

# SURVIVING OR THRIVING AFTER MIFID



CONSULTING > SOLUTIONS > OUTSOURCING

## White Paper

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### Executive Summary

The Markets in Financial Instruments Directive (MiFID) sets the stage to make Europe a more attractive market for investors. Even though half of Europe is late in amending national laws to incorporate MiFID, change is already underway. New trading venues, such as Chi-X, are emerging to create more competition. Trade volumes are increasing while the trade size is decreasing. This is illustrated in reports from the European stock exchanges that show a 50-120% increase in 2007 trading volumes over 2006 levels with an average 20% smaller trade size<sup>1</sup>.

From research conducted by Atos Consulting, the business consulting arm of Atos Origin, on how prepared financial organisations are ahead of MiFID, it seems that a 'wait and see' attitude prevails. Atos Consulting estimates that firms have spent 20-25% less than initially expected by deferring investment because they want to see the actual impact of MiFID will be. For example, will the liquidity market fragment as predicted?

To thrive after MiFID, organisations need to differentiate their execution policies and demonstrate 'Best Execution' through publication of trade statistics. They also need to maximise order flow volume and reduce marginal transaction costs to ensure competitive advantage.

This white paper looks at what financial firms can still do to gain and retain competitive advantage and so become one of the winners in the new market that will emerge when MiFID comes into effect on 1 November 2007.

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# MIFID – BALANCE BETWEEN REGULATIONS AND MARKET FORCES

MiFID, a cornerstone of the EU Financial Services Action Plan, balances principles of transparency and competition with implementing regulations on a cross-border scale that has never before been attempted. In this paper, we set out the key defining features of the legislation, the landscape in which it is being adopted, and the critical role of technology in the transformation of principles into winning business strategies and practices.

## Impact on the market

MiFID sets the stage for greater transparency and competition by:

- > Removing the remaining barriers to Pan-European competition, such as the national concentration rules requiring trades to be concluded through local markets.
- > Introducing principles-based regulation, better enabling commercial innovation.
- > Obliging firms to provide the best possible results for client trades, by taking into account client needs, product type, and market conditions.
- > Requiring firms to better understand the knowledge, experience and financial condition of their clients through suitability and appropriateness testing.

## Impacts on clients

After MiFID, clients will have access to more comprehensive and enhanced information on firms' products and services. The focus on client protection will mean that some clients will have greater restrictions on what they can trade.

Clients will benefit from the management and disclosure of conflicts of interest and non-monetary benefits provided by third parties. This paves the way for greater transparency and trust.

“ . . . a rule reflects the consensus of past situations and can only address circumstances known or anticipated by regulators at the time of implementation. Thus, rules become outdated as circumstances change . . .

While principles are characterised by less preciseness, they remain more durable and widely accepted. Indeed, principles leave an open window to adapt judgements in case of changing circumstances and thus need less frequent changes which would spread out confusion.”<sup>2</sup>

**Yves Mersch**

President of the Banque centrale du Luxembourg

14 June 2007

<sup>2</sup>BIS Review – 7 September 2007 – <http://www.bis.org/review/r070712e.pdf?noframes=1>

# 'BEST EXECUTION' DