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"MiFID the Era for Powerful Investor Protection in a Better Integrated EU Financial Services Market"

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ABBREVIATION TABLE

ATS:	Alternative Trading Systems
CESR:	Committee of European Securities Regulators
COB:	Conduct of Business Rules
EU:	European Union
ECCP:	European Central Counterparty Limited
EEA:	European Economic Area
FSAP:	Financial Services Action Plan
ISD:	Investment Services Directive
LSE:	London Stock Exchange
MiFID:	Market in Financial Instruments Directive
MTF:	Multilateral Trading Facility
SI:	Systematic Internalisers
SME:	Small and Medium Size Investment Firm
OTC:	Over the Counter

INTRODUCTION

There is a consensus that despite considerable progress is achieved towards a single market for wholesale financial services market with European service providers, institutional investors and large undertakings operate on a pan-European scale, retail financial markets remain fragmented and lag behind. This lack of integration is explained by a range of factors like language and cultural preferences however the true causes of continuing fragmentation between member states are reasonably attributable to the divergence of national systems of financial regulation and consumer protection. In this respect to overcome this major problem an important regulatory move is undertaken by the European Commission.

As of November 1, 2007, Markets in Financial Instruments Directive (MiFID) 2004/39/EC took effect in European Economic Area and well before that time it has created intense debate in European financial circles. The reasons for that tension were various. First and foremost, the MiFID's coverage is wider than the Investment Services Directive 93/6/EC it replaces. The scope is wider in terms of its extended "investment services" and "financial instruments" definition which are central determining the effect of the provisions. Briefly, the definition of investment service covers MiFID financial instruments related services only and activities with regards to non-MiFID instruments fall outside the scope of what constitutes an investment service. The Directive is applicable for banks, brokers and exchanges and all types of other financial services firms across Europe dealing with financial instruments. According to the recent statistical data in European Financial Integration Report 2007 EU 25 is home to around 8500 credit institutions there are many more investment intermediaries therefore, financial intermediation is a vital economic sector in its own right in Europe however it is argued that the true meaning of the financial sector simply lies less in its own size or in its direct participation in the GDP than its role in the financing of the real (commercial and industrial) sectors. In this context as the cornerstone legislation for harmonization of intermediation services or financial instruments trading, what MiFID regulates or introduces for the markets had far reaching effects. In addition, MiFID has introduced some contentious issues such as removal of concentration rule which has the potential of changing the landscape for securities trading in established exchanges. Moreover it sets forth an ambitious investor protection measure called “best execution” principle for investment firms in order to achieve the best possible price and using the most efficient, cost-effective clearing and settlement systems.

As can be inferred from the Recitals of the Directive, MiFID’s main goals are investor protection, harmonization of securities trading, enhancing competition by removing stock market monopolies and help firms operate cross-border across the European Union.

This dissertation notably focuses on the investor protection motive and better integration of EU financial services aspect of the MiFID. Nevertheless as will be discussed in its relevant chapters the Directive links some of its investor protection provisions with markets and transparency rules for this reason these concepts are also touched upon to grasp the overall effect of the Directive. In this regard, apart from dealing with the investor protection regime of the MiFID, the EU financial integration is dealt with in a historical setting with reference to the European Commission’s 1985 White Paper and Financial Services Action Plan. The reason for reference to the latter notably due to the fact that MiFID was central for delivering the further integration and more competition aims of the FSAP. Besides, in order to understand the main goals, novelties and its investor protection measures of the MIFID, Investment Services Directive is also assessed with its themes and shortcomings. Finally, for figuring out the MiFID investor protection context, Art.19, 21 and 22 are reviewed. Within this framework, common conduct of business obligations is stipulated for the investment firms. These obligations include extensive “information requirements” meant for investor monitoring for the intermediaries activities. “Suitability and appropriateness tests” for non execution only services which place intermediaries under high duty of care obligations. “Best execution” rule intended for ensuring the best possible deals in financial instruments dealing on and off exchange markets. This review is broadly meant for clarifying the subject matter and we will try to illustrate why these rules are introduced and whether they serve to the objective of the Directive.

Before starting with the historical background that leads to the introduction of the MiFID, we would like to underline the more recent background. This covers the Commission’s view as the owner of this regulatory initiative, perceptions of some commentators from the financial services industry and we would like to state our criticism for the Directive.

According to Internal Market Commissioner Charlie McCreevy, in the MiFID world financial services firms will be able to deal in a wide variety of financial instruments and undertake investment services right across the EU. This will be possible on the basis of a single passport and under the control of a single regulator- that of their "home" member state. Post MiFID there will be no more monopolies of exchange for trading of securities and this will lead to a significant increase in competition both across borders and domestically between the Exchanges and other trading venues. As exemplified above, generally Commission refers to MiFID as instrumental for increasing investor protection, widening choice, reducing the cost of capital, creating growth, and enhancing Europe's competitiveness by transforming the landscape for the trading of securities in a more competitive and efficient financial markets settings. They deem recent initiatives in the area of trade reporting and market data dissemination by investment firms and the recent wave of possible transatlantic stock exchange mergers to some extent a preparation for the post-MiFID regulatory environment.

Despite enhancing investor protection and competition between trading venues has been two core themes, equally important for delivering the Directive's goals the latter has been a much more disputed issue. This is mostly because investor protection is highly intangible in nature but competition in securities trading has immediate commercial outcomes. Due to the developments already observed in trading venues some commentators argue that this Directive would be a new "Big Bang" for financial markets and some predicted it as a financial revolution.

As with criticism to the Directive; MiFID's investor protection measures are grounded by extensive disclosure of information to investors assuming that this information will empower them against risks or to make better decisions on how to structure their portfolio. On the other hand, this assumption is highly reliant that investors are financially capable to digest this information. Therefore, promotion of investor education is essential to accomplish Directive's goal since less sophisticated clients compared to professional clients will be ignorant of MiFID's measures and gain no benefit.

Although MiFID requires high level of harmonization of rules to address the fragmentation of financial markets, the implementation of these rules in member states would be through Directives and regulatory supervision will be carried out by 30 separate competent authorities therefore, the fragmentation risk still exists in spite of the provisions for strengthened supervisory cooperation.

MiFID’s aim to enhance competition among investment firms and in securities trading may not work in favor of small and medium sized intermediary firms. Due to the fact that best execution provisions require tapping the best possible deals, middle-market financial firms may find it hard to compete on price with big investment banks offering securities trading across asset classes. Also the volume and detail of new legislation will result as heavier compliance cost i.e. carrying out information requirements, client classification and suitability test. This poses another challenge for these firms to endure. Even though this may cause an oligopoly market, at the end of the day it can still be the investors` gain that they can access more competitive prices.

I. HISTORICAL BACKGROUND

Investor protection and the integrity and stability of the marketplace are traditionally conceived as the main motives of regulating investment services and securities markets. The intensity of regulation is reliant upon factors such as: market structures; investor profiles; the maturity of the marketplace; saving patterns; and cultural attitudes towards regulation. Uniform rules promote investor confidence and increase the level of investor protection. By allowing the stability and efficient functioning in the integrated marketplace this in turn escalates the likelihood of cross-border investment.[1]

In economic terms it is argued that the policy of promoting an integrated financial market stands on the suggestion of significant connection between financial market development and economic growth. These suggestions have been supported by the Articles 49 and 56 of the Treaty of Rome[2], establishing the European Community prescribing free movement of services and of capital are two of the four freedoms. Furthermore, the EU's Lisbon strategy[3] has also underlined the economic benefits of a European integrated financial market back by providing the Union more effective policies and laying down an appropriate framework within which to develop them.[4]

The Commission's 1985 White Paper[5] and the adoption of the Single European Act in 1987 are considered to be reforming instruments serving the process of financial integration and liberalization and demonstrating a strong commitment to the creation of "an area without internal frontiers" in which the free movement of goods, services and capital is ensured in accordance with the provision of the EC Treaty. An integrated financial sector was a crucial part of this project.[6] On the whole, this project was a success meeting the target date of 1992 and putting an EU regulatory framework for

[1] Chalmers, D., Hadjiemmanuil, C., Monti, G., Tomkins, A. (2006) *European Union Law:* Cambridge University Press p. 786

[2] On 25th March 1957, two treaties were signed in Rome that gave birth to the European Economic Community (EEC) and to European Atomic Energy Community (Euratom): the Treaties of Rome. The signatories of the historic agreement were France, Netherlands, Belgium, Luxemburg, Italy and the Federal Republic of Germany.

[3] During the meeting of the European Council in Lisbon in March 2000, the Heads of State or Government launched a "Lisbon Strategy" aimed at making the EU the most competitive economy in the world and achieving full employment by 2010. This strategy, developed at subsequent meetings of the European Council and rests on economic, social and environmental pillars.

[4] Aubry, N., McKee, M. MiFID: Where did it come from, where is it taking us? Journal of International Banking Law and Regulation, 2007, 22(4), 177-186, p.5

[5] Completing the Internal Market : White Paper from the Commission to the European Council Milan, 28-29 June 1985), COM (85) 310, 14.6.1985.

[6] Chalmers, D., Hadjiemmanuil, C., Monti, G., Tomkins, A. (2006) *European Union Law:* Cambridge University Press p. 788.

securities markets and financial services was in place. However, particularly for securities markets, where the experience of the EU member states was limited, this framework was not as well developed and obstacles to the provision of cross-border financial services remained.

There are numerous factors that explain the shortcomings of the single market approach and fragmented nature of EU capital markets. The lack of integration is connected to cultural or historical preferences, which manifests itself in the choice of the preferred channel of intermediation (UK market vs. Germany bank finance), the differing clearing and settlement market structures, which increases the cost of cross-border trading, and the diversity of legal traditions reflected in approaches to matters such as collateral, bankruptcy and tax regimes. Furthermore, restrictions imposed by the member states on the asset choice of pension funds also affects the integration of markets and play a major role in creating obstacles to integration. Regulatory obstacles may be considered as another underlying barrier to integration. In certain areas, EU-level legislation is missing or legislation may be in place, but it is indistinct and offers too much discretion to the member states in implementation. Notoriously legislation may be improperly transposed or the Commission may be slow in enforcing it. In addition, owing to the constantly evolving nature of financial markets legislation which is too detailed rapidly becomes outdated presenting severe problems for securities markets. Due to the recent emergence of securities markets, which were until recently largely state-controlled in many member states, unlike in the area of banking, the European Commission was not so strict in enforcing the harmonization requirements and lacked experience in dealing with these markets.

The introduction of the euro in 1999 presented a real opportunity in the fragmented setting of the EU financial services markets, being a financial tool with the capacity to keep, the cost of capital and financial intermediation to a minimum. At the same time, realizing the full gains from a single currency was also dependent on a fully integrated financial market. Therefore, the EU initiated two proposals to update the regulation in place and reform the regulatory processes and structures governing the enactment of financial regulation at the EU level. [7]

[7] Lannoo, K. and Levin, M. Securities Market Regulation in the EU, Everything You Always Wanted to Know about the Lamfalussy Procedure, p.10. CEPS Research Report in finance and banking, No. 33 May 2004.

