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The Markets in Financial Instruments Directive: Banking on Market and Supervisory Efficiency

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The *Markets in Financial Instruments Directive*: Banking on Market and Supervisory Efficiency

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Abstract

The Markets in Financial Instruments Directive (MiFID) which comes to life on November 1, 2007, represents a major step toward the creation of a single, more competitive, cross-border securities market in Europe. Together with other components of the European Commission's Financial Services Action Plan, MiFID has the potential to significantly transform the provision of financial services and the functioning of capital markets in Europe. This paper assesses the directive and the dynamics it creates from a broad perspective, focusing on those aspects that carry relatively higher transformation potential, and on the appropriate supervisory arrangements for European securities markets once MiFID is operational.

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CONTENTS

Glossary

ATS	Alternative Trading System
CESR	Committee of European Securities Regulators
EEA	European Economic Area
EU	European Union
FSAP	Financial Services Action Plan
ISD	Investment Services Directive
MiFID	Markets in Financial Instruments Directive
MTF	Multilateral Trading Facility
SI	Systematic Internalizer
TRACE	Trade Reporting And Compliance Engine

I. INTRODUCTION

The creation of a truly integrated, competitive financial market in Europe is necessary for monetary union in Europe to deliver its full potential. Bringing together national banking markets and developing a single capital market have been widely recognized as crucial to increase Europe's growth potential. London Economics evaluated in a 2002 study that full integration of capital markets could add more than 1 percent to GDP growth per year.[1] Although the transformation of the financial market architecture in Europe started in the late 1980s, it accelerated the throughout the 1990s in preparation for the advent of monetary union. The momentum has built further since then, fueled in particular by financial globalization.[2] However, it was realized that monetary union would not create a single financial market by itself and earlier studies had identified remaining barriers to the creation of such a market. This led to the launch in 1999 of the Financial Services Action Plan (FSAP), a broad legislative and regulatory program that gave further momentum to financial integration in Europe. Combined with additional measures that were agreed in response to market developments, the FSAP built the backbone for Europe's future financial markets.[3] As a result, financial integration in Europe has progressed significantly, most notably in the provision of wholesale financial services. The next step along the road to full integration is the implementation of the Markets in Financial Instruments Directive (MiFID).

The Markets in Financial Instruments Directive is the centerpiece of the FSAP and a major step toward the creation of a single securities market in Europe. MiFID was adopted in April 2004 by the European Council and the European Parliament, and will become applicable in November 2007. MiFID is the most far-reaching piece of European legislation related to securities markets and the provision of non-bank financial services since the Investment Services Directive (ISD), which it replaces. The ISD was a first, partial attempt to create a single market for financial services across the EU. Although MiFID pursues the same ultimate objectives as the ISD, it sets up a more comprehensive and homogeneous regulatory framework, including an updated and expanded "passport system", in order to create a level playing field and eliminate remaining barriers to the provision of cross-border securities-related financial services.

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[1] London Economics (2002)

[2] IMF (2007) for a description of financial integration in Europe

[3] While the supranational legislative phase of the FSAP was largely completed by the 2005 target date, its full impact will only become clear in the years ahead. Appendix I provides a description of the main initiatives contained in the Financial Services Action Plan.

MiFID has the potential to significantly transform the provision of financial services and the functioning of capital markets, primarily equity markets, in Europe. MiFID relies on several complementary levers to foster increased integration of EU securities markets. These are:

- *Competition.* The new framework injects new competition among financial intermediaries at each step of a security's transaction cycle, from the provision of investment advice to the practical execution and settlement of the transaction. A major feature of MiFID is to open the execution (and settlement) of equity transactions to a variety of operators, through competing trading venues.

- *Best execution and transparency*. To balance the risks of opaqueness and liquidity dissipation stemming from a potentially more fragmented trading infrastructure, MiFID relies on increased transparency and information requirements for the benefit of the market, while best execution requirements will provide more systematic investor protection.

- *Regulatory cooperation and supervisory convergence.* Increased cooperation among securities regulators, notably thorough convergence of supervisory practices, is essential for a homogeneous implementation of MiFID. This, in turn, is key to ensure that more contestability and competition lead to larger and deeper markets rather than more but less liquid ones.

The aim of this paper is not to offer a comprehensive description of MiFID, but to assess the directive and the dynamics it creates from a broader perspective, focusing on those aspects that carry relatively higher transformation potential. Although the full impact of MiFID on the architecture of the European financial market and the financial services industry will only become clearer over time, the paper suggests some outcomes and risks. It is organized as follows: Section II presents the main features of MiFID; Section III assesses the potential impact of MiFID on the architecture and on the functioning of European capital markets; Section IV highlights the challenges associated with the implementation of the Directive and suggests improvements to the existing regulatory framework; and Section V concludes.

II. Main Features of MiFID

The objective of MiFID is to foster the emergence of a single, more competitive, cross-border securities market across the EU. The Directive promotes, and often prescribes through detailed rules, European-wide legislative harmonization for key components of the provision of financial services along three central principles: increased competition, including across borders, on a level playing field; increased market efficiency; and better investor protection.[4] This combination is expected to encourage market intermediaries to

[4] Directive 2004/39/EC (2004); Commission Regulation (EC) 1287/2006 (2006); Commission Directive 2006/73/EC.

offer and investors to demand more financial services as well as to increase participation in (and therefore liquidity of) financial markets. More specifically, MiFID opens competition between trading venues and broadens and simplifies the use of the European passport for the provision of financial services across borders. Simultaneously, increased market transparency and best execution obligations aim at preserving market efficiency without weakening investor protection.

