



## MiFID – Providing a Framework for Best Execution

The launch of the EMU has seen the emergence of an integrated and securitized financial system in Europe. Technological advancement and market growth created a wider range of financial products and services in addition to increasing cross-border trading and settlement activity.

The introduction of the euro produced a marked demand for foreign securities within the EU. However, transactions across members of the EU were hindered on account of a number of barriers, prominent among them being the national difference in market practices, legal systems and tax procedures, higher transaction costs for cross-border trading and settlement, inefficient regulatory systems, and inconsistencies in the treatment of similar businesses. The need to access multiple clearing and settlement systems coupled with the use of intermediaries increased the risks and costs for a cross-border investor. Consequently, the pattern of securities trading witnessed in Europe remained largely restricted to national lines. A major component of Europe's plans to transform into an economic powerhouse is to achieve a single, integrated financial market. Such a move would envisage a comprehensive restructuring of all financial market activities.

Now, with the planned integration of financial markets, Europe will see reduced capital costs, greater employment opportunities, and the elimination of regulatory and market barriers that encourage the free flow of finance within Europe. MiFID is one such directive in this direction. This paper explores the ramifications of MiFID in greater depth.

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MiFID forms one of the cornerstones of the EU's securities regulatory regime, and proposes to deliver an effective "single passport" that will allow investment firms and regulated markets to operate under a set of rules that will enhance investor protection across Europe. MiFID is being adopted using a legislative approach known as the "Lamfalussy Process".\*

Under Level 1 of MiFID, legislative acts concentrating on the core political principles of each directive or regulation were adopted in April 2004. In June 2004, the European Parliament authorised the Committee of European Securities Regulators to provide technical advice for Level 2 measures.

In February 2006, based on the advice from the Committee of European Securities Regulators (CESR) and industry representatives, the European Commission tabled formal draft Level 2 proposals on implementation measures and submitted them to the European Parliament and the European Securities Committee (ESC) for approval. Under Level 2, the European Commission, after consulting a new European Securities Committee (made up of representatives of the European Commission and member states), would request advice from the new ESC (with advisory functions) on the rapid and detailed implementation of Level 1 directives or regulations. Under Level 3, the European Securities Regulators Committee would work on joint interpretation and common standards in order to ensure consistent implementation and application of Level 1 and Level 2 legislation. Under Level 4, the European Commission would verify whether

member states were in compliance with the EU. MiFID contains 73 articles and applies to all investment firms and impacts nearly all asset classes. It would permit investment firms to operate throughout Europe on the basis of home country-supervision.

The directive lays down the standards expected of investment firms in various areas, which are:

- best execution
- investment advice
- business continuity
- classification, agreements, disclosures and reporting and asset protection for customers
- compliance obligations
- conflict of interests
- transaction reporting, derivatives trading, execution-only services
- information disclosure, internal systems, outsourcing
- pre- and post-trade transparency
- documentation

Initially, the provisions are applicable to only equities, with all asset classes likely to be brought under its coverage over a period of time. The provisions under the directive can be broadly classified under three areas.

#### **a) Managing and protecting clients**

Article 29, 30 and 31 prescribe that investment firms will have to provide their customers (and potential customers) with information specific to their firms, the services they provide, and the financial instruments that are the object of these services. Article 48 and 49 have

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specific provision relating to the fiduciary duty of investment firms to their clients concerning aggregation and allocation of orders and transactions.

Investment advice has been brought within the scope of the regulation. Therefore, firms have to undertake a suitability test to assess the appropriateness of the range of services, products or transactions offered to ensure that they meet all client needs. Investment firms have to notify customers about their re-classification into categories such as retail, professional and counterparty and, subsequently, inform them about the resultant impact of this classification. This categorisation is performed based on the level of the knowledge and sophistication of the client. In addition, investment firms are required to provide customers with:

- fair and proper information relating to the risks of investment services and products
- periodic reports, which could be daily, monthly or semi-annually, providing information on firm identification; trading day, time, and venue; nature of the order/ transaction, quantity and unit price; and, total consideration and details of commissions and expenses charged
- details of safe-keeping of funds and instruments belonging to customers and the resultant risks, including the extent to which any of these have been subject to securities financing transactions

Firms are required to prove having undertaken best execution on behalf of clients, and maintain detailed records supporting the same.

### b) Managing conflict of interests

The directive requires member firms to establish and implement a conflict of interest

policy, defining the circumstances that would constitute a conflict of interest for their various services, and describing any risk mitigation measures that would be adopted for managing the same. Investment firms would be required to:

- implement procedures to prevent or restrict exchange of information
- ensure segregation of activities
- enforce adequate supervision of relevant people
- put in place systems for the disclosure of conflict of interests to clients, especially, for those situations where measures adopted by the firm fail to prevent the risk of damage to clients

The directive has detailed provisions as regards investment research undertaken by investment firms, prohibition on personal transactions, nature of duties undertaken, acceptance of inducement or non-monetary benefits by financial analysts and relevant persons engaged in investment research.