More specifically, the launch of the euro produced a move towards greater investment in equities and the delivery of a genuinely pan-European bond market. On the other hand, as from the 1990s the business background was affected by globalization and technological innovation that resulted huge transformation and expansion of markets, In more concrete terms, globalization created the internationalization of financial portfolios and the placement of terminals of EU exchanges in the United States for both equities (such as virt-x) and derivatives (such as LIFFE, EUREX). New technologies made it easy for capital, and those who need it, to go to the lowest cost centre. The nature of the markets was fundamentally modified especially in relation to the ways in which investors, intermediaries and markets organize and interact with each other.[8]

Against this background, the European Commission prepared the Financial Services Action Plan (FSAP) as a response to a request made by the Cardiff European Council in June 1998. The objective of this plan was to correct the regulatory problems mentioned above and to ensure that the financial services sector in the EU realized its full potential, particularly with the launch of the euro.

One of the areas that the FSAP deals with is the establishment of a common legal framework for integrated securities and derivatives markets. In this regard, one of the Commission's intentions was to determine the most convenient legislative and non-legislative means of improving the Investment Services Directive (ISD), primarily with respect to national conduct of business rules. MiFID's[9] history begins with the reforming attempts of ISD and develops this further as becomes a major part of the FSAP, for creating a pan-European capital market.[10]

1. Financial Services Action Plan (FSAP)

The overall objective of the Action Plan was to create a single market in financial services in Europe by 2005. In order to fulfill this objective it was realized that the EU’s legislation had to be updated, widened and deepened and the legislative process had to be speeded up. Therefore, after the publication of the FSAP the Commission set out a framework for the reform of existing legislation, and the enactment of new legislation in

[8] Aubry, N., McKee, M. MiFID: Where did it come from, where is it taking us? Journal of International Banking Law and Regulation, 2007, 22(4), 177-186, p.2.
[9] Directive 2004/39/EC on Markets in Financial Instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC published in Official Jornal of the European Union in 30.04.2004.
[10] http://www.fsa.gov.uk/Pages/About/What/International/mifid/background/index.shtml

the areas which had not been included in the previous harmonization attempts. EC legislation, particularly in the areas of market abuse, investment firm-retail customer relations, operation of licensed financial exchanges and of Alternative Trading Systems (ATS) which have been enacted in the context of FSAP, deviates completely from the principle of minimum harmonization and creates self-standing pan-European regulatory regimes.

The main regulatory themes focused in the FSAP include the implementation of the measures regarding the new Capital Requirements Directive which implements the Basel II framework in the European Union, and MiFID, aimed at reinforcing competition between investment services providers and enhancing investor protection. Alongside this are the regulation introducing International Financial Reporting Standards; the Market Abuse Directive, the Prospectus Directive; the Transparency Directive, to deal with financial reporting requirements, disclosure of interests in securities, and communications with holders of shares and debt securities and the market.[11]

The FSAP proposed 42 legislative initiatives in four key areas such as “wholesale finance”, “retail finance”, “financial supervision” and “linked areas”. With respect to wholesale finance, the launch of the euro created far-reaching change in EU wholesale markets. Indeed, 19 of the FSAP’s proposals are concentrated in this area. The Commission has proposed new legislation concerning the regulation of securities markets and broker/dealers (ISD II), a new market abuse and insider trading directive, an extended prospectus directive and a directive on regular and ad-hoc reporting requirements. In terms of retail finance area, where ‘open and secure’ retail markets are the primary goal, 9 measures were initiated in order to create clear and transparent information and to define redress procedures. These measures aim to ensure a high level of consumer protection while avoiding opening the door to protectionism.

In the linked areas, the Commission has proposed the phasing out of harmful tax competition, the creation of a common approach to the taxation of savings income and the greater uniformity in the member states of processes of corporate governance. Variation in corporate taxes and taxes on savings income, and differences in corporate governance rules, such as shareholders’ rights, are deemed to create additional uncertainty to cross-

[11] Avgouleas, E. “EC Securities Regulation, A Single Regime for an Integrated Securities Market: Harmonised We Stand, Harmonised We Fail? Part 1”, of Journal of International Banking Law and Regulation 2007, 22(2), 79-87 p.2.

border activity and to lead to distortions to the development of a single capital market.[12]

In order to accelerate the integration of wholesale financial markets the FSAP has been used as the main means. In terms of integration of the corporate bond and equity market, although a relatively high level is accomplished over the past years, full potential has not been achieved yet. Being one of the last elements of the FSAP regulatory framework, the MiFID is meant to bring competition, remove some barriers to integration and provide incentives for innovation in the EU capital markets.[13]

2. The Lamfalussy Approach

After the adoption of the FSAP in 1999, an extensive reform of capital markets' regulation was carried out in the EU. In the post-FSAP regime, EU now regulates, rather than supports the construction of the single capital and investment services market. This new massive body of legislation was enacted under the remarkable influence of the Lamfalussy legislative model for delegated law-making. This legislative model means that capital market rules are now adopted in the form of principles-based "level 1" measures adopted under normal inter-institutional procedures, and detailed "level 2" rules adopted by the Commission advised by the Committee of European Securities Regulators (CESR) and supervised by European Securities Committee (ESC).[14]

The "Lamfalussy legislative model-approach" is devised by a Committee of Wise Men appointed by the French Presidency in July 2000 in order to improve the effectiveness of the EU's securities market regulatory process. The Committee was chaired by Alexandre Lamfalussy with the task of drafting proposals under a new four-level legislative process, in which significant powers are delegated to implementing committees.

The reasons behind this move can be explained as follows. "Mutual recognition"[15], "minimal harmonization" and "home country control" are the underlying principles that form the EU's single market framework. However, in time, as the single

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[12] Aubry, N., McKee, M. MiFID: Where did it come from, where is it taking us? Journal of International Banking Law and Regulation, 2007, 22(4), 177-186, p.3.

[13] European Financial Integration Report 2007, Brussels, 10.12.2007 SEC(2007) 1696 Commission Staff Working Document, p.42.

[14] Moloney, N. (2006) *Effective Policy Design for the Retail Investment Services Market in* Investor Protection in Europe *Corporate Law Making, the MiFID and Beyond:* Oxford University Press, p.381.

[15] Mutual recognition which is a critical concept on the functioning of the EU financial services market is meant for preventing the host State from applying its rules to a service that is already subject to the rules of another jurisdiction so that the provider is subject to a single set of national rules, although he operates in several jurisdictions.

market became more integrated, a process of further harmonization and centralization has developed. This being the case, member states and the European Parliament are demanding more control over EU decision-making. Moreover, in the area of securities markets and financial markets in general, a specific problem has emerged with respect to adapting legislation swiftly to market developments, while respecting the fundamental principles of democratic institutions. The "Lamfalussy approach" can be said to solve the abovementioned problems by allowing the EU to enact laws reflecting general principles of regulation, with details being left to implementing committees.[16]

On the other hand, the "Lamfalussy legislative model-approach" can be evaluated as an attempt to support the Action Plan, in an attempt to make the European decision-making and regulatory structures for the securities markets more rational and efficient. Owing to the new delegated law making structure, most of the necessary rules outlined in the FSAP been agreed on time and are now being put in place. Lamfalussy in separating "principle" from "detail" in European securities laws minimizes room for ambiguity in primary legislation and allowing technical rules to flow from the underlying principles. It aims not only at speed, but also at quality, flexibility, consistency, involvement of expertise, transparency and efficiency. To achieve these targets, some instruments and institutions were set out. A public consultation tool to be carried out with all interested parties is established as the guarantee of the quality and proportionality of each level of rule-setting. In addition, the creation of a Committee of European Securities Regulators (CESR), made up of each member state's securities regulator, was instrumental in ensuring greater co-ordination and trust among regulators, implementing the rules and better enforcement of the rules once adopted.

MIFID was one of the first pieces of legislation in which the new "Lamfalussy approach" was applied. In addition to the main MiFID directive (at "level 1") there would be additional "implementing measures" in the form of secondary legislation (at "level 2") to fill in necessary detail.[17] Despite the fact that the Lamfalussy approach has received political acceptance, and has spread to other areas of market regulation such as banking and insurance, it is criticized for its the ambiguity in deciding what is principle and what is detail in regulation, and for the tendency towards further centralization of

[16]Lannoo, K. and Levin, M. Securities Market Regulation in the EU, Everything You Always Wanted to Know about the Lamfalussy Procedure, p.22. CEPS Research Report in finance and banking, No. 33 May 2004.

[17] Aubry, N., McKee, M. MiFID: Where did it come from, where is it taking us? Journal of International Banking Law and Regulation, 2007, 22(4), 177-186, p.4.

regulation and supervision in its determination of the interaction between democratic accountability and decision-making efficiency. To date, as the EU's financial markets to continue to successfully develop, there has been a consensus allowing further strengthening of the centre.[18]

3. The Investment Services Directive Regime

Adopted in 1993, for the first time at the EU level, the ISD provided a legislative framework for investment firms and securities market in the EU. It applies to all investment firms in the field of investment services so far as securities and money market instruments are concerned. This framework was meant to liberalize the provision of investment services in the Community. Due to the very significant differences between national securities markets, development has been long and politically controversial.

3.1. The Main ISD Principles

The core concepts of the Directive include: a single passport for investment intermediaries; harmonisation of some aspects of exchange law; the definition of regulated markets[19]; minimum standards for post trade transparency; the concentration rule[20] and investor protection provisions, which were in embryonic, developing form.[21] More specifically, the ISD introduces a list of the investment services and instruments and also imposes operating conditions reliant on so called capacity criteria. This seeks to that a firm is sufficiently funded and that staff are qualified, of "sufficiently good repute", and appropriately organized to deliver the services. Furthermore, the ISD imposed a new code of conduct rules in the form of high level requirements which member states could supplement with other requirements.

The most important principle of this Directive was to allow, for the first time, European investment firms, active in the field of securities, to operate across Europe with a single authorization for investment firms in their member state. In other words, this significant right, referred as the European passport, means that, member states must

[18] Lannoo, K. and Levin, M. Securities Market Regulation in the EU, Everything You Always Wanted to Know about the Lamfalussy Procedure, p.22. CEPS Research Report in finance and banking, No. 33 May 2004.

[19] Regulated market is a market place, trading system or exchange which meets the minimum EU standards under MiFID it means bringing together of multiple third-party buying and selling interests in financial instruments in the system and in accordance with its nondiscretionary rules.

[20] Under certain circumstances, a member state may require that the transactions connected with investment services be carried out on an organized market (known as *obligation of order concentration* applicable within certain Member States such as, France, Italy or Spain.)