By suppressing the possibility for national authorities to impose an order concentration rule, MiFID aims at fostering competition for order execution among different trading venues. Some form of an order concentration rule has traditionally been in place in various European countries (e.g., France, Spain, Italy, Germany, the Netherlands, Denmark, and Finland). This requires that transactions be executed on a regulated market. While MiFID reaffirms the specific role played by regulated markets in listing securities and financial instruments, it authorizes two additional trading venues where orders can be executed in an organized manner: Multilateral Trading Facilities (MTFs) and "Systematic Internalizers" (SIs). MTFs (or Alternative Trading Systems (ATSs)) are electronic platforms that facilitate the execution of trades by matching clients' orders.[5] SIs are firms that execute client orders by dealing on their own account outside a regulated market or a MTF on an organized, systematic and frequent basis.[6]

With a view to increasing cross-border provision of financial services and fostering competition, the Directive broadens the reach of the European passport. While the cross-border provision of financial services has remained rather low until now, MiFID could prove to be a catalyst for cross-border integration in these areas, contributing to a quickening of the pace of de-segmentation of markets along the currently prevailing domestic lines. Under the passport framework, first introduced by the ISD, a firm licensed to provide financial services in its home country has the right to provide these same services throughout EU countries, without the need for an additional license. MiFID applies this approach to a broader range of financial instruments and significantly extends the list of financial services that can be "passported" across European countries.[7] For instance, operating a Multilateral Trading Facility is explicitly recognized as a passportable activity: from its home country, an MTF can therefore freely provide remote access facilities on the territory of any "host" country.

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[5] Various forms of ATSs exist, from order-driven systems as well as quote-driven or market-maker, systems, to bulletin boards and crossing systems. In Europe, MTFs have developed primarily in bond markets (e.g., Bondware, MTS and EuroMTS), and to a lesser extent in equity markets (e.g., Instinet, Tradelink). While most are focusing on wholesale market participants, some are accessible to retail investors.

[6] Article 4(1)(7), Directive 2004/39. To be considered systematic internalization, such activity must be carried out according to non-discretionary rules and procedures, have a material commercial role for the firm, and must be available to clients on a regular or continuous basis.

[7] See Appendix II for a list of passportable financial services and activities, and financial instruments covered by MiFID.

The provision of investment advice is similarly recognized as a stand alone "passportable" activity and so are a broader range of asset management activities. Moreover, with the aim of facilitating the use of the passport and the cross-border provision of services, MiFID establishes the principle of the exclusive application of home country regulation and rules out the possibility for host country regulators to impose additional requirements on foreign financial services providers. Branches of investment firms, however, are required to comply with host country regulation in specific areas (e.g., conduct of business, best execution, order execution, etc.) for activities conducted in the host country.[8]

To encourage investors and others to take advantage of the more level playing field, MiFID reinforces and harmonizes investor protection rules, in particular to the benefit of retail investors. Best execution is a key concept introduced by MiFID. The notion of executing trades in the "best interest of customers" was part of the ISD, but its implementation primarily focused on a narrower notion of best trading price. In contrast, the obligation of best execution refers to a broader range of quantitative (price and fees) and qualitative (speed of execution, likelihood of execution and settlement) factors and requires market intermediaries to seek the best overall conditions, considering the characteristics (size, nature) of the order received.[9] MiFID requires investment firms to establish and implement on a consistent basis a verifiable written order execution policy, to which clients have to give consent prior to starting business. This policy details how orders will be executed and the factors affecting the choice of the trading venues (Chart 1). In addition to best execution requirements, investor protection is organized through strengthened and harmonized client classification rules, marketing communication rules, and suitability and appropriateness ("Know Your Customer") principles. Rules, aimed at identifying and preventing conflicts of interest, preventing undue inducements, and strengthened reporting requirements also contribute to improved investor protection.

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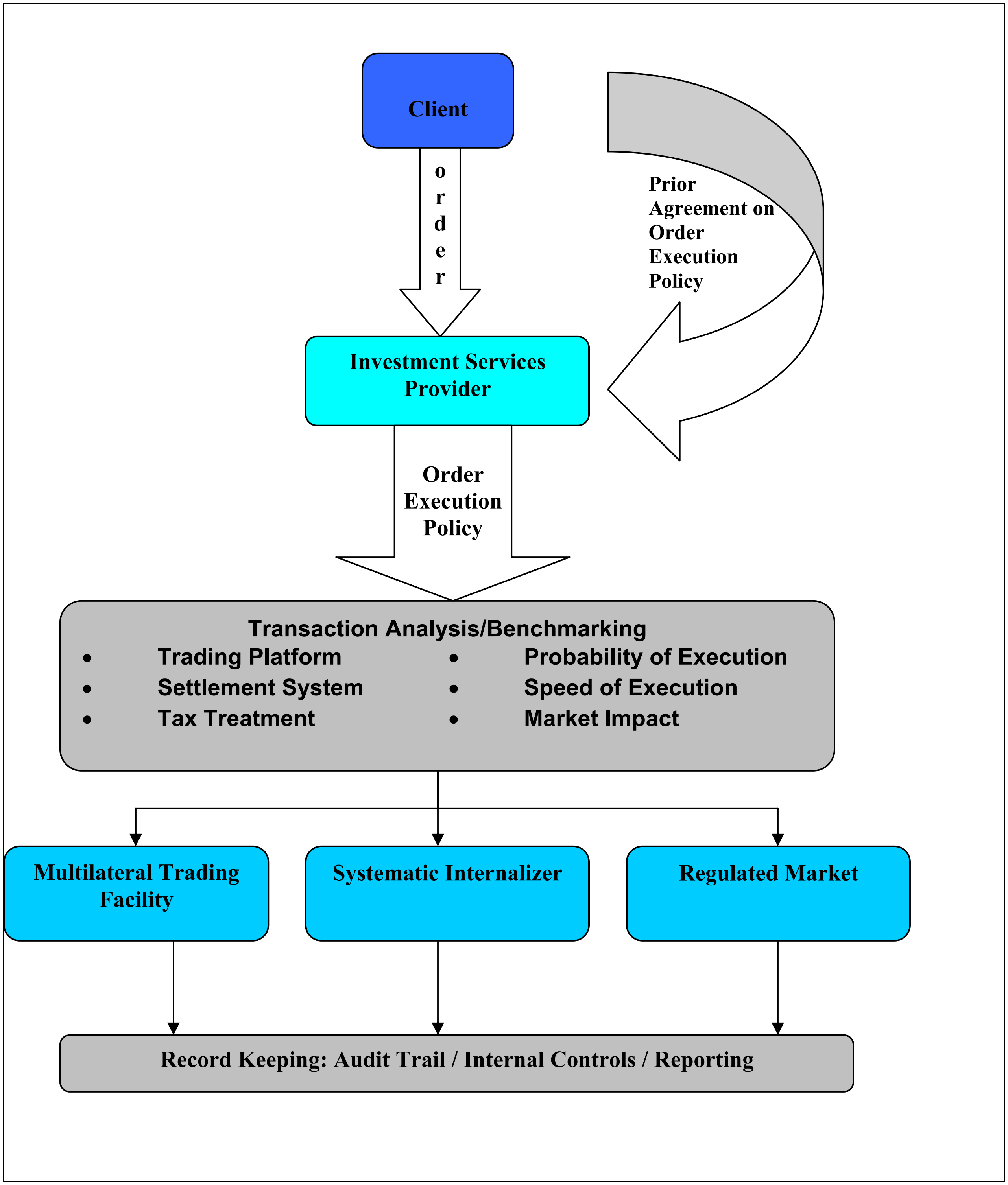
[8] For activities conducted in another Member State from a branch located in a host country, home country regulation applies. Home/host supervisory arrangements for branches, and in particular the organization of transaction reporting remain among the most contentious interpretative issues.

[9] Note that clearing and settlement costs are explicitly mentioned among execution costs that need to be considered. Mirroring this provision, the Directive stipulates that Member States cannot prevent investment firms, MTFs and regulated markets from using clearing and settlement systems located in other Member Sates.

Chart.1 Best Execution: A Synthetic View



The principle of best execution apply to all market intermediaries (irrespective of the trading venue used) and all financial instruments covered by MiFID. However, client categorization also determines the obligations of financial services providers under MiFID, in particular with regard to the "suitability" and the "appropriateness" of the services provided, and forms of communication to clients. For example, most best execution requirements benefit retail and "professional" clients, but do not apply to so-called "eligible counterparties."[10] However, eligible counterparties can always request to benefit from the level of protection granted to lower categories of clients. This is very likely to be the case whenever the final beneficiaries of the services provided by an eligible counterparty will be retail investors, such as investors in UCITS. The obligation of best execution also applies to portfolio managers, including managers of private investment pools such as hedge funds.[11] MiFID will provide a form of EU-wide regulatory harmonization, in particular regarding the provision of cross-border services. At the same time, investment firms distributing hedge funds will have to comply with MiFID's investor protection rules, in particular when seeking retail investor business.

Increased market transparency aims at guaranteeing that competition between trading venues does not lead to fragmented market liquidity and also contributes to better investor protection. Pre-trade transparency requirements (i.e., disclosure of current bid and offer prices, depth of trading interests at current prices, best bid and offer prices posted by market makers) apply to share transactions conducted on regulated markets, MTFs, or through SIs. They are particularly important to allow investors and other market participants to have a complete view of market conditions and to access trading venues where liquidity is superior. Combined with best execution obligations, pre-trade transparency is expected to ensure that increased competition between trading platforms does not result in liquidity fragmentation. Post-trade disclosure obligations require all market intermediaries to publish the details (i.e., price, volume, time) of share transactions they have undertaken. In fact, MiFID requires that transaction information be disclosed rapidly ("as far as possible in real time") after the trade is completed. However, exceptions can be granted by national authorities for large trades and block trades.[12]

Although the objective of MiFID is also to promote a homogeneous "rule book" for the provision of financial services throughout the EU, it does not impose an indiscriminate set of rules for all transactions. Compared with the ISD, MiFID covers a much broader set of financial instruments, and in particular derivative instruments, including "exotic" structures (see Appendix II). The requirements of the Directive vary with the instruments

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[10] "Professional clients" are investment firms, credit institutions, other large institutional investors and large undertakings. Among professional clients, the most sophisticated ones are considered (or can ask to be classified as) "eligible counterparties" and do not benefit from the protection afforded by the conduct of business rules.

[11] Although hedge funds in Europe have to comply with a set of EU regulations (Market abuse, Prospectus, Money laundering), hedge fund activities remain regulated primarily at the level of each Member State.

