron Alexander Lamfalussy, former Head of the European Monetary Institute) which was set up at the request of the European Council. "Lamfalussy" Directives are split into two levels – the "level 1" Directive which establishes the guiding principles of the legislation agreed in co-decision by EP/Council and the "level 2" implementing measures (see question 3). The advantage of this "split-level" approach is that it allows the Council and Parliament to focus on the key political decisions, while technical implementing details are worked through afterwards. This flexibility allows for more rapid and frequent adaptation of the legislation so that it can keep pace with market and technological developments.

3. How does the "Lamfalussy process" work?

The "Lamfalussy process" centres around a "4 level" legislative approach:

- *Level 1:* Level 1 is traditional EU decision making, i.e. Directives or Regulations proposed by the Commission and then co-decided by the European Parliament (EP) and the Council. These Directives or Regulations contain framework principles.

- *Level 2:* Technical implementing measures to render the level 1 principles operational, can be adopted, adapted and updated by the Commission after having been submitted to the European Securities Committee (ESC) – a committee composed mainly of members of Ministries of Finance - and the European Parliament for their opinion. The Committee of European Securities Regulators (CESR), an independent advisory body made up of securities regulators, can advise the Commission on the technical implementing details to be included in level 2 legislation. This advice is provided in response to specific "mandates" from the Commission asking for help in particular areas. Level 2 implementing measures do not in any way alter the principles agreed at Level 1; they simply provide the technical details which are necessary to make these principles operational.
- *Level 3:* In order to facilitate coherent implementation and uniform application of EU legislation by the Member States, CESR may adopt non-binding guidelines. CESR can also adopt common standards regarding matters not covered by EU legislation (but these standards have to be compatible with level 1 and 2 legislation).
- *Level 4:* Enforcement: This refers to monitoring correctness of implementation of EU legislation into national legislation by the Commission and, in case of non-conformity, launching of infringement proceedings which can end before the European Court of Justice.

4. What are the timelines and what is the state of play of readiness of MiFID?

MiFID comes into force on 1 November 2007. The transposition deadline was 31 January 2007, with the intention of giving firms 9 months in which to adapt their systems to the MiFID changes[1]. The Legislation (level 1 and level 2 – see question n° 3) was adopted in 2 phases by EU institutions

- the framework or 'Level 1' Directive was adopted in April 2004

- two level 2 measures (one Directive and one Regulation) were adopted in (July and published in September 2006. In practical terms, since April 2004 Member States have been transposing the level 1 and preparing the transposition of the level 2 directives into their national legislation. In parallel, firms have been preparing themselves for the new regime. The Regulation does not require transposition, however a series of adaptations were necessary to both the national legislative and supervisory framework as well as in the way firms carry out the business to allow to the MiFID to produce its effect.

It is expected that the great majority of the 30 EU and EEA States will have fully transposed both the Level 1 and Level 2 Directives by 1 November, with almost all the rest to transpose fully very shortly thereafter. The state of play of MiFID transposition is published on our website:

http://ec.europa.eu/internal_market/securities/isd/mifid_implementation_en.htm.

This page is regularly updated as information comes in from Member States.

[1] The MiFID as a whole was originally due to come into force in April 2006. The legislation was postponed to enable more time for the detailed implementing rules to be finalised.

CESR recently published guidance to the market on the situation of firms doing business into, or from, Member States who have not transposed as at 1 November. These arrangements by CESR will allow for minimal disruption in cross-border business where those firms were covered by a passport under the existing regime, i.e. the Investment Services Directive (ISD).

5. What exactly are the provisions of the Level 1 Directive?

The Level 1 Directive abolishes the so called 'concentration rule' (in other words, Member States can no longer require investment firms to route orders only to stock exchanges). This means that, in many Member States, exchanges will be exposed to competition from multilateral trading facilities (MTFs), i.e. broadly non-exchange trading platforms and 'systematic internalisers', i.e. banks or investment firms who systematically execute client orders internally on own account (rather than sending them to exchanges).

MTFs and 'systematic internalisers' will be subject to similar pre- and post-trade transparency requirements as the exchanges. This will ensure a level playing field between the exchanges and their new competitors – and full information on trading activity to the market.

The Level 1 Directive also updates the 'single passport' for investment firms, which was first introduced in the ISD. It extends the list of services and financial instruments covered to bring it into line with the new market realities. For example, investment advice is covered for the first time. This reflects modern trends since more and more retail customers are investing in securities and seeking advice from their bank or their broker. This will allow investment firms to provide services across the EU on the basis of a single authorisation from their "home" Member State. At the same time, investor protection rules are strengthened and harmonised at a high level so that investors can feel confident in using the services of investment firms, wherever those firms originate from in the EU. Ensuring investor confidence is critical for pan-European trading to deepen.