[21] Moloney, N. (2006) *Effective Policy Design for the Retail Investment Services Market in* Investor Protection in Europe *Corporate Law Making, the MiFID and Beyond:* Oxford University Press, p.387.

permit investment firms from other member states to carry out in their territory the activities authorized by the home country without the need for further, local regulatory approvals. This may be done either by establishing a branch or providing services without a branch. To create an integrated pan-European financial market in which investment firms could operate freely and seamlessly, unimpeded by national boundaries, the passport concept was considered to be essential.

Another significant principle that shaped the securities trading environment in the EU was the concentration rule. Given the significant differences between national securities markets structures, the ISD granted the option of using either model-concentration (concentrated equities trading in one venue--the national stock exchange or bourse such as France, Italy and Spain) or competition (a degree of competition between trading venues such as United Kingdom and Germany).[22]

Common "conduct of business rules" were specified in Art.11 for firms undertaking cross-border business. The conduct of business rules were laid out in high level terms to allow Member States to supplement these with other requirements. Also, by the virtue of Article 11(2), it was possible for national authorities to apply their own conduct of business rules on the grounds of protecting the public interest ("general good"). National authorities have implemented this provision in different ways. This has inevitably led to overlapping and sometimes conflicting legislation at national level, which in turn generated legal uncertainty and significantly increased costs for investment service providers and their clients. It also made it difficult for investment service providers to have access to, or to compete effectively within, the framework of other member states' "regulated markets".

Following more than a decade of the implementation of the ISD, markets were heavily fragmented at all levels (exchanges, intermediaries, buy-side) and it remained fairly difficult for any professional or retail client to tap into what could be a single pool of liquidity in a transparent, simple and cost efficient way. Consequently, the state of a European capital market was still a long way from realizing the potential benefits of the single market in financial services.[23] Given that the ISD did not deliver a strong impetus towards European integration of securities markets and under the pressures that arose from the introduction of the euro, globalization and technological advances in

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[22] Giraud, J. R. and D'Hondt, C. (2006) MiFID, Convergence towards a unified European Capital Markets Industry by 2006 Risk Books, p.4-9.
[23] Aubry, N., McKee, M. MiFID: Where did it come from, where is it taking us? Journal of International Banking Law and Regulation, 2007, 22(4), 177-186, p.5.

financial services, the European Commission found it necessary to publish a communication called “upgrading the ISD”.

3.2. The Reasons for Updating the ISD

The main shortcomings of the ISD regime can be summarized as insufficient harmonization of national prudential regulation and of conduct of business regimes (COB) together with a failure to address market developments like the emergence of alternative trading venues and internalization practice. In addition, the ISD did not cover the provision of investment advice, dealing in commodity derivatives and the production and dissemination of investment research. Models of regulatory co-operation were designed for an era when linkages between national financial markets were not intensively in use therefore, the ISD did not provide a clear allocation of supervisory and enforcement responsibilities between national regulatory authorities within the European Union.

As the ISD regime lacked a uniform COB, it was recognized that the development of a single market for transactions in financial instruments was being deterred by individual member state regulations on firms, especially in relation to conduct of business and organisational requirements. In consequence, to compensate this failure, MiFID sets out a series of rules for firms in this area, providing that once the relevant requirements are met, a firm move under the passport into other member states and provide services and activities without further restrictions.[24]

The second main weakness was the lack of a regulatory setting for ATS and the execution of client orders internally (“off exchange”) by investment firms and banks, by either matching them “in house” with another client order, or executing them against a proprietary position[25]. The traditional regulatory model, on which the ISD was based, made a clear distinction between the functions of a market intermediary and those of a marketplace. This division could no longer be made due to the strong competition between different methods of trade execution: exchanges, new trading systems, and in-

[24] The Benefits of MiFID Report for the Financial Services Authority by Europe Economics Accessed from http://www.fsa.gov.uk/pubs/international/mifid_impact.pdf

[25] Proprietary Dealing, commercial situations, 1. The broker dealer sells its own instruments to or buys for its own account from, the client even though the sales desk dealing with the client is separate from the trading desk. This includes a riskless principal transaction (where the firm buys as principal from one client and immediately sells to another.) 2. Underwriting/buying a new issue of securities and selling them to the client. 3. The portfolio manager buys securities for its clients from its affiliated broker-dealer; Nelson, P. (2008) Capital Markets Law and Compliance the Implications of MiFID, Cambridge University Press, Cambridge, p. 150.

house order execution by investment firms.[26] MiFID seeks to promote a more level playing field between established stock exchanges, newer forms of equity trading venues and investment firms. To this end it prescribes transparency requirements for regulated markets and multilateral trading facilities (MTFs), and also for certain firms that internalise client orders ("systematic internalisers" - SI).[27]

II. MIFID - NOVELTIES, MAIN GOALS AND EXPECTED BENEFITS

MiFID as the new legal framework governing investment services and financial markets in Europe replaced the outdated ISD as a result of the consultation process which the Commission services carried out during 2000-2002. The Commission concluded the main priority policy areas that the new MiFID should deal with. The major topics were about improving the passport for investment firms, extending the services and products covered by the ISD, strengthening the conduct of business provisions, removing the concentration rule, improving transparency requirements, strengthening regulatory co-operation cross-border.[28]

Consultations were deemed to be an important factor of Lamfalussy regulatory structure and this tool has been effectively used in the preparation stage of the MiFID. Nevertheless, some commentators from the securities industry argue that the preparation stage has lacked an efficient cost-benefit analysis.[29] Areas such as extending the services and products can be seen as an effort to complete, upgrade the ISD regime with respect to market developments while others, like improving the passport for investment firms and strengthening the conduct of business provisions, were meant to provide a more efficient integration and enhancing investor protection.

In compliance with the Lamfalussy process the MiFID regime consists of a two level European legislation: "Level 1" Directive of the European Parliament and Council, adopted in April 2004; and "Level 2" legislation which is adopted by the Commission and

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[26] Avgouleas, E. "EC Securities Regulation, A Single Regime for an Integrated Securities Market: Harmonised We Stand, Harmonised We Fail? Part 1", of Journal of International Banking Law and Regulation 2007, 22(2), 79-87 p.2.

[27] The Benefits of MiFID Report for the Financial Services Authority by Europe Economics Accessed from http://www.fsa.gov.uk/pubs/international/mifid_impact.pdf

[28] Aubry, N., McKee, M. MiFID: Where did it come from, where is it taking us? Journal of International Banking Law and Regulation, 2007, 22(4), 177-186, p.5.

[29] Knight, A. (2007) *"MiFID's Impact Upon the Retail Investment Markets"* in The Future of Investing After MiFID Wiley Finance, p. 211.

made up of a regulation[30] concerning the market structure[31] issues and a Directive[32], that will deal with the conduct of business and organizational matters.

1. Novelties

Promotion of Investor Protection

MiFID introduces common standards of investor protection throughout the EU. In this context, a comprehensive organization and COB regime (regarding safeguarding of client funds, record-keeping, outsourcing, information requirements, suitability and appropriateness test, client classification and best execution obligations) are introduced as new requirements. Besides it is obligatory for investment firms to create an internal audit division that is independent of all other functions and activities of the firm. Among these new rules, MiFID's "best execution" requirements are an important component of the investor protection standards as they are designed to promote not only market efficiency generally but also the best possible execution results for investors individually.[33]

Investment firms within the scope of the MiFID also have to comply with the Capital Requirements Directive, which sets requirements for the regulatory capital that a firm must hold, can be considered as another strand of the investor protection theme. These provisions guarantee the solvency of the financial institutions and, in simpler terms, their ability to fulfill their commitments to their clients.

Abolishment of the Concentration Rule

As mentioned above, the ISD regime allowed member states to require the routing of client orders to national exchanges. MiFID abolishes this rule upon imposing the condition for increased pre - and post trade transparency requirements and best execution obligation. Market developments in the area of securities trading made the Commission interpret the concentration rule as a barrier to the emergence of an integrated and

[30] Commission Regulation (EC) No 1287/2006 of 10 August 2006 implementing Directive 2004/39/EC as regards record-keeping obligations for investment firms, transaction reporting, market transparency, admission of financial instruments to trading, and defined terms, published in Official Journal of the European Union in 02.09.2006.

[31] Market structures comprise the rules and institutions that determine competition among trading platforms. This definition encompasses the framework for interaction, including exchange fees, which ultimately shape order execution strategies. The focus includes external factors that impact business and operating models driving opportunities to grow revenues and to reduce costs.

[32] Commission Directive 2006/73/EC as regards organisational requirements and operating conditions for investment firms and defined terms, published in Official Journal of the European Union in 02.09.2006.

[33] Best Execution under MiFID Questions and Answers May 2007, Ref: CESR/07-320, The Committee of European Securities Regulators, p.3.

competitive trading infrastructure. Within this new environment it was predicted that competition, and a level-playing field among execution venues such as Regulated Markets, MTFs, and SIs, will be established by removal of the concentration rule.

New Types of Investment Services

MiFID introduces a new "investment service" relating to the operation of MTFs. Investment firms or market operators[34] will be able to operate alternative trading systems and benefit from the common passport, which means their services will be available to users throughout the EU on the basis of home country authorization. To achieve this target, MTFs shall be entitled to finalize, clear, and settle transactions concluded on them through access to central counterparty and clearing and settlement facilities operated in another Member State - pursuant to Art. 34 of the MiFID.

As a reflection of current trends that ever more retail customers are investing in securities and seeking advice from their bank or their broker, "investment advice" is treated as one of the "investment services". This service was formerly listed as an "ancillary service" under the ISD. Being qualified as an "investment service", the providers of this service can operate across the EU with a single authorization from their "home" member state on a stand alone basis. This reform is introduced to contribute to a better integration of European capital markets.

New "Systematic Internalization" Concept

MiFID introduces a number of obligations imposed on investment firms that deal on own account by executing client orders on an "organized", "frequent", and "systematic" basis "off" a regulated market or an MTF, called "systematic internalisers". A major obligation for the SIs is to publish firm quotes for "liquid" shares and only in relation to orders of up to the 'standard market size'.

New Financial Instruments

Since commodity derivatives are included in the list of financial instruments trading and intermediation services concerning these instruments will be governed by the MiFID. The extension of the financial instruments list to commodity derivatives is welcomed since investment firms will benefit from single passport for cross-border provision of investment services in commodity derivatives which was not the case in the

[34] "Market operator" means a person or persons who manages and/or operates the business of a regulated market. The market operator may be the regulated market (exchange) itself.

ISD regime.

Additionally, the list of financial instruments covered by the MiFID is extended by a number of innovative contracts. Such contracts include credit derivatives, contracts for differences, and derivatives settled in cash or capable to be settled in cash at the option of one of the parties.