[12] Rather than being left to the discretion of national authorities, the definition of what constitutes a large trade and the permitted length of disclosure deferral are harmonized, and based on the average daily turnover in each share.

traded, the platform on which they are traded, and the quality of the clients, resulting in a complex web of rules and multiple requirements imposed on market intermediaries. For example, reflecting the riskier nature of their activity, Systematic Internalizers are subject to pre-trade transparency obligations only for equities listed on a regulated market, considered liquid in the sense of the Directive, for which the SI has chosen to make a market, and only up to a standard size.[13]

MiFID' transparency requirements do not apply to non-equity markets.[14] Following a heated debate on transparency in fixed-income markets and in particular the corporate bond market where "spontaneous" transparency is rather scarce, the European Commission recently confirmed that, in the absence of obvious "market failures", it did not intend to extend existing transparency requirements to these markets.[15] Concerns have been raised that transparency requirements would negatively impact liquidity and deter market participants from committing resources. Furthermore, it has been argued that, given the predominantly professional nature of these markets, there was little need for additional transparency. The US experience following the implementation of TRACE, calls into question the validity of such concerns.[16] While the introduction of TRACE is believed to be responsible for a sharp decline in the profitability of corporate bond trading desks, it did not result in a notable decline in market liquidity, and was accompanied by increased retail investor participation.

III. Potential Impact on European Capital Markets

The new environment created by MiFID could trigger drastic changes in the architecture of capital markets and in the organization of financial intermediation in Europe. Such changes could result from both the increased competition that MiFID unleashes and the technological challenges that the Directive represents. Both can be expected to affect all market intermediaries and financial services providers, to varying degrees. Broader passporting possibilities and the opening of trading venues to new actors are likely to foster competition for market shares in a large array of financial services, from trade execution to investment advice and asset management. Simultaneously, MiFID is a major technological challenge for financial services providers. They will have to accommodate stringent new trade transparency and trade reporting requirements. More

[13] Liquid shares in the sense of the directive are shares trading daily with a significant volume or turnover, and with a free float of Euro 500 million or more. Standard market sizes are derived from the average value of trades observed on the relevant market for each share.

[14] Member States have the option to extent and adapt this transparency regime to financial instruments other than equities.

[15] CESR (2007)

[16] TRACE (Trade Reporting And Compliance Engine) which was introduced in 2002 organizes real-time dissemination of transaction and price data on about 29,000 corporate bond issues (99 percent of the corporate bond universe).

generally, the more level the playing field, the more technology (i.e., the ability to offer a large range of services and innovate in a cost-effective way) will operate as a discriminating factor.

MiFID is both a business opportunity and a source of additional costs for financial intermediaries. The emergence of SIs is among the most novel and visible feature of MiFID. SIs can be viewed as in-house exchanges for shares in which they elect to undertake business. For market intermediaries, internalizing market activity (and liquidity) is, in theory, an appealing alternative to routing orders to external trading platforms. In practice, however, the costs of setting up the appropriate infrastructure represent a barrier to entry that only firms with sufficient volume of activity and appropriate technical resources will be able to cross. Similar constraints are likely to prevent small to medium-sized banks and investment service providers from taking full advantage of the broadening passporting possibilities offered by MiFID, whereas they may face increased competition in their domestic markets. In the same vein, MiFID is expected to result in a significant increase in data production and data processing by financial services providers. BearingPoint, a management and technology consultant, estimates that financial institutions should prepare for a fourfold increase in pre-trade data and a doubling of post-trade data, as a result of more frequent updating of prices by an increasing number of trading venues and the emergence of new data providers. [17] This technological challenge may also prove difficult to address for small to medium-sized market participants.

MiFID could therefore increase the polarization of the financial services industry in Europe. MiFID could threaten the integrated/cross-selling business model that remains prevalent in most Continental European countries, as cost consideration and best execution requirements may increase the pressure to outsource activities or rely on third-party providers. [18] This may be especially true in asset management activities and the distribution of investment products. Regarding the latter, MiFID is likely to accelerate the move from captive distribution networks to open distribution platforms. Ultimately, a possible outcome could be to widen the gap between the largest and the smallest market intermediaries, with the latter increasingly focusing on niche clientele and specific market segments. Such an outcome would not necessarily translate into less competition, which would limit the choice offered to investors, provided that it takes place in a post-MiFID context of more contestable markets. There might be fewer intermediaries overall but among them a larger group would compete more fiercely across borders, ultimately boosting market efficiency.

Stock markets in Europe differ significantly in size, a key factor that will shape their ability to compete in the new MiFID environment. Table 1 highlights both the fragmentation of the European landscape and the sheer differences in size between the well-established and increasingly global Western European stock markets and their more recent

[17] BearingPoint (2007); Lannoo (2007a)

[18] JPMorgan Chase (2006)

Central and Eastern European peers. An increasingly competitive environment is likely to raise the critical size needed for exchanges to attract and retain liquidity and to generate the resources required to invest in value-adding IT-intensive activities. Whether local stock markets in Central and Eastern Europe have the ability to develop on their own remains an open question. The largest issuers in the region may increasingly find it more efficient to list directly on the major international exchanges in order to secure access to international investors and to broader pools of liquidity.

