

MiFID Review: Objectives for MiFID2/MiFIR

*EUROPEAN PARLIAMENT COMMITTEE ON ECONOMIC AND MONETARY AFFAIRS
Public Hearing, 5 December 2011*

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As the European Parliament embarks on its consultations of the MiFID Review, it is of crucial importance to carefully evaluate the effects of MiFID and to compare them with the initial objectives of the legislation.

MiFID is about the regulation of trading infrastructures, intermediaries in investment services and investor protection in the EU. The Directive replaced the 1993 Investment Services Directive (ISD), which opened up equity securities markets in the EU to more competition by allowing free cross-border provision of services, but allowed member states the possibility to maintain the monopoly of the local stock market. MiFID abolished the monopoly, introduced two new categories of trading venues – multilateral trading facilities (MTFs) and systematic internalisers – and introduced more detailed and stricter investor protection rules, mostly through best execution requirements. Price transparency, however, was not extended to bond and derivative markets.

Four years after coming into force in November 2007, MiFID has led to a greater fragmentation of equity trades over different venues, which has reduced trading costs while not damaging liquidity. Investment firms have invested in routing technology to spread trades over different execution venues, to reduce market impact and benefit from increased competition. The incumbent stock exchanges, however, have withstood competition well, as demonstrated by the fact that essentially only one newcomer, Chi-X, has managed to obtain a sizeable market share. The overall market share of new entrants stood at about 30% at the end of August. Investment firms have benefitted from waivers and ambiguity in the systematic internaliser regime concerning price transparency in bilateral trades, i.e. trades on own account.

On the application of the new investor protection regime, the impact of the Directive has been much less pronounced. As its coming into force coincided with the start of the financial crisis, the Directive was seen to be well suited to the challenges posed by its tight investor protection rules. Nevertheless, the evidence suggests that the rules on best execution, investor suitability and conflicts of interest, however well designed they may have been, have not been properly applied. This failure can be attributed essentially to a lack of adequate enforcement, ambiguities in the MiFID text and the incapacity to control all the aspects of the implementation. Some of these issues have been addressed by the creation of the European Supervisory Authorities (ESAs) and others will be tackled in the draft amendments of MiFID.

Further to a survey on MiFID implementation that CEPS/ECMI published in early 2011, it seems that the main issues yet to be resolved in the Directive's implementation concern data quality and consolidation,

and the application of conduct of business rules. Data quality has deteriorated as a result of the fragmentation of trading venues, the lack of standardised data formats and flags and the unwillingness of data vendors and primary markets to cooperate. This problem was widely discussed in the CESR 2010 consultation on MiFID, and has been addressed in the MiFID 2 draft. As regards conduct of business rules, verification of the application of the best execution provisions is hampered by the lack of consolidated data pools. Another issue is the application of conflict of interest rules, where, although many firms have made improvements, the enforcement of the rules on inducements seems to be non-existent. MiFID 2 is therefore proposing to strengthen these rules.

The most glaring omissions of MiFID were the application of the price transparency provisions to non-equity markets and the interoperability for post-trade provisions. The failure to extend price transparency to bond markets is a missed opportunity, which the European Commission should have corrected much earlier. It is now seen as a fact, as the challenge will be OTC derivative markets. On settlement provisions, MiFID should have added the free provision of settlement services for Central Securities Depositories (CSD), which the Commission will now soon propose.

Back in 2007, MiFID was seen to be a revolution for Europe's financial markets. Although the Directive was first perceived as a huge burden, the tide turned rapidly and firms began to see it as an opportunity. Seen in hindsight, the Directive has enhanced efficiency and competition in Europe's financial markets, has stimulated technological investments and has proven well effective in confronting the problems raised by the financial crisis. MiFID 2 should definitely maintain this momentum, clarify the ambiguities, but stay clear of over-regulating the securities trading space.

References

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