Updating the "Single Passport"

MiFID improves the 'passport' for investment firms by clarifying the line between the respective responsibilities of home and host states and generally eliminating some of the vague jurisdictional matters that arose under the ISD. In particular, this target will be achieved through inclusion of COB regime for investment firms under the remit of the home country competent authority. Also, the single passport principle will apply so far new financial instruments and investment services are concerned. Consequently, this new approach for passporting will facilitate cross-border business and inject fresh competition into the European investment services industry.

New Transparency Regime for Equity Markets

Increased level of pre- and post-trade transparency for transactions in shares that are admitted to trading on regulated markets can be regarded as a significant change created by the MiFID. Transparency refers to the disclosure of quote[35] and trade related information. The Directive deals with this matter through two main methods: 1. in the context of pre-trade transparency, regulated markets and MTFs are required to make information publicly available about "orders" and "quotes" on their systems, while firms that internalize customer orders on a systematic, organized and frequent basis in relation to liquid shares as defined are required to make publicly available "quotes" in those shares; 2. to promote trade transparency, regulated markets, MTFs and investment firms are required to make publicly available information about completed transactions.

The elaboration of a uniform level of obligatory transparency requirements across different transaction venues and the accomplishment of a political consensus to abolish the "concentration rule" were interrelated. Otherwise considerable volumes might transfer from regulated markets to opaque transaction venues for regulatory arbitrage reasons,

[35] The last price at which a security or commodity traded at, meaning the most recent price at which a buyer and seller agreed on a price and transacted some amount of the asset.

leaving transparent markets in a disadvantageous position.[36]

More Extensive Transaction Reporting Requirements

MiFID requires investment firms to report transactions to their local regulators. Moreover, this new reporting framework also encompasses the exchange of transaction reports between CESR members, which are the competent authorities of each member state. This new component of the Directive entailed intensive planning and information technology structures at the level of individual CESR Members as well as within CESR.[37] The principal intention of this move is to support regulators' anti-market abuse efforts and the monitoring of compliance with transaction execution rules.[38]

Greater Harmonization for Regulated Markets

MiFID introduces new rules for the licensing and operation of regulated markets and requirements regarding the management of regulated markets and persons exercising significant influence over the management of regulated markets.

2. Main Goals

According to the Wall Street Journal:

"*MiFID governs where and how shares can be traded and is meant to encourage greater competition among trading venues by lowering the cost of transacting business in Europe and boosting investment in listed companies."* [39]

This extract succinctly states overall MiFID aims. With respect to the goals, the European Commission declared[40] these as creating a true Single Market in which services can be provided freely and instruments traded across borders, promoting the emergence of an efficient, transparent and integrated financial trading infrastructure, establishing a high level of investor protection and confidence while strengthening enforcement and supervisory cooperation. These goals are founded on guiding principles of "home country authorization and supervision", "open competition in the provision of services

[36] White, L. (2007)*"The Benefits, Opportunities and Challenges of MiFID"* in The Future of Investing After MiFID Wiley Finance, p. 2.
[37] Use of Data Standard Codes in Transaction Reporting Directive on Markets in Financial Instruments MiFID Public Consultation December 2006, Ref: CESR/06-648-b, The Committee of European Securities Regulators, p.3.
[38] Nelson, P. (2008) Capital Markets Law and Compliance the Implications of MiFID, Cambridge University Press, Cambridge, p. 418.
[39] January/February/ 2008 The Information Management Journal p.11
[40] Securities Markets Unit Screening Process Explanatory Meeting with Croatia and Turkey 30 March 2006. European Commission Internal Market and Services DG. Investment Services and Markets in Financial Instruments in the EU, Radostina IVANOVA, Jiri KROL.

and marketplace functions" and "proportionate response to demonstrable risks to investor protection and orderly functioning of markets." These principles have determined the subject matter and direction of various new provisions that will be dealt in the following chapters.

In particular, the core ideas are also clearly stated in the recitals to the Directive as follows:

…

(2) … Community should encompass the full range of investor-oriented activities. To this end, it is necessary to provide for the degree of harmonisation needed to offer investors a high level of protection and to allow investment firms to provide services throughout the Community, being a Single Market, on the basis of home country supervision.

(31) One of the objectives of this Directive is to protect investors. Measures to protect investors should be adapted to the particularities of each category of investors (retail, professional and counterparties).

(44) With the twofold aim of protecting investors and ensuring the smooth operation of securities markets, it is necessary to ensure that transparency of transactions is achieved and that the rules laid down for that purpose apply to investment firms when they operate on the markets.

(17) Persons who provide the investment services and/or perform investment activities covered by this Directive should be subject to authorisation by their home Member States in order to protect investors and the stability of the financial system.

(5) ... It is necessary to recognise the emergence of a new generation of organised trading systems alongside regulated markets which should be subjected to obligations designed to preserve the efficient and orderly functioning of financial markets.

(71) The objective of creating an integrated financial market, in which investors are effectively protected and the efficiency and integrity of the overall market are safeguarded, requires the establishment of common regulatory requirements relating to investment firms wherever they are authorised in the Community and governing the functioning of regulated markets and other trading systems so as to prevent opacity or disruption on one market from undermining the efficient operation of the European financial system as a whole…

2.1. Investor Protection

As mentioned above, the FSAP aimed to reform EU capital market regulation and identified the development of retail investor market through regulation as a key instrument of this policy. Therefore, investment services rules, which are most relevant to retail investors, were re-regulated under the Markets in Financial Instruments Directive and it was situated at the heart of the FSAP and of this new retail investor agenda. As an implication of this policy investor confidence has to be improved in order to attract household savings and retail investors to capital markets. However delivery and measuring of the outcomes of investor protection is an intangible concept and is complex and controversial. The explanatory memorandum to the MiFID proposal states that the new investor protection regime would allow investors to be confident that investment firms would act diligently and in their best interests. This approach clearly grants wide powers to regulators on such a subject which is hard to define or not viable for empirical testing. Although, in the post-FSAP era evidence-based law making and cost benefit analysis were central issues, the Commission remained committed to the investor protection focused, regulation mode.

According to MiFID, the EU's regulatory strategy to construct an "investor friendly market" is based on the hypothesis that regulation and investor activity is linked. Basically this regulatory strategy acknowledges regulation as means for delivering investor protection, investor confidence, increased retail activity and deems regulation as instrumental for generating investor choice and empowering investors.

Pursuant to the discretionary nature of Art.11 of the ISD, investor protection rules varied extensively in Member States. Uncertainty as to protections available across the market and variations in the level of protection constituted threats to investor confidence. Thus, to compensate this fragmented perception, a unified approach was favoured by the new COB regime. In particular, Art.19, 21 and 22 for the first time stipulated the key investor/investment firm relationship, in an unprecedented wide coverage from execution only to discretionary portfolio management, from marketing to pre-contract disclosure to contractual protections, from initial advice and suitability assessment to order execution and across on –and off-line sectors. [41]

MiFID`s main contribution to the investor protection theme is the harmonisation of core investor protection topics such as "best execution", "information to clients",

[41] Moloney, N. (2006) *Effective Policy Design for the Retail Investment Services Market in* Investor Protection in Europe Corporate Law Making, the MiFID and Beyond*:* Oxford University Press, p.382-388.

"order handling", "suitability", "investment advice", "inducements" and "conflicts of interest for the first time. High level of harmonisation of these issues will make investors confident in using the services of investment firms wherever they are in Europe and wherever the investment firms come from in Europe. Consumers will enjoy the same level of protection whether they choose a domestic service provider or a foreign one. Thus this gives both investors and regulators an assurance that foreign firms will not be able to exploit susceptible consumers. Another implication of these strong and consistent investor protection rules being agreed across the Community level is that they eased the way to political agreement on a stronger passport.[42]

To illustrate MiFID's safeguard for consumers, it is worth noting strict limits on the inducements that banks or financial advisers can receive in respect of the services which they provide to their clients. Likewise, when executing client orders, firms will have to take all reasonable steps to deliver the best possible result ("best execution"), which means ensuring that small scale, retail clients get the best price for the instrument and the costs associated with the execution. MiFID characterizes the investor firm and client relationship with its emphasis on the fiduciary duties[43] of firms towards their clients. The identification and management of conflicts of interest, and the collection of sufficient information when providing investment services to ensure that the products and services that they provide are "suitable" or "appropriate" for clients both signify this modern and through approach.[44]

Extensive disclosure is at the heart of rules to fulfil the investor protection and investor choice - the two objectives of the EU's regulatory strategy for the retail investment services market. Disclosure with regard to marketing, pre-contract, and contract is addressed by Art.19 deals while Arts.21 and 22 cover disclosure in order execution. This reliance on disclosure as a major building block suggests an approach that the investor as rational actor and mirrors the regulatory strategy's stress on informed investors and on limited intervention in the investor's decision.[45]

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[42] White, L. (2007) *"The Benefits, Opportunities and Challenges of MiFID"* in The Future of Investing After MiFID edited by Skinner, C. p. 6

[43] Fiduciary duty, being a common law concept arising from equity regulates the conduct of those bound to act for the benefit of others rather than for themselves. A fiduciary can be explained as someone who has assumed to act for or on behalf of another in a specific matter in circumstances which lead to a relationship of trust and confidence.

[44] EU Focus 2007, 221, 2-3, p.3.

[45] Moloney, N. (2006) *Effective Policy Design for the Retail Investment Services Market in* Investor Protection in Europe Corporate Law Making, the MiFID and Beyond*:* Oxford University Press, p.394.

Despite the flexibility in limited areas like outsourcing, the requirements are excessively burdensome and rigid. This can significantly increase costs of compliance and cause difficulties for small and medium size investment firms (SMEs) to sustain. Some commentators are not convinced that SMEs pose such a threat to systemic stability, or have ever been implicated in extensive violation of prudential and investor protection rules that worth the regulatory cost at that scale.[46] Clearly, the European Commission's regulatory framework is addressing all types of firms in an industry that is already dominated by big players. The EU legislator's motive for imposing the new COB was not solely originating from threats and experiences caused by the SMEs. Therefore, at this point, two scenarios may be visualized. The first one is that the European Commission does not agree that the compliance cost will likely cause the elimination of SMEs. The second is that the Commission foresees that the market in the long run will be made up of only big players which conduct business under high investor protection and prudential standards. At this point, European Financial Integration Report 2007 [47] states that concentration in financial services industry is not an appropriate measure of competition. Since competition is largely determined by the contestability of the respective market and the available evidence suggests that consumers and SMEs would benefit from stronger competition at the EU level. Thus, new distribution channels such telecommunication and internet services may offer prospects to reinforce integration and contestability of retail markets.

2.2. Competition and Market Access

The post MiFID environment is likely to affect the competition and market access aspects of the financial services market in two ways. As a result of stimulating cross border competition, intermediaries can be expected to come under pressure to match incoming firms' offers, cost structures and support services. This would diversify the range of products, services and markets investors and issuers can access.[48] On the other hand fostering competition between share trading venues is the second expected outcome relevant to competition issues. The more contentious of these two consequences is the one about trading venues.