Table 1. Capitalization of European Stock Markets at year-end 2006

	Capitalization (Euro millions)	Value of Share Trading (Euro millions)	Number of Listed Companies
London SE	2,877,605	5,742,376	3,256
Borsa Italiana	778,501	1,258,470	311
Euronext	2,812,261	3,047,592	1,210
Deutsche Boerse	1,241,963	2,164,848	760
BME Spanish SE	1,003,299	1,529,437	…
Swiss Exchange	919,414	1,059,131	348
OMX markets	851,460	1,010,469	791
Oslo Bors	212,284	307,818	229
Athens SE	157,941	85,333	290
Warsaw SE	148,775	55,702	265
Vienna SE	146,197	64,893	113
Irish SE	123,824	64,592	70
Luxembourg SE	60,303	209	260
Budapest SE	31,689	23,441	41
Ljubljana SE	11,513	1,554	100

Source: World Federation of Exchanges

Differences in revenue structures are also significant, reflecting the diversity of business models among European stock markets, (Table 2). Trading fees and market data gathering and dissemination are significant sources of revenue for most stock exchanges. They are the primary revenue sources exposed to increased competition, as MiFID requires that transaction details be made available to market participants "on a reasonable commercial basis, and in a manner which is accessible to other market participants".[19] They represent significant sources of revenue for most exchanges (with the exception of Deutsche Boerse), and are especially important for the London Stock Exchange and to a lesser extent, for the Spanish market and the OMX group.[20] LSE may be particularly exposed to increased competition as it lists a large number of the most liquid European shares, those that are most likely to attract renewed interest from SIs and MTFs. [21] However, the size of the London

[19] Bishop (2006)

[20] The LSE may be particularly exposed to increased competition as it lists a large number of the most liquid European shares, those that are most likely to attract renewed interest from SIs and MTFs.

[21] Lannoo (2007b)

market may also cushion it against the immediate impact of heightened fee competition. The same may not be true for the Spanish stock market. Furthermore, the Spanish, German, and Italian markets derive a substantial part of their revenue from in-house clearing, settlement, and custody activities, which are under increased pressure to open up to competition. As competition rises, it will be increasingly important for market intermediaries to be able to offer technology-intensive value added functionalities. At the moment, IT is a significant source of revenue only for OMX and, to a much lesser extent, Euronext.[22]

Table 2. Selected European Stock Markets- Sources of Revenues (end 2006, % of Total)

	London SE	Euronext	Deutsche Boerse	BME Spanish SE	OMX markets	Borsa Italiana
Listing	18.1	5	16.9	9	9.5	10.5
Trading	46.9	28.2		48.1	21.8	29.5
(o/w Fixed Income)		(2.2)		(2.2)		(10.4)
Derivatives	2.7	35.5	32.2	8.4	17.9	7.5
Post-Market activities*		1.3	37.8	21.7		35.7
Data Services	30.3	10.2	8	9.1	13.3	14.4
IT		16.7	5.1	3.7	33.7	0.8
Others	2.1	3			3.8	1.7
Total	100	100	100	100	100	100

* Clearing, Settlement, Custody.
Sources: Annual Reports, Author's Calculations.

Stock exchanges are already pressured by emerging competition from MTSs and SIs to capture liquidity. With the disappearance of the concentration rule and the end of regulated markets' monopoly on data provision, stock exchanges find themselves in a situation similar to that of the telecommunications operators on the eve of the liberalization in the 1990s. Competitive pressure is already building. In September 2006, a consortium of major investment banks announced the creation of their own market data service ("Project Boat"), to compete with similar services offered by stock markets.[23] Competition is also gathering momentum on the trading front, as illustrated by the emergence of MTFs such as "Chi-X" and "Project Turquoise", and on the clearing front.[24] The major regulated stock markets have

[22] OMX is a major supplier of financial market technology solutions to other stock exchanges.

[23] Citigroup, Credit Suisse, Deutsche Bank, Goldman Sachs, HSBC, Merrill Lynch, Morgan Stanley, UBS, and ABN-Amro, the initial promoters of Project Boat are estimated to account for about 50 percent of equity trading in Europe. They have recently been joined by Barclays Capital, BNP Paribas, Dresdner Kleinwort, JPMorgan, Chase, and Royal Bank of Scotland.

[24] Project Turquoise has been launched by some of the largest investment banks (Citigroup, Credit Suisse, Deutsche Bank, Goldman Sachs, Merrill Lynch, Morgan Stanley, and UBS), potentially themselves among the main SIs.

already started to reduce fees, ahead of the November MiFID deadline, while simultaneously widening the range of technology-intensive value-added services they offer. Order optimization, algorithm trading devices, transaction cost analysis and real-time data dissemination are examples of such services that are being given increased importance under MiFID).

MiFID is a strong additional incentive for market operators to consolidate or intensify cooperation. This is especially true for small and medium-sized markets (e.g., Vienna SE strategy relative to Central and Eastern European stock markets), but is also a valid approach for larger markets.[25] In the last two years, a number of significant transactions have already occurred, contributing to reshaping the European (and global) stock market landscape. OMX has rapidly increased its presence in the Nordic-Baltic region, and owns six out of the seven stock local exchanges. The Swedish market operator is now at the center of a bidding war between NASDAQ and Borse Dubai on the one hand, and the Qatar Investment Authority, also a major shareholder in the London Stock Exchange (LSE), on the other hand. In 2006, the NYSE and Euronext agreed to merge, creating the first transatlantic group of exchanges. In 2007, Deutsche Boerse's derivatives market Eurex acquired the U.S-based International Securities Exchange, and the LSE and Borsa Italiana agreed to merge.