6. What is in the Level 2 measures?

The Commission can only adopt "level 2" measures in those areas where the "level 1" Directive specifically gives it the power to do so. This applies to just 18 out of 73 provisions in the level 1 Directive. The main areas covered are:

- <u>conduct of business requirements for firms</u>, e.g. their obligation to divide their clients into different categories ("eligible counterparties", "professional" and "retail"), their obligations towards each category of client, their obligation to assess whether the products and services which they provide are "suitable" or "appropriate" for their client and their obligation to secure "best execution" for their clients (i.e. the best possible result with the emphasis on best price for retail investors).
- <u>organisational requirements for firms and markets</u>, e.g. compliance, risk management and internal audit functions that operate independently, identification and management of conflicts of interest and limitations on out-sourcing, especially to third countries;
- <u>transaction reporting</u> to relevant competent authorities of buy and sell transactions in all financial instruments;
- <u>transparency requirements</u> for the trading of shares (i.e. pre- and post trade transparency for regulated markets, MTFs and 'systematic internalisers') to ensure a level playing field between exchanges, MTFs and systematic internalisers for the trading of the most liquid shares in Europe.

7. Why did we need MiFID?

We needed MIFID because the old Investment Services Directive was out of date, didn't work well in many areas and needed replacing. The 'passport' system was not working well enough. It had to be updated so as to eliminate barriers to cross-border trading and thus inject fresh competition into the European investment services industry which is so vital to the European economy, e.g. in dealing with the financial implications of the pensions time-bomb. And investor protection needed to be enhanced to attract new investors to EU capital markets. The "concentration rule" that some Member States applied represented a barrier to the emergence of an integrated and competitive trading infrastructure and so needed to be removed. Finally, modernisation was necessary; new services, such as investment advice, and new financial instruments, such as derivatives, needed to be brought within the scope of European legislation in order for these products to circulate freely.

8. What will MiFID mean for consumers and small investors?

MiFID is good news for consumers. They will have a bigger choice of investment service providers – who will be required, all of them, to conform to high standards of behaviour to their clients. This should allow them to seek out services of the best quality at the cheapest price. Firms will be subject to greater competition forcing them to be more responsible vis-à-vis their clients and to offer a better level of service. More generally, small-scale and retail investors will have a bigger choice of products and services to choose from and equities, bonds etc to invest in, thus allowing them to maximise the returns on their savings. This will help to guarantee a higher standard of living for millions of people – e.g. during retirement.

Consumers will enjoy the same level of protection whether they choose a domestic service provider or a foreign one. And the level of protection they will have will be high. MiFID builds in a range of tough safeguards for consumers. For example, there will be strict limits on the inducements which banks or financial advisers can receive in respect of the services which they provide to their clients. When executing client orders, firms will have to take all reasonable steps to deliver the best possible result ("best execution"). For retail clients, the emphasis will be on ensuring that they get the best price for the instrument and the costs associated with the execution.

The approach is not to flood consumers with reams of information which may not be relevant to them and which they may have difficulty in understanding. Instead, the emphasis will be on the fiduciary duties of firms towards their clients (i.e. their duty to always put their client's interests first). This will include a range of measures including a modern and thorough approach to the identification and management of conflicts of interest. Firms are also required, when providing investment services, to collect sufficient information to ensure that the products and services which they provide are "suitable" or "appropriate" for their clients.

Clearly, this new investor protection regime will apply to the full extended list of products and services which are now covered by the MiFID thus ensuring even greater protection for consumers.

9. Which firms will benefit most from the MiFID?

The first movers and the better prepared will be the winners. For those firms who have been prepared to adapt expeditiously and make the necessary preparations, the opportunities will be considerable, and not just limited to equities. We expect that firms who choose to become "systematic internalisers" may use their upgraded electronic equipment to internalise other financial products as well across a range of European markets. On the other hand, those investment firms that seek to ignore MiFID or treat it solely as a compliance issue may well find themselves seriously disadvantaged.

10. What will be the overall effects of the MiFID?

It will significantly reduce the barriers to cross-border trading of shares and cross-border provision of investment services. It will end the monopoly which certain stock exchanges have had on the trading of securities. As a result, it will create new opportunities for firms, markets and indeed consumers. However, its precise effects will depend on the extent to which the various players are prepared to seize the opportunities on offer. If they are prepared to do so, there could be a significant increase in competition among exchanges and between exchanges and other trading platforms. And there could a big increase in stronger cross border trading, and a significant decrease in the cost of capital – benefiting the overall economy - large and small firms alike - and investors.

Levels of competition between investment firms will force them to become more efficient and productive, leaving them better able to withstand increasingly tough global competition. It will lower costs for issuers and investors of accessing capital markets and give investors a far greater choice of equities, bonds etc to invest in – allowing them to maximise their returns. This would enable businesses to invest more so that they can grow and create more wealth and jobs.