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[46] Avgouleas, E. "EC Securities Regulation, A Single Regime for an Integrated Securities Market: Harmonised We Stand, Harmonised We Fail? Part 1", of Journal of International Banking Law and Regulation 2007, 22(2), 79-87 p.5.

[47] European Financial Integration Report 2007, Brussels, 10.12.2007 SEC(2007) 1696 Commission Staff Working Document, p.29.

[48] White, L. "*The Benefits, Opportunities and Challenges of MiFID*" in The Future of Investing After MiFID, Wiley Finance p. 5.

To promote competition between trading venues and also to offer investors a choice between different trading functionalities such as regulated markets and MTFs and internalising intermediaries, MiFID allows internalisation [49] of orders therefore eliminating concentration provisions. In this way, the financial services industry is moving to a more competitive model with tight operating conditions, higher technology and operating cost. Yet this can be used as a competitive advantage particularly for investment firms. This has already given way to a number of initiatives by investment banks that will be mentioned hereinafter.

In simpler terms, MiFID aims to encourage more investors to buy and sell shares by setting rules to boost competition and protect consumers. As a result of MiFID's market liberalisation, there are now more venues for trading shares and reporting trades, which is a vital service to investors.[50]

MiFID requirements apply to all equity trades, whether on or off-exchange. As the EU is a strong advocate of competition, MiFID makes it easier to trade off-exchange. By removing the concentration rule and imposing pre- and post-trade reporting obligations for over the counter (OTC)[51] trades, it legitimizes off-exchange trades and thereby encourages the setting up of alternative trading venues.[52]

The fundamental hypothesis underlying the Directive in its abovementioned approach is that both regulated markets and MTFs perform essentially the same function.[53] MiFID requires regulated markets, MTFs and SIs to publish the price, volume and time of a transaction as close to real-time as possible and in a way that is easily accessible to other market participants. Thus, MiFID will change the nature of competition in share trading. Although most shares in Europe are still traded on exchanges, there is growing interest in alternatives, such as off-exchange trading. MiFID will accelerate this trend by ending monopolies through elimination of the concentration rule. In addition under the concentration rule, which can be accepted as a protectionist measure for exchanges, the incumbent exchanges exploit heavy fees on membership and

[49] Internalisation: MiFID provides a framework for the execution of client orders internally (" off exchange") by investment firms and banks, by either matching them " in house" with another client order, or executing them against a proprietary position. Nelson, P. (2008) Capital Markets Law and Compliance the Implications of MiFID, Cambridge University Press, Cambridge, p. 150.

[50] http://www.computerweekly.com/Articles/2008/03/13/229844/mifid-ushers-in-trading-technology-skills-boom.htm

[51] OTC Trade: A decentralized market of securities not listed on an exchange where market participants trade over the telephone, facsimile or electronic network instead of a physical trading floor. There is no central exchange or meeting place for this market.

[52] http://www.markit.com/information/boat/about-mifid.html

[53] see 2006/73/EC, Recital (6).

tariffs on each trade.[54] In effect, MiFID simply recognises the reality that financial markets are increasingly moving away from the established exchanges.[55] In a similar fashion in America, new electronic exchanges have emerged in Europe such as Chi-X[56]. New electronic exchanges claim themselves as offering investors cheaper and faster trading services than the established exchanges and they expect to prosper under MiFID. Consequently, exchanges, facing the threat of greater competition, are already evaluating mergers.[57] Thus far, the LSE has joined forces with Borsa Italiana, and the exchanges of Paris, Amsterdam, Brussels and Lisbon have forged Euronext, acquired by the New York Stock Exchange in 2006. [58]

The majority of this "off-exchange" trading was carried out within the big investment banks themselves and among their clients. Compared to exchanges, few or no fees were paid moreover as a big advantage of trading in these "dark pools"[59] pricing and volumes could be kept opaque as these deals were executed via the investment banks' own book of business. In order to bring this hidden practice of internalization within the trading firm under the regulator's touch, best execution and transparency principles were introduced in MiFID.[60]

In 2007, European Central Counterparty Limited (ECCP) and nine of the world's largest investment banks[61] in London which represent about half the order flow into European equities took an initiative to launch their own electronic exchange called *Project Turquoise*. It has been set up to take advantage of stock-trading rules under the MiFID which has broken the monopolies of Europe's established exchanges. This new MTF will trade in competition with established bourses like the London Stock Exchange (LSE) and Deutsche Börse.[62] They aim to create an electronic European equities platform

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[54] Aubry, N., McKee, M. MiFID: Where did it come from, where is it taking us? Journal of International Banking Law and Regulation, 2007, 22(4), 177-186, p.5

[55] BT Global Financial Services, estimates that between 30% and 50% of share trading in Europe is already "off-exchange", *Big headache or Big Bang?* Economist, 00130613, 10/27/2007, Vol. 385, Issue 8552.

[56] Chi-X is the first MTF to have emerged in Europe which captured an average daily market share in FTSE 100 stocks of 13 per cent in July 2008.

[57]Aubry, N., McKee, M. MiFID: Where did it come from, where is it taking us? Journal of International Banking Law and Regulation, 2007, 22(4), 177-186, p.5.

[58] Big headache or Big Bang? Economist, 00130613, 10/27/2007, Vol. 385, Issue 8552.

[59] Dark pools aim to reduce information leakage while finding anonymous liquidity. Dark pools, an increasingly used buzzword, exist where firm orders are not yet executed nor displayed to the market. http://www.exchange-handbook.co.uk/index.cfm?section=articles&action=detail&id=68965.

[60] Ryan, J. (2007) *An Overview of MiFID* in The Future of Investing After MiFID Wiley Finance p.13.

[61] BNP Paribas; Citigroup; Credit Suisse; Deutsche Bank; Goldman Sachs; Merrill Lynch; Morgan Stanley; Société Générale and UBS.

[62] Turquoise, the pan European equities platform started trading on a "limited live" basis in 15 August 2008. By the end of August 2008, Turquoise will offer trading in some French and Dutch stocks in addition to 10 British and German stocks, with a full panoply of 1,267 shares across 12 markets. The launch of Turquoise

as an MTF alternative to traditional stock exchanges. This project is a clear evidence of the opportunities released by the MiFID in the European trading environment.[63] The initiative has already affected European Stock Exchanges such as the London Stock Exchange and Deutsche Börse resulting deep fee cuts and incentives late August and early September 2008 to defend themselves against a wave of new entrants in equities trading.[64]

2.3. Transparency

Greater transparency is another target of the MiFID regime. The visualization for the future is that investors should be able to subscribe to information services that let them see the whole market in certain shares, not only what is on offer at the local stock exchange. This will allow investors to get the best deal in the market. This outcome of more transparency also relevant for stock exchanges in competition terms, since exchanges make a profit from selling such information.[65] As in the LSE's case, for example, which obtains almost a third of its revenue from "information services", clearly this means that some of their profit will be under threat.

Benefits of transparency are faster price discovery, enhanced market efficiency through greater availability of information and opportunities for investors to monitor brokers. As a result, brokers will compete and reduce their rents to attract order flow. On the other hand, higher levels of transparency may bring in other costs, like greater difficulty in executing large transactions.[66]

More to the point, by the virtue of MiFID regime, as of November 2007 there are no national boundaries for equity trading within the EU. There is continuous pre-trade quoting and trades of up to standard market size have to be reported within three minutes of execution. Block trades (those of over 10,000) can be reported over 48 hours. These rules apply to trades conducted both on- and off-exchange. Compared to the previous ISD regime, this is significantly different for OTC traders since they have to operate within a new, stringent regulatory framework with respect to reporting their transactions.

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about two years after plans to launch the venture were initially conceived. The project was hit by several delays, earning it the nickname "Project Tortoise. Grant, J. published in Financial Times, August 18 2008.

[63] Aubry, N., McKee, M. MiFID: Where did it come from, where is it taking us? Journal of International Banking Law and Regulation, 2007, 22(4), 177-186, p.10

[64] see Financial Times, August 31 2008. Grant, J. "LSE cuts fees to fend off competition".

[65] Aubry, N., McKee, M. MiFID: Where did it come from, where is it taking us? Journal of International Banking Law and Regulation, 2007, 22(4), 177-186, p.5.

[66] Davies, R., Dufour, A., Quin, B. S. (2006) *The MiFID: Competition in a New European Equity Market Regulatory Structure* in Investor Protection in Europe Corporate Law Making, the MiFID and Beyond*:* Oxford University Press, p.169.

Reporting requirements of OTC transactions by investment houses differed to a great extent between member states until the MiFID came into force. Under the new MiFID regime, however, all OTC equity transactions need to be reported and published to the market. This data will no longer be in the ownership of the Exchanges. After MiFID, investment service providers will have the extra power to retain and publish the pricing information on their own trades. Since, investment firms realized that MiFID's transparency requirements offer the opportunity to consolidate the hitherto fragmented market of European OTC equities, nine leading investment banks decided to form a consortium to create Markit BOAT™. This is a central platform for the collection, collation, validation and distribution of European OTC pre- and post-trade information as required by the MiFID. This information would be helpful for trading decision-makers operating in a disparate and opaque market. Their aim is to create a robust, real-time platform using standard industry technology that enables all European equity dealers to meet their regulatory requirements via a cheaper and more efficient trade reporting facility in simpler terms which give investors real-time information about what is being bought and for how much. [67]

Overall MiFID puts off-exchange markets in a more regulated environment by requiring them to disclose more pricing information. Moreover, off-exchange markets will more likely be freer to attract trading business away from the traditional exchanges. In consequence, this new situation is expected to create established exchanges operating with lower fees with a higher speed of transactions. Nevertheless it is still a point of hot debate whether this new fragmentation in trading venues would "balkanise" trading by channeling it in so many directions that it evaporates or it adds to overall liquidity.[68]

3. Expected Benefits

In parallel with MiFID's novelties and main themes stated above the expected benefits will be summarized below.