There is a risk that more competition and transparency may lead to a fragmentation of market liquidity. This risk revolves around the extent to which the opening up of the execution and settlement of transactions, best execution requirements, and transparency rules will effectively compensate for the potentially centripetal effects of more fragmented market structures on market liquidity. The risk that increased transparency requirements will negatively impact the provision of liquidity by market intermediaries, in particular for second tier equities, is difficult to assess ahead of the effective implementation of MiFID, and will need to be monitored closely. Similarly, less constraining pre-trade transparency requirements for Systematic Internalizers may result in the emergence of pockets of opaqueness.[26] The predicted growth of so-called "dark pools" of liquidity in Europe (i.e., anonymous trading devices such as crossing networks which match orders off-market and are accessible only through electronic means) and the concomitant development of algorithm trading to track this hidden liquidity illustrate these concerns. Moreover, the ability of the many mechanisms to efficiently aggregate transaction data, a key component of the price formation mechanism, has not been fully tested. Ultimately, the extent to which fragmentation of liquidity presents a risk significantly hinges on the ability of supervisors to build and implement a common understanding of MiFID rules.

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[25] Wiener Boerse holds a minority stake in the Hungarian Stock Exchange, and has concluded cooperation agreements with eight other stock exchanges in Southeast Europe. Such cooperation agreements cover, for example, data dissemination, and the development and marketing of stock indices.

[26] D'Hondt, Giraud (2007)

IV. Implementation Challenges

The Market in Financial Instruments Directive is a far reaching and complex web of legislation, and its implementation requires sustained and concerted efforts by public authorities and market participants. The challenge of implementing MiFID will not stop when the Directive comes into force. Rather, November 2007 will be the starting point of a new challenge for European supervisors tasked with the responsibility of delivering consistent convergence of supervisory practices over time. This is essential to ensure that more competition comes with more liquid markets. In addition, monitoring tools will rapidly be required to assess the impact of MiFID over time and identify where corrective actions may be needed.

In the broader sense, MiFID comprises a "Lamfalussy Level 1" Directive, focusing on framework principles, complemented by technical implementation measures (Level 2 Directive and Regulation). The Regulation covers issues where a set of stand-alone, directly applicable implementing measures has been considered both legally possible and technically necessary to guarantee that MiFID can function uniformly in all EU financial markets. In contrast, in the transposition of the (principle-based) implementing directive, Member States have retained a limited ability to adapt MiFID provisions to their national legal system. Following the adoption of these texts, attention has progressively shifted to their transposition into national legislation and their implementation by national regulators. In the Lamfalussy framework, this crucial task is delegated to expert committees composed of national regulators. [27] The Committee of European Securities Regulators (CESR) is responsible for promoting a consistent and homogeneous day-to-day implementation of MiFID, by issuing guidelines and reviewing national regulatory practices.[28]

The first and most pressing challenge is for national authorities to meet the implementation deadline. Member States were required to transpose MiFID into their national legislation by the end of January 2007, a deadline effectively fulfilled by only two Member states. To allow market participants to put in place the practical arrangements required to be compliant with the directive and Member States to effectively transpose the directives, the application date of MiFID has been postponed until November 1, 2007. As of September 2007, fourteen countries (out of thirty EU Member States and EEA countries) had notified of the full transposition of *Level* 1 and 2 Directives into their national legislation. All but two countries were expecting to have completed the transposition process by the November 2007 deadline. Any further delay in the implementation of MiFID due to failure to resolve interpretative issues would send the wrong political signal and damage the credibility of the Lamfalussy framework. It would also entail significant opportunity costs and create potentially damaging legal uncertainty for market participants.

[27] See Appendix III for a description of the Lamfalussy framework and the Comitology procedure.

[28] CESR (2006)

Market participants appear unevenly prepared for the November deadline. Although assessing readiness is difficult, surveys have typically indicated that only a small number of market participants (i.e., the large banks and brokers, and the large stock exchanges) have a clear understanding of the full implications of MiFID for their own activities, and have taken the required actions. As the November deadline approaches, a number of market participants, however, appear still unprepared or unconcerned, due to a lack of knowledge or understanding, viewing the whole process largely as a compliance exercise.

The debate over transparency rules in non-equity markets is likely to resurface in the medium-term. Regarding bond markets, various forms and levels of transparency can be envisaged, and they can be adapted to the particularities of these markets.[29] Implementing and monitoring best execution requirements in these markets without some degree of post and pre-trade transparency is likely to prove particularly challenging. Furthermore, a situation where Member States retain full discretion regarding the transparency regime of fixed-income markets (and all non-equity markets for that matter) is difficult to reconcile with the overall harmonization objectives of MiFID, and is a source of additional implementation difficulties. Industry-led initiatives are currently being considered to address the issue of transparency in fixed-income markets, and European authorities need to encourage and closely monitor these developments. However, they also need to be ready to take the initiative should market participants fail to advance these issues. More generally, such work should not be limited to plain vanilla fixed-income products, but should also include cash and synthetic structured products.[30]

The nature and complexity of MiFID makes CESR's task in promoting the convergence of supervisory practices particularly challenging. MiFID combines both detailed and technical provisions and high-level principles. Their consistent implementation requires that securities regulators reach a common interpretation. However, experience has shown that the issues CESR has to deal with easily become "politically charged" rather than confined to a purely technical level. For instance, while progress has been made regarding the interpretation of the notion of best execution and its implementation in fixed-income and derivative markets, the supervision and reporting of cross-border securities transactions and the organization of home/host supervisory arrangements for branches have proved particularly contentious issues.

The debate on the implementation of MiFID boils down to the appropriate supervisory arrangements for European securities markets. The status and the decision-making process followed by CESR (and other Level 3 committees) compound the implementing difficulties caused by the complexity of MiFID. CESR operates within the boundaries of the

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[29] Casey (2006) and Dunne (2007) for a detailed discussion on bond market transparency.