11. How were MiFID and its implementing measures developed? Did the Commission talk to the relevant stakeholders?

Yes. The Commission adopted an open and comprehensive approach in order to build the widest possible consensus. The level 1 Directive was debated from 2000 to 2004. It was an exhaustive and inclusive debate.

The level 2 measures were the result of an unprecedented and intense round of consultations with all stakeholders – including Member States, regulators, firms and consumers. They were based largely on the advice provided by CESR which itself is the product of long, in depth technical discussions among experts in the securities regulators, as well as extensive consultation with the public. There were repeated and lengthy discussions in the ESC based on discussion and feedback documents prepared by the Commission services.

The process was iterative and transparent. Indeed, there were no fewer than 11 public consultations (organised either by the Commission or CESR). The Commission maintained an "open door" policy. There were innumerable meetings at all levels with industry and consumer representatives and other interested parties.

12. Has the Commission carried out a cost benefit analysis (impact assessment)?

The Commission has not carried out a formal and exhaustive economic cost benefit analysis (CBA) of MiFID as a separate piece of legislation. It was not a requirement 5 years ago when work on the level 1 Directive was started.

Moreover, costing the potential benefits of individual items of FSAP legislation is hazardous; establishing economic cause and effect in such complex, interwoven markets very difficult.

However, there has been a major study quantifying the potential macro benefits of integrating capital markets as a whole (London Economics, November 2002) – a study that was appraised by peer review. The study's results, although very positive, were felt, if anything, to under-estimate the overall benefits of European integration to the EU economy. The study found that integration of financial markets in the then EU-15 would produce a reduction in the cost of equity capital of around 50 bp, a reduction in cost of bond capital for non-financial issuers of 40bp, an increase in GDP of 1.1%, and total business investment up 6% and private consumption up 0.8%.

The extensive, transparent and open stakeholder consultation – plus the information gathering and analysis which the Commission carried out during the preparation of both the level 1 and the level 2 measures –produced a very sound economic and technical basis for decision taking, including a thorough assessment of the legal measures' impact on firms, markets and consumers.

Furthermore the MiFID measures were drawn up in accordance with "better regulation" principles. The Commission adopted a "principles-based" approach. The aim is not to tell firms how to run their businesses. Instead, the measures set out the principles which they must adhere to. The Commission also rejected the "one size fits all" approach. The measures were drafted with an awareness of the diversity of market structures and service providers. Rules should be applied in an appropriate and proportionate manner. This is explicitly recognised in numerous provisions where the requirements vary according to the nature, scale and complexity of the particular investment firm and its business or the sophistication of its clients.

13. How has the Commission been contributing to the transposition effort?

The Commission has been actively contributing to transposition in a number of ways:

- through a series of Transposition Workshops with Member States which have clarified questions of interpretation;

- through its 'Your questions on MiFID' web-page[2]. This tool, which is always open to the public, enables consumers and firms to ask questions of interpretation of the Directive;

- by providing interpretative guidance on difficult issues such as the application fo best execution to dealer markets and the supervision of cross-border branches.

[2] http://ec.europa.eu/internal_market/securities/isd/questions/index_en.htm

After the expiry of the transposition deadline in January 2007, the Commission has launched its enforcement activity (so-called ‘Level 4’ of the Lamfalussy process). The Commission has been active in putting pressure on those Member States who have been late in transposing. It has also been using ‘name and shame’ tools to urge all Member States to transpose in a timely fashion. Infringement procedures were opened – and in a number of cases still continue – against those Member States which did not transpose on time.

14. What happens next?

The focus for the Commission will be on ensuring that the level 1 Directive (and the level 2 Directive) are transposed into national law fully (level 4 of the Lamfalussy process). The Commission will continue to pursue infringement procedures against Member States who fail to do this. It will continue to publish its "Lamfalussy Scoreboard" which tracks the progress of the different Member States in transposing all the Lamfalussy Directives.

It is also important to ensure that the MiFID is consistently applied and enforced. This requires much closer co-operation between Europe's supervisors. That is the aim of ‘Level 3’ of the ‘Lamfalussy’ process. It will promote convergence of supervisory practices in Europe. CESR has already produced an important number of level 3 non-binding guidance. At this stage, CESR are now discussing the next phase of level 3 guidance to be launched in 2008[3].

Finally, the Commission will continually evaluate the MiFID. It will ask whether or not it has got it right. Is it working in practice? Has it delivered the intended results? When carrying out this evaluation, the Commission will talk to practitioners, market participants and investors/consumers – i.e. those who are directly affected by the MiFID and who are therefore best placed to identify any problems.

In addition, the MiFID specifically requires the Commission to draw up reports on the implementation of particular provisions (e.g. professional indemnity insurance, pre-trade transparency of systematic internalisers, pre- and post-trade transparency of financial instruments other than shares). The majority of these reports are due to appear during after 2008.

If any changes to the MIFID implementing rules are necessary then the mechanisms in place can allow for relatively speedy adjustment.

[3] http://www.cesr-eu.org/