Owing to the extended passport approach considerable deregulation is anticipated by replacing equivalent national measures with the simplified, principles-based approach of the rules contained in MiFID.[69] More streamlined operation of single EU passport for investment firms will facilitate a pan European securities market. Due to extended single

[67] http://www.markit.com/information/boat/about-markit-boat.html
[68] *Big headache or Big Bang?* Economist, 00130613, 10/27/2007, Vol. 385, Issue 8552
[69] White, L. (2007)*"The Benefits, Opportunities and Challenges of MiFID"* in The Future of Investing After MiFID Wiley Finance, p. 4.

passport and stronger home country supervision principles, costs of obtaining, maintaining authorization and costs of compliance will be reduced compared to previous ISD regime that empowers host country competent authorities for the abovementioned issues. In addition, harmonisation of investor protection provisions, like best execution, information to clients, order handling, and suitability, will provide the same level of protection to investors regardless of whether their firm is a domestic or a foreign one will reduce the costs of establishing and maintaining 'market reputation' for investment firms. In relation to the improvement of the single passport for cross-border provision of investment services, access to new markets will be improved. With regard to market functioning, best execution and transparency requirements will improve prices and increase competition in the publication of firms' data. Also, reductions in transactions costs are expected due to aggregation effects.[70]

MiFID sets the regulatory framework to encourage competitive new entry and entrepreneurial opportunity. Realising this opportunity arises from understanding and embracing looming changes to market structures;[71] therefore expected benefits are reliant on the extent to which the various players are ready to take hold of the opportunities on offer. Providing that investors and market players such as exchanges and investment service providers take advantage of this more competition friendly environment, a major decrease in the cost of capital is expected. This will also force investment firms become more efficient and productive which in turn will make them better able to tolerate increasingly tough global competition.[72]

MiFID diversifies the options provided to investors with respect to products, services and investment service providers that the latter is required to comply with high COB towards their clients. This will place firms under greater competition so investors will be able to look for services of the best quality at the cheapest price. The new setting will force particularly investment service providers to be more responsible vis-à-vis their clients and to offer a better level of service.

Even though a high duty of care and significant information technology requirements seem to be challenging and heavier on the investment firm side, in the long run it may work in the interests of large banks and to the detriment of smaller exchanges.

[70] The Benefits of MiFID Report for the Financial Services Authority by Europe Economics Accessed from http://www.fsa.gov.uk/pubs/international/mifid_impact.pdf

[71] Barnes, R. MiFID and its Impact http://www.exchange-handbook.co.uk/index.cfm?section=articles&action=detail&id=68965

[72] EU Focus 2007, 221, 2-3, p.3.

The best execution principle which require traders execute a buy or sell order on any exchange or trading system that likely gives the best deal for their clients, will inevitably lead to reductions in trading volume for established stock exchanges. On the other hand, as an incentive for investment firms the trades, rather than being reported to a national exchange, can simply be made public. This means not only a significant business opportunity, but also a potential cost saving for the investment firms.[73]

MiFID is expected to affect three types of relationships pertaining: to buy-side firms[74] and their clients; sell-side firms with their buy-side clients; and exchange and broker relationships. Changes to these relationships will lead to competition that will reduce exchange and central counterparty (CCP) fees. This is particularly important because lower exchange fees increase liquidity which may entail upgraded faster matching engines which will improve investment performance. Smart-order-routing[75] will operate in Europe to pool the multiple physical liquidity puddles formed by competitive new entry. Due to the new trading environment set by MiFID requirements, order flow will concentrate at the most capable venues in an increasingly severe technological and commercial race.[76] The benefits of MiFID to the industry is strongly disputed, nevertheless, already consolidation moves by exchanges, and new transaction platforms being developed by market players, prove that something similar to a revolution in financial services may be underway. This is why some commentators refer to the Directive as the "new Big Bang"[77].[78]

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[73] *Big headache or Big Bang?* Economist, 00130613, 10/27/2007, Vol. 385, Issue 8552

[74] Buy-side firms refers to firms which buy and sell as customers of sell side firms which are banks and brokerages who are required to be market makers in a given security. Buy side firms usually take speculative positions or making relative value trades.

[75] Smart order routing is the automatic routing of a trade to a pre-determined execution destination. London Stock Exchange recently has launched of EUROSETSTM — the Dutch Trading Service. This service is meant for smart order routing by offering trading in the most liquid Dutch securities. With this new facility, LSE is providing investors with a choice of markets on which to execute their trade. The idea arises from a new challenge, as competition hits the capital markets, national exchanges are no longer default destinations for trade execution. Electronic systems are now able to automatically select the correct or preferred execution location. Such a solution would allow investors to specify the destination themselves, or enable them to ask the broker to determine the best execution venue.https://www.londonstockexchange.com/NR/rdonlyres/A33CA845-D617-45CA-9FFC-A19CD55DCA94/0/EUROSETSSmartOderRoutingFactSheet090804.pdf

[76] Barnes, R. MiFID and its Impact http://www.exchange-handbook.co.uk/index.cfm?section=articles&action=detail&id=68965

[77] Big Bang London 1986 is referred as the reform process of London Stock Exchange as a financial centre. This transformation was encouraged or forced by the UK Government, the Office of Fair Trading to make the Exchange more competitive especially with regard to fixed commissions, market access for acting as a broker and capitalization structure of the Exchange is strengthened. Stoakes, C.(2005) All You Need to Know About the City, Longtail.

[78] Aubry, N., McKee, M. MiFID: Where did it come from, where is it taking us? Journal of International Banking Law and Regulation, 2007, 22(4), 177-186, p.10

III. INVESTOR PROTECTION INSTRUMENTS of MiFID

Like other securities regulations all over the world MiFID is not designed to be the ultimate insurance policy against risks. The motive of this regulatory initiative as to investor protection theme is not to eliminate uncertainty but to ensure market transparency by its investor protection rules and its measures. Providing investors with all available material information to make a responsible investment decision and warning investors where uncertainties exist constitute the main features of the Directive. Prevention of fraud is also another foundation goal being a very basic investor protection issue.

In case, investors are aware of the risks by proper disclosure by issuers for known and reasonably anticipated risks, investors could diversify their portfolios according to their tolerance to risk. This means issuers that have better risk management policies and procedures with a lower cost of capital will be favored by investors and charge a premium where risks are unreasonably high. Besides, in the post-MiFID borderless marketplace, owing to the transparency requirements of the MiFID, investors will be better equipped or given a better chance to make comparisons between issuers in different member states as well as in different industries. At that point, it should be underlined that investment firms, particularly those conducting business in derivatives markets for the highly sophisticated instruments or structured products which entail risk management will have to assume bigger responsibilities. This reality has been made clear in financial crises like the Parmalat and Argentina defaults or the turmoil triggered by the US sub-prime mortgage crisis since August 2007[79]. Therefore, the more rigorous suitability and appropriateness provisions together with the new transparency and best execution requirements are very likely to be seen as the better approach for the prevention of the financial crises which produce serious investor pain. Providing that, MiFID provisions are properly enforced, it is envisaged that the possibility of retail investors buying inappropriate or unsuitable financial products could be minimized.[80]

1. Conduct of Business Obligations (Art. 19)

[79] US sub-prime mortgage crisis started in 2007 is widely accepted to be caused by risky loans, subsequently repackaged and sold to institutional investors, who did not properly or fully evaluate the nature of the underlying risks of these structured instruments.
[80] Chirico, A. Suitability and Appropriateness under MIFID: ‘Faithful watchdogs’ or ‘terrible twins’? Ceps Paper in ECMI Policy Brief No.9 September 2007, p.2.

MiFID provides a wider universe of opportunities of investments for end investors in securities markets by having access to offerings from any member state located within the EEA[81]. But this availability does come at a cost for investment firms. In order to benefit this borderless marketplace the overall MiFID regulatory framework sets forth more prescriptive obligations upon investment firms. Accordingly, these firms will be subject to, *inter alia,* with the MiFID set of rules on organisational requirements and on COB. In other words, the need to observe up to 30 separate sets of rules across the EEA no longer exists under the MiFID regulatory framework.

The European Commission's implementing Directive regarding organizational requirements and operating conditions Art.4 requires member states notify the Commission of any super-equivalent provisions they plan to introduce. This provision is limiting the scope of member states to diverge from the pan-European conduct of business requirements and stands for an effort to guarantee the uniformity of rules.

The rationale behind this compliance move not only serves for a matter of law enforcement but also beyond that observing these rules in the post-MiFID landscape will give investment firms the strength to withstand an increased level of competition among investment firms and ultimately preparing them to harsher competition on a global scale. Hence, compliance to COB can be evaluated both as a legal obligation and an urging incentive to become more efficient by adopting a more client-focused approach. Being truly proactive in working in the best interests of their clients is now overriding principle that has paramount importance for firms to increase customers' confidence in their action. By the virtue of this framework investors are able to select their providers from a more transparent marketplace, on the basis of a much more informed choice. Therefore compared to the situation in the past compliance to COB will generate, a new European investors' protection regime that will gain much more weight.[82]

Conduct of business rules focus upon all aspects of client dealings and cover key areas such as client classification, information requirements, suitability and appropriateness tests. A common opinion across the financial services industry is that MiFID compliance is a key driver to investing in new technology to tackle with new and reinforced aspects of investor protection such as client classification, client reporting and

[81] European Economic Area, encompassing EU Member states but also Norway, Lichtenstein and Iceland signifies the geographical borders for MiFID implementation.
[82] Chirico, A. Suitability and Appropriateness under MIFID: 'Faithful watchdogs' or 'terrible twins'? Ceps Paper in ECMI Policy Brief No.9 September 2007, p.2.

management solutions. Especially with respect to distributors of investment products, improvement of ability to store and retain much more detailed ‘know your customer’ information will be vital. The means used to retrieve that information also will have to be well-organized in order to report to clients, to the regulator or to the internal compliance team. As a result, having document management systems able to provide immediate and secure information will become typical.

1.1. Obligation to Act in Client’s Best Interest (Art. 19 (1))

Consumer protection rules mainly Article 19 of the MiFID apply in any case while dealing with an investment service. Pursuant to Article 19(1) when providing investment services and/or, where appropriate, ancillary services to clients, an investment firm must act honestly, fairly and professionally in accordance with the best interests of its clients. To exemplify what constitutes honest, fair and professional act it may be helpful to refer to Article 26 of the implementing Directive 2006/73/EC regulating inducements. Investment firms are not regarded as acting honestly, fairly and professionally if they pay or are paid any fee or commission, or provided with any non-monetary benefit, other than the ones indicated by the provision.

1.2. Suitability and Appropriateness Tests (Art. 19 (4), (5) and (6))

The MiFID differentiates between execution-only and non execution-only services. When the service being provided is execution only, neither the suitability test (Art. 19(4)) nor the appropriateness test (Article 19(5)) applies. Suitability test is mainly related to investment advice or portfolio management whereas appropriateness test refers to non advised products and ancillary services such as corporate finance.

Basically, suitability and appropriateness assessments meant for determining if the investment firms’ clients have the necessary expertise, experience and knowledge to trade in financial instruments, and to understand the risks associated to this trading activity or have capability to absorb risks in accordance with his/her investment objectives. These tests represent the first concrete application of the general obligation to act fairly, honestly and professionally in accordance with the best interests of the client. This concept was previously evaluated under ‘fiduciary duty’ status. [83]

The suitability test is required by MiFID for the services where the client places a greater reliance on the recommendation given by the firm – investment advice and

[83] Chirico, A. Suitability and Appropriateness under MIFID: ‘Faithful watchdogs’ or ‘terrible twins’? Ceps Paper in ECMI Policy Brief No.9 September 2007, p.3.

portfolio management. That is why an investment firm is only allowed to provide such recommendation if the firm is satisfied that this recommendation is suitable for the clients. The assessment of the client's knowledge and experience is an essential part of the suitability test and it cannot be removed thereby Article 35(1)(c) Directive 2006/73/EC explicitly stipulates that the client should be able to understand the risks involved in the transaction. If this is not the case, the investment firm is not allowed to provide such a recommendation.