[30] Structured financial products, such as Collateralized Debt/Loan Obligations (CDOs/CLOs) are excluded from MiFID provisions altogether, provided they are "customized" to the needs of a particular client.

"delegated mandate" from the Commission and the European Parliament but its members—national regulators/supervisors—are ultimately accountable to their national authorities, and this can cause serious tensions. The composition of the Committee and its consensual, non-binding approach has facilitated a common understanding of MiFID legislation among national regulators, thereby promoting a first level of regulatory convergence. The task will remain incomplete should these first steps not be followed by increased day-to-day convergence of supervisory practices and the development of a common supervisory culture and deeper cooperation among national supervisors.[31] Without such convergence, the risks of a "regulatory renationalization" are all the more real, as ultimately the logic of MiFID implies a move from rule-based to principle-based supervisory practices.[32]

The February 2006 report of the Financial Services Committee on financial supervision in the EU clearly emphasized that further steps were needed for European supervisory arrangements to keep up with market developments. To this end, the report listed a series of possible improvements within and outside the Lamfalussy framework. Some of these suggestions have started to be implemented and have contributed to increased supervisory convergence. For example, a review panel has been established within CESR, responsible for reviewing the implementation of EU legislation and CESR guidelines by national regulators. New supervisory tools include mediation mechanisms and updated data-sharing arrangements among CESR members. However, more needs to be done, in particular to foster the delegation of tasks and responsibilities among members.

Looking forward, significant benefits could be obtained by establishing more firmly the legitimacy of CESR within the current institutional framework and strengthening its ability to act as an autonomous entity in targeted areas. The recently published "final report of the Inter-Institutional Monitoring Group" offers a series of recommendations to improve the functioning of the Lamfalussy framework.[33] With regard to CESR and other Level 3 committees, the report acknowledges that further developments in the functioning of these committees, improvement in their performance and, possibly, new ways of working will be necessary to foster continued integration of European financial markets and changes in regulations. The report calls for the tools at the disposal of the Committees to be adapted to these challenges. In particular, Level 3 Committees need to be equipped with a clear mandate endorsed by EU political bodies. Similarly, national regulatory and supervisory agencies should be explicitly required to cooperate and support the EU convergence process. Furthermore, the report suggests that increased work effectiveness would result from

[31] These concerns are not limited to the implementation of MiFID, but also to other components of the Financial Services Action Plan. Similarly, they are not specific to CESR, but apply in similar terms to other Level 3 committees.

[32] This is illustrated for example by the implementation of best execution principle: the nature of the requirements (e.g., both an obligation of means and results) and the diversity of situations where the principle applies would make a rule-based approach impracticable.

[33] Inter-Institutional Monitoring Group (2007).

allowing Level 3 Committees to make more use of qualified majority votes. The report of the Inter-Institutional Monitoring Group is a very useful basis to start adapting Europe's regulatory and supervisory framework to the fast emerging reality of integrated financial markets. Harmonizing supervisors' enforcement processes and sanctions, promoting the use of delegation mechanisms among supervisors, although not explicitly mentioned in the report of the monitoring group, would also be significant steps toward a more efficient management of cross-border integration.

V. Conclusions

MiFID is a major upheaval of European capital markets and a high risk/high reward strategy relying on market efficiency. It is a powerful endeavor designed to lead the way toward seamless, more competitive and more efficient capital markets in Europe, starting with equity markets. However, it could also, in an extreme scenario, fuel market fragmentation. Key issues related to market functioning are, by definition, unanswerable at present, and will only unfold gradually. They relate primarily to the evolution of market liquidity, and the efficiency of price discovery mechanisms in the new MiFID environment: To what extent will best execution requirements and transparency rules, and their active enforcement by investors, effectively compensate the potentially centripetal effects of more fragmented market structures on market liquidity? In the same vein, the risk that increased transparency requirements will negatively impact the provision of liquidity by market intermediaries cannot be fully discarded. Similarly, the absence of pre-trade transparency requirements for systematic internalizers trading in "non-liquid" shares and for transactions above the standard market size may result in the emergence of pockets of opaqueness. The ability of market-led mechanisms to efficiently aggregate transaction data, a key component of the price formation mechanism, also remains an open question. Other major issues relate to investors' behavior and their capacity to effectively take advantage of a new environment of lower access costs and increased protection, and to the management of conflicts of interest by large investment banks managing MTFs or acting as systematic internalizers.

Whether MiFID proves successful will depend to a large extent on the ability of securities regulators to work together. Keeping at bay the risks of market fragmentation and allowing the full potential of MiFID to unroll hinges heavily upon the quality of cooperation among regulators and the effectiveness of the convergence of supervisory practices. The stakes are especially high, given the nature and complexity of MiFID. For MiFID to effectively be a milestone on the road toward an integrated, more innovative, and more efficient financial services industry in Europe, supervisory arrangements need to be equal to the task. Progress achieved in recent years shows that the Lamfalussy framework has been instrumental in fostering cooperation and convergence among national regulators/supervisors. But the limitations of the framework's existing structure have also been exposed. CESR, as a Level 3 committee, will have an increasing role to play in the years to come to breathe life into MiFID and other FSAP regulations. This responsibility needs to be reflected in the committee's status and mandate as well as in the mandate of national securities supervisors. Addressing existing or potential deficiencies in the supervisory organization is ultimately a political responsibility. The review of the

Lamfalussy framework is an opportunity to adjust Europe's existing supervisory architecture to the MiFID era, and send the appropriate signal to markets. This opportunity cannot be missed.