### c) Delivering market integrity and transparency

MiFID will eliminate the concentration rules practised in certain EU member states (France, Italy and Spain), and ensure that investors and investment firms can undertake cross-border trading freely across EU member states in an efficient and cost-effective manner. It also brings within its ambit multilateral trading facilities like ECNs (Electronic Communication Networks) and ATs (Alternative Trading Systems), with a stipulation for publishing pre-trade bid/offer prices and post-trade details of transactions such as price, volume and time. Article 21 decrees the manner

in which client orders must be executed and mandates that investment firms establish and implement effective arrangements for complying with the provisions of the article. With stringent pre- and post-trade disclosures, MiFID requires systematic internalizers to publish firm pre-trade quotes and disseminate the same to the public on a regular and continuous basis, coupled with post-trade reporting of volume, price and time of trade, near to real-time.

Investment firms that need to satisfy the best execution requirement under the directive would now need to consider, among others, the following factors:

- speed of execution
- likelihood of execution and settlement
- size of the order
- nature of the order
- market impact costs
- opportunity costs (also referred to as implementation shortfall)
- timing

Investment firms need to ensure best execution for customers, keeping in mind customer characteristics, nature of orders, attributes of financial instruments and execution venues where the order can be directed, without discriminating between execution venues by structuring their commissions or charges.

Investment firms would have to undertake an annual review of the execution policy and their order execution arrangements and disclose the relative importance of factors that affect the quality of execution, such as details of execution venues, and any other information that they rely on to ensure best execution. With the multitude of execution venues available, firms will find this area a major challenge. It would place firms with the onerous task to define best execution policy for each client depending on various client characteristics

and the nature of the financial product to be transacted.

Investment firms under the directive would be required to store detailed price movements for each financial instrument from various execution venues, and provide a complete transaction cost analysis for each venue. Investment firms and asset management companies would need to procure data, or face a situation where an incomplete view of the market can impact their competitive strength, along with interconnected compliance issues. It is here that data vendors would play a significant role. It would necessitate that firms review existing IT systems and processes in the pre-trade and post-trade area apart from storing voluminous data that needs to be accessible at real time. Records have to be retained for a minimum period of five years with a provision for the firm to reconstitute each vital stage of transaction processing.

Investment firms would be required to maintain an effective and independent compliance function, an internal audit function, and establish a comprehensive risk management and outsourcing policy (where applicable) commensurate with the nature, scale and complexity of services and activities undertaken by the firm.

MiFID will impact the functioning of firms who are currently subject to the ISD. Some of these important entities include exchanges, multilateral trading facilities like ECNs and ATS, issuers, investment banks, portfolio managers, stock brokers and broker dealers, corporate finance firms, futures and options firms, commodities firms, firms operating collective investment schemes, hedge funds and private equity funds, occupational pension scheme firms, life companies and friendly

societies, financial advisers and authorised professional firms.

### Challenges Ahead

The implementation of MiFID poses serious challenges to both regulators as well as entities that need to comply. As far as the EC and CESR are concerned, the challenge lies in the uniform implementation of Level 3 across various member states and the coordination between 30 different regulators across multiple geographies. Data would have to be aggregated at various levels in the absence of uniform data standards and security identifiers. MiFID's stipulation on "best execution" throws up significant challenges for the sell-side, specifically, with respect to demands for increased data storage and bandwidth. In short, MiFID will bring about a complete change in market structure and pricing.

Under Level 4 of the Lamfalussy Committee Report, the EC would be required to monitor compliance of member states as regards implementation of the directive and initiate measures aimed at improving consistency in the implementation and execution of securities legislation across the EU. This would imply that investment firms and other entities, which flourished under the earlier national regime with concentration rules, would now be obliged to operate in a competitive landscape.

Data management, in terms of data consolidation, dissemination and publication, is likely to throw up a major challenge for execution venues such as regulated exchanges, multilateral trading facilities and systematic internalizers.

The provisions relating to best execution could also see an increased use of algorithmic trading in Europe, thereby ushering in real-time, multi-

asset class, low-latency, and non-stop trading across multiple execution venues. The level and complexity of IT systems needed to support best execution and transaction reporting requirements would be considerably high.

Nearly 45 percent of records pertaining to trade data used across the front, middle and back office would now be influenced by the increase in cross-border trading due to MiFID. Managing reference data will prove to be an additional challenge.

Some of the industry initiatives in this regard include the formation of a MiFID Joint Working Group by four major industry associations to identify compliance requirements and the need for new standards.

MiFID would also force securities firms to re-engineer and realign their business processes. Realigning systems would impact operational procedures, some of which may need modification. Given this scenario, firms need to draw up plans on how to achieve compliance by the prescribed deadline. MiFID opens immense business opportunities for investment firms for the development of new and innovative products and services for an EU-wide market.

It looks like securities firms across Europe will be burning the midnight oil for months to come. And, the reason for that would be, henceforth, the "Investor is going to be King".

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\* The "Lamfalussy Committee" was appointed in July 2000 to identify administrative, regulatory, and other types of obstacles that impede trans-border securities transactions and suggest suitable measures to remedy the situation and meet the objectives of FSAP. The committee submitted its report proposing a four-level approach for the regulation of the European Securities Market. The report also led to the creation of the Committee of European Securities Regulators (CESR), which is now empowered to speed up the adoption of common rules for the working of the securities markets. Over 42 new directives are likely to be implemented till 2008, and almost all of them have an impact on investment firms.



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July, 2006

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