On the basis of the information received from the client if the investment firm consider that the product or service is not appropriate to the client it shall warn the client. In cases where the client provides insufficient information regarding his knowledge and experience, the investment firm shall warn the client that such a decision will not allow the firm to determine whether the service or product envisaged is appropriate for him. Therefore, it can be inferred that these provisions reflect the general approach of the Directive for empowering investors through investor choice.

The MiFID and the implementing Directive text which is clearly more detailed one contain comprehensive provisions for the testing of clients. Some commentators argue that the EU legislator could have favored a more high-level principles based approach but they still justify the way provisions were formulated due to the concerns that absence of detailed regulation, prevailing practice would weaken the quality of fiduciary protection to clients.[84]

1.3. Information Requirements (Art. 19 (2, 3, 7 and 8))

MiFID information requirements refer to the necessity for firms providing accurate information to the clients such as the correct details of the transactions that have been made on behalf of them. Fulfilling this duty will provide an analysis to the clients on their investment portfolio.[85] In addition, investment firms have to report on all services they have provided to its clients on the basis of the general obligation set out in Article 19(8) MiFID.

Article 19(3) of the MiFID and Article 33 of the implementing Directive require the investment firm to inform its clients on all costs and associated charges related to the provision of investment services, as well as the services of order execution. Thus, clients

[84] Smith, D. and Leggett, S. (2007) *"Client Classification"* in the Future of Investing After MiFID Wiley Finance, p. 68.
[85] Ryan, J. *An Overview of MiFID* in The Future of Investing After MiFID Wiley Finance p.23.

need to be informed about the details of fees, commissions or mark-ups which the investment firms charge for execution services. On condition that those fees are properly disclosed prior to the provision of services as required by Article 29 of the implementing Directive and reported to the clients in line with the obligations set out in Article 40 of the implementing directive, the investment firms are free to set their fees as they wish.[86]

According to the implementing Directive, the level of detail of information given to clients should be comprehensive and not general as to omit any essential elements. A link between the level of information and client category is established by accepting that it may vary according to the client's categorisation as either a retail client or a professional client. Moreover it underlines the link between providing clients with adequate information on the risk and nature of financial instrument and an investment decision taken on a properly informed way. [87]

2. Client Classification (Art.24)

Client classification is a completely new set of obligations introduced by the MiFID regime and basically means how firms' regulatory requirements for the business are conducted with each client category. In other words when an "investment service" is provided to a client, the client should be classified in order to determine the appropriate level of investor protection. In some situations, "ancillary services" stated in Annex I to MiFID will require clients to be classified. Thus, investment firms have to re-map and re-classify new and already existing clients into three main categories as 'Retail clients', According to the 'Professional clients' and 'Eligible counterparties'[88].

According to the criteria set out in Annex II of the MiFID to be considered as a professional client pertain to financial resources and relevant experience. MiFID client classification is structured to apply regulation inversely proportional to the experience and financial resources of the client. Therefore, retail clients are entitled to receive the highest level of regulatory protection. This also served to avoid over-regulating expert institutional clients and investment firms.

Transfers between client groups are allowed so clients can opt-up as well as opt-down for lower versus greater levels of protection. Investment firms, either on their own

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[86] Your Questions and Answers by European Commission Accessed from http://ec.europa.eu/internal_market/securities/isd/index_en.htm

[87] see 2006/73/EC, Recital (45).

[88] Eligible counterparties are regulated financial institutions and central government public bodies. This category is a subset of professional clients, as all eligible counterparties are also professional clients.

initiative or at the request of the client concerned may treat as a professional or retail client a client that might otherwise be classified as an eligible counterparty or as the other alternative treat as a retail client a client that is considered as a professional client.

Investment firms inform clients about their right that client has to make a request for a different categorisation on a trade by trade basis or in relation to a particular investment service or transaction. Investment firms also inform investors about any limitations to the level of client protection that it would entail. The reason to opt-down as an investor is gaining more protection for an unfamiliar investment product whereas the reason for opt-up could be enabling a retail investor trade in complex products. On the other hand, protection that will be applied with respect to each client category is not crystal clear since there is not an exhaustive list of the specific levels of investor protection for each group. However in order to elaborate the context of investor protection provisions available for each category of clients under MiFID regime, it is possible to generally group them. As set out in Articles 27 to 49 of implementing Directive 2006/73/EC; they are about giving information to clients carrying the qualities of not being misleading but fair and clear. Also providing clients with information concerning the investment firm, its services for retail clients, financial instruments, safeguarding of client financial instruments, client categorisation or client funds and costs and associated charges. Finally, clarifying about assesment of suitability and appropriateness provision. Many of these investor protection measures apply only to retail clients.

For eligible counterparties due to the provisions of Article 24 of Directive 2004/39/EC and Article 52 of Directive 2006/73/EC; best execution, conduct of business and client order handling obligations do not apply with respect to execution of orders on behalf of clients, dealing on own account, and reception and transmission of orders. Due to Recital 40 of the MiFID, eligible counterparties should be considered to be acting as clients. One consequence of this is that the protections of Articles 13 and 18, regarding to conflicts of interest and client assets will still be applicable.

Providing that an adequate assessment of the client's expertise, experience and knowledge is undertaken by the investment firm and this gives reasonable assurance, due to the type of the transactions or services at issue, that the client is competent for making his own investment decisions and understanding the risks involved, retail clients may waive some of the protections given by the conduct of business rules upon request.

Thereby, retail investors upon such reclassification can be treated as "professional clients" by the investment firms.[89] Categorisation as professional client limits the amount of protection that will be afforded to these clients under MiFID. For this reason, it is in the interest of investor protection that the categories be interpreted narrowly.

Client classification is also critical to assess the suitability and appropriateness of the products or services given to investors. MiFID drives firms to truly know their clients and move beyond a focus on identity checks and criminal activity. Therefore, client take-on processes and systems need to be upgraded. In this respect, client classification, likewise client testing requirements as in suitability and appropriateness tests, by requiring collection of extensive further information, create both opportunities and challenges for investment firms, insurers and financial advisors endorsed by the MiFID. Hence, this is not only a compliance expense, but also an opportunity for firms that they could use richer client data into client relationship management systems to strengthen their cross selling capabilities.[90]

The detailed focus on client classification arises from the need formulating regulations which are proportional to the needs of a wide range of clients. Therefore as stated on the European Commission, Background Note to Implementing Directive 2004/39/EC, the Commission aims to provide both clients and regulators the necessary tools to be able to discern and punish inefficiency and unprincipled conduct by firms.

3. Best Execution (Art. 21)

Best execution as a market quality concept is dealt as a consumer protection measure and it is renowned as the main component of investor protection characteristic of the MiFID. The underlying principle for best execution obligation is about addressing the information asymmetry between customers and firms. Customers and firms do not have the same degree of access to price information. However price dimension constitutes only one of the best execution requirements. There are some other factors such as execution speed, cost and settlement. Moreover, ideal best execution requirements may require firms to seek for client order characteristics and market conditions as well.

Particularly in securities component of the financial markets, retail investors

[89] Chirico, A. Suitability and Appropriateness under MIFID: 'Faithful watchdogs' or 'terrible twins'? Ceps Paper in ECMI Policy Brief No.9 September 2007, p.2.
[90] Smith, D. and Leggett, S. (2007) *"Client Classification"* in the Future of Investing After MiFID Wiley Finance, p. 72.

typically rely on the firms with which they have account agreements to provide market information on the types of products, prices and trading venues, investment advice and transaction execution services. In contrast with the retail banking, where there is increasing disclosure and the ability to compare prices on products such as annual percentage rates on loans, retail clients of investment firms are in general unable to compare the appropriateness of advice they are receiving. Therefore, investors are not able to or equipped with enough data for measuring the efficiency of trade execution. They are also unable to detect whether firms have conflicts of interest or if they are receiving inducements to execute trades in a way which might not provide the best value to the client. [91]

Defining best execution can be a hard task simply because "best" is subjective according to the needs and trade patterns of respective investors. To this end, market order traders demand fast execution and expect to get the current best price available whereas limit order traders usually expect to fast execution at once the limit is reached. Fulfillment of best execution obligation for brokers is a difficult duty since it entails using costly resources like time, effort, skill and systems.[92]

Under Art.21 MiFID *"a firm must take all reasonable steps to obtain the best possible result, taking into account price, costs, speed, likelihood of execution and settlement, size nature or any other consideration relevant to the execution of client transactions…"* Due to the recital 33 of the Directive this obligation should apply to the firm which owes contractual or agency obligations. Moreover investment firms with a fiduciary trading or investment responsibility have to draw up a "best execution policy" in place. This execution policy is the firm's key instrument in achieving best execution and must be reviewed in 12 months, for example to review if new execution venues are included or which access mode to trading venues directly by becoming a member of the exchange or via intermediaries likely secure the lowest execution costs for their clients. The Directive and its implementing measures do not prescribe how many venues an investment firm has to use or how many investment firms it should rely on for execution services. On the other hand, Article 21(3) of MiFID specifies that the order execution policy must include in respect of each class of instruments, information on the different

[91] Smith, D. and Leggett, S. (2007) *"Client Classification"* in the Future of Investing After MiFID Wiley Finance, p. 66.
[92] Davies, R., Dufour, A., Quin, B. S. (2006) *The MiFID: Competition in a New European Equity Market Regulatory Structure* in Investor Protection in Europe Corporate Law Making, the MiFID and Beyond*:* Oxford University Press, p.169.

venues where the investment firm executes its client orders and the factors affecting the choice of execution venues. The policy must at least include those venues that enable the investment firm to obtain on a consistent basis the best possible result for client orders.

In order to comply with the best execution requirement, firms should ensure that appropriate execution policies and/or arrangements are effectively implemented for the carrying out of all orders. Nevertheless, this principle does not put firms under an obligation to obtain the best possible result for each individual order. Instead, in accordance with the execution policy it entails firms apply their execution policies to each order with a view to obtaining the best possible result. Besides, all investment firms that carry out orders should also disclose "appropriate information" to clients about their execution policies and monitor and review their performance.[93]

Investment firms must be able to supply proof of best execution, such as logs, or snapshots of trading at the time of execution, should a client request it. Obviously, this requires a correct outlook of the whole market. For retail orders, to fulfill best execution requirement, the Directive deems price as the primary factor for a retail investor's best execution perspective and gives priority to it by stipulating it as the first factor to be fulfilled in the absence of specific instruction otherwise.