APPENDIX I

FSAP: Main Initiatives in Wholesale Financial Markets and Prudential Supervision

Themes	Content
Market Abuse	Harmonized rules on the prevention of insider dealing and market manipulation
Markets in Financial Instruments	Authorization and conduct of business of securities firms and exchanges
Prospectus	Single passport for issuers of equity and debt securities on the basis of the prospectus approved by the regulator of the issuer's country
Transparency	Financial reporting and dissemination of information by securities issuers
Accounting	Implementation of International Financial Reporting Standards (IFRS)
Regulation of UCITS Depositaries	Harmonization of national rules regarding depositaries of assets in UCITS, including depositaries' liability, the convergence of prudential requirements, transparency, and investor information
Implementation of UCITS Directives	Simplified prospectus; clarification on the use of derivatives instruments by UCITS, risk management standards and investor protection
Occupational Pension Funds	Guidance principles for asset allocation ("prudent person rule"), elimination of discriminatory tax provisions
Settlement Finality	Reduction of systemic risk in payment and securities settlement systems
Status of Collateral	Increased legal certainty regarding the validity and enforceability of collateral arrangements backing cross-border transactions
Cross-Border Mergers	Rules governing take-over bids and the protection of minority shareholders
Statutory Audit	Duties and responsibilities of statutory auditors; independence and ethics; criteria for national public oversight of the audit profession
Capital Framework for Banks and Investment Firms	Implementation of Basel II/CRD
Financial Conglomerates	Identification of "significant financial groups" and designation of a supervisory co-coordinator for each conglomerate
Reinsurance Supervision	Harmonization of supervisory methods, removal of the remaining barriers for intra-EU cross- border reinsurance, and increased protection of policy holders
Insurance Solvency	Creation of a consistent risk-based insurance solvency system (Solvency II)

Sources: IMF (2007)

APPENDIX II

Financial Services, Activities and Financial Instruments Covered by MiFID

Investment Services and Activities

- Reception and transmission of orders, and Execution of orders on behalf of clients
- Own account dealing
- Portfolio Management
- Investment Advice
- Underwriting and Placing of financial instruments
- Operation of Multilateral Trading Facilities

Ancillary Services

- Safekeeping and administration of financial instruments on the account of clients
- Granting credits or loans to investors in order for these clients to carry out transactions in financial instruments
- Advice to undertakings on capital structure, industrial strategy, advice and services related to mergers and acquisitions
- Foreign Exchange services connected to the provision of investment services
- Investment research and financial analysis, or other forms of general recommendation relating to transactions in financial instruments
- Services related to underwriting

Financial Instruments

- Transferable securities, Money-market instruments and Units in Collective Investment Undertakings (UCITS)
- Financial Derivatives (Options, futures, swaps, forward rate agreements and any other derivative contracts relating to securities, currencies, interest rates or yields, or other derivative instruments, financial indices or financial measures which may be settled physically or in cash).
- Physically-settled commodity derivatives traded on regulated exchanges or MTFs (Options, futures, swaps, forward rate agreements and any other derivative contracts relating to commodities that must or may be settled in cash).
- Credit Derivatives and Financial contracts for differences
- “Exotic” derivatives (i.e., relating to climatic variables, freight rates, emission allowances, inflation rates or other economic variables) that must or may settle in cash.

APPENDIX III

European Comitology and the Lamfalussy process

"Comitology" or "committee procedure" refers to the procedures under which the European Commission exercises the implementing powers conferred on it by European legislative bodies (i.e., the European Parliament and the Council).[34] So-called "Comitology committees" are created by the legislative branch to assist the Commission, and exist in nearly all important policy sectors. They are composed of Member State representatives. Draft implementing measures are submitted for opinion by the Commission to Comitology committees before adoption, and can be re-submitted to the Council for final decision in case of divergence between the Commission and the committee.

The Lamfalussy framework is the major vehicle for the design and implementation of the FSAP regulatory work. The objective is to speed up the legislative process, deliver more uniform and better technical regulation, and facilitate supervisory convergence.[35] The framework comprises four levels:

- Level 1: core principles of legislation, in the form of framework directives adopted by the European Council and the Parliament.

- Level 2: technical implementation of framework directives, by the Commission, on the basis of recommendations made by high level regulatory committees (Comitology committees), in consultation with Level 3 committees, users and experts from the industry.[36]

- Level 3: implementation of EU legislation at the national level, delegated to expert committees composed of national regulators.[37] Level 3 committees are responsible for supporting a consistent day-to-day implementation of EU legislation, by issuing guidelines and reviewing national regulatory practices.

- Level 4: compliance with and enforcement of legislation by Member States is mainly the responsibility of the European Commission.

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[34] Legal acts are regulations, directives or decisions which have a legal effect (direct or via transposition into national law by the Member States). These Legal acts are adopted by the legislative branch (The Council and the European Parliament), or the Commission, when it is entitled to adopt implementing measures.

[35] Initially limited to the securities markets, the Lamfalussy process was extended in November 2003 to the banking, insurance, and pension sectors as well as to the mutual funds industry.

[36] Level 2 Committees are the European Securities Committee (ESC), the European Banking Committee (EBC), and the European Insurance Committee (EIC).

[37] The Committee of European Securities Regulators (CSER), the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS), and the Committee of European Banking Supervisors (CEBS).

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