Best execution obligation on a trader to execute orders on terms most favorable to the client is valid both on and off-exchange. This means, on the basis of the factors and criteria that is set out in the intermediaries' own "best execution policies" intermediaries shall direct orders to those trading platforms offering the best overall result for their clients. According to the Directive brokers shall include, all those venues which consistently offer the best overall result in the list of venues they make use of. By doing this, the Directive aims to support the competition between trading venues. The message is brokers should go beyond incumbent exchanges' options and seek out further offers in other trading venues to make sure to execute the best deals for their clients.[94]

Despite the fact that best execution applies to all financial instruments traded on and off-exchange, it is not expected that execution obligations will be applied in the same way for various instruments. Recital 70 of the MiFID implementing Directive clarifies that by stating that, transactions involving customized OTC financial instruments for

[93] Best Execution under MiFID Questions and Answers May 2007, Ref: CESR/07-320, The Committee of European Securities Regulators, p.6.
[94] White, L. (2007) *"The Benefits, Opportunities and Challenges of MiFID"* in the Future of Investing After MiFID Wiley Finance, p. 6.

instance may not be comparable for best execution purposes with transactions involving shares traded on centralized execution venues.

There is also an implicit relationship between client classification and “Best Execution” provisions created by the MiFID. The status of a firm’s client depending on their knowledge and experience has a direct impact on the level of duty of care which must be applied therefore correct classification of a firm’s clients is vital for the process of delivering and evidencing best execution. This can be argued as challenge for the investment firms. As clients are allowed to opt-up as well as opt-down for lower versus greater levels of best execution protection, it is essential for dealing desks which are charged by carrying out best execution duty should adapt themselves to the new client category and its implications.[95]

MiFID’s "best execution" obligation for clients generated great deal of opposition from investment banks due to the fact that it brings huge compliance costs. Clearly the investment necessary to comply with “best execution” is greater than that involved in order reception and transmission, but on the other hand the potential returns are also greater. In this regard, a firm’s “Order Execution Policy” will be their competitive differentiator.[96]

Best execution rule in investor protection concept is connected with allowing internalisation which is another novelty of the MiFID. In a similar fashion to US experience, EU legislation as well allows internalisation if appropriate best execution and pre and post trade transparency, order handling, display of client limit order requirements are introduced. The reason of this similarity is ensuring a level playing field between the three types of trading venues to assure the same level of investor protection.

4. Client Order Handling (Art. 22 (1))

Investment firms are required to carry out client orders quickly and accurately under the MiFID (*“…investment firms authorised to execute orders on behalf of clients implement procedures and arrangements which provide for the prompt, fair and expeditious execution of client orders, relative to other client orders or the trading interests of the investment firm….”*). Also, the Level 2 measures states that, firms are required to, ensure that any orders that are executed from the client’s assets in the form of settlements are required to be carried out quickly and delivered efficiently to the account

[95] Kirby, A. (2007) *“Best Execution”* in the Future of Investing After MiFID Wiley Finance, p. 45.
[96] Jenkins, A. (2007) *“Passporting”* in The Future of Investing After MiFID Wiley Finance, p. 5.

of each relevant client. In addition to this, under dominant market conditions client limit orders that are not immediately executed should be made public and investment firms should refrain from front running[97].[98]

V. CONCLUSION

If we refer to our dissertation title, MiFID providing powerful investor protection in a better integrated EU financial services market, it infers two main arguments that by the virtue of the MiFID regime the level of investor protection is increased and financial services markets are more harmonized in other words better integrated. Having reviewed the novelties, main goals of the Directive with investor protection instruments it is possible to support these arguments with some evidence from the Directive itself and recent developments in financial markets.

To start with better financial integration; MiFID's Recitals and European Commission's declarations signify the importance of a better integrated, competitive EU financial services market. In practical terms, this can be understood as trading and settling securities of other member states as easily domestic ones where issuers can more easily raise capital in a European rather than a domestic market. Within this setting, national regulatory requirements are considered by many observers to constitute a key obstacle to the integration. In order to tackle with this difficulty MiFID introduces extended single passport approach. This has been primarily carried out by including conduct of business obligations which has critical importance for investor protection under the remit of home country supervision. To achieve single passport target the Directive also eliminates some of the vague jurisdictional matters that arose under the ISD. As an extra measure to guarantee the uniformity of COB and address the risk of implementing the Directive in different ways across Europe, the European Commission's implementing Directive regarding organizational requirements and operating conditions Art.4 requires member states notify the Commission of any super-equivalent provisions they plan to introduce regarding conduct of business obligations.

[97] Front running is the illegal practice of a stock broker executing orders on a security for their own account (and thus affecting prices) before filling orders previously submitted by their customers.

[98] Ryan, J. (2007) *"An Overview of MiFID"* in The Future of Investing After MiFID Wiley Finance, p.23.

Moreover, the single passport principle will apply so far new financial instruments and investment services are concerned. Thus, this new approach for passporting will contribute and facilitate financial integration. Extended single passport principle, on the contrary to the general perception by the financial services industry will possibly reduce the overall level of regulation on firms by reducing costs of obtaining and maintaining authorization. Therefore simply it becomes easier and cheaper to carry out cross border business.

Another landmark approach MiFID brings in terms of financial integration is the removal of concentration rule. This move mainly serves boosting competition and market efficiency in securities trading. Market efficiency is considered to reflect lower volatility and greater economies of scale, probability of order execution and market depth. These concepts are also interrelated with creating an integrated, pan-European market. Removal of the concentration rule provides emergence of an integrated and competitive trading infrastructure by allowing a level-playing field among execution venues such as regulated markets, multilateral trading facilities, and systematic internalizers which in turn means greater economies of scale, probability of order execution and market depth. Up until now the recent initiatives for launching new MTFs and transaction reporting platforms by large investment banks, the fee cuts for the services of incumbent stock exchanges and consolidation attempts of some of these exchanges via mergers already proved that abolishment of concentration of rule is instrumental for market integration and efficiency.

As a result of aforementioned developments post MiFID market setting will lead to a wide range of trading platforms therefore market landscape is expected to be more complex. Thus far, specifically the trading platform of Easdaq, once planned as the pan-European exchange, but could not be realized before MiFID came into effect has been reestablished as a cross-border trading platform called Equiduct. Data dissemination firms such as Reuters and Bloomberg are developing information offerings to comply with MIFID. Also stock exchanges such as LSE and Deutsche Borse are developing a suite of new products. These developments evidence that implementation of MIFID by the financial institutions is not regarded only as a costly compliance exercise but also as an opportunity with some commercial benefits in. These developments also herald a more innovative and competitive market structure which will operate across Europe is underway. Formerly, due to over the counter market trading with lack of transparency requirements lead to fragmentation of markets and unequal competition between stock exchanges and OTC trading. However, owing to MiFID implementation there will be horizontal and vertical “fair” competition between market places such as regulated markets, multilateral trading facilities and systematic internalizers and among each category on equal terms with regard to transparency requirements.

Excellence in technology, more sophisticated tools and methods to manage is now considered as a new key competitive advantage in this setting. This will lead to an urgent need and also cost for investment firms to upgrade themselves. It can be predicted that although MiFID's compliance cost seem to be heaviest on the investment firms in due course the exchanges seem to be affected taking into consideration new entrants in the securities trading markets.

With regard to enhancing investor protection; due to the major role of retail financial services play in everyday life of EU citizens, market fragmentation and inefficiency in retail financial services market is top on the agenda for the European Commission. This fragmentation in regulatory and market structures damage investor confidence. Reinforcing investor confidence in cross border investing is a clear priority linked with better financial integration aim. To fulfil investor confidence, common COB is regarded as central instrument as it delivers same standards of investor protection across Europe, regardless of investment firms’ home country. Under this new common investor protection environment with greater focus on disclosure, best possible deals, suitability tests and client classification MiFID creates opportunities for investment firms delivering the highest standards and duty of care. COB regime through heavy disclosure requirements is structured to produce a group of informed and active investors. On the other hand, investors’ options are diversified by extending the scope of financial instruments and investment service providers complying high COB towards their clients. This will create greater competition among investor firms so investors will be able to look for services of the best quality at the cheapest price.

In addition, best execution and transparency requirements will improve prices by making more trade information easily available for investors and will increase competition in the publication of firms’ data. Provisions on best execution as part of conduct of business rules constitute new provisions for all member states. The aim of these provisions is to maximise the value of a client’s portfolio and it is not a question of best price, but depends on taking all reasonable steps to obtain the best possible result, taking a range of factors into account. Overall the retail investor may end up with a better deal on best execution but it may be difficult route for firms to achieve this. In legal terms if an investor experiences failure of investment firm to fulfil obligations arising from conduct of business obligations, or other specific investor protections such as best execution there are several options for redress. First and foremost on the basis of contractual obligations or fiduciary duties it is possible to claim compensation. Moreover, in example if the investment firm's quality of execution is likely to be open to doubt or challenge, then the investor by summarising the circumstances may help ease disciplinary action yet this is likely to stem from if a client understands "best execution" policies. This leads us to the general assumption of MiFID's investor protection provisions that investor provided with the necessary data shall make most convenient choices or monitor investment firms however this is highly reliant to the financial capability of investor in a given situation.

Other than best execution rule which serves both investor protection and market efficiency, client classification is also regarded as the starting point, central importance to investor protection approach of the MiFID. Client classification provisions give flexibility both for investors and investment service providers in relation to the level of protection they wish to receive since for different client groups, MiFID has different approaches. Retail clients are provided entitled to receive the highest level of regulatory protection which is reasonable and by this way this also serves avoiding over-regulating expert institutional clients and investment firms.

With regard to opting up and down in client categories could be a tough work for intermediaries to carry out the relevant best execution requirements for the new category of the given investor and to reap the benefits of these measures. Client classification is also critical to assess the suitability and appropriateness of the products or services given to investors. It can be argued that a truly innovative feature of the MiFID is the way that the measures are in connection with client classification to information requirements, best execution and order handling. Accordingly these set of investor protection measures work together.

Overall, the MiFID as a regulatory initiative with its capacity to govern EU financial markets provides innovative principles and approaches for financial integration i.e. *extended single passport* and investor protection i.e. *common conduct of business obligations, best execution*. It also abolishes barriers i.e. *removal of concentration rule* to competitive securities markets. As stated above competition in trading platforms is already evident. In terms of delivering investor confidence, uniform rules and new principles will be instrumental since they give chances to investors to monitor, compare and receive more suitable services to their needs. However when it comes to cross border trading due to investor bias to cross border trading and the financial capability of investors, it is likely that change will be observed gradually. Finally, referring to Internal Market Commissioner Mc Creevy's' words for MiFID as *"…Regulation is a double-edged sword. Get it right and it can tear down barriers. Get it wrong and it can be part of the problem..."* for the time being it seems the sword is got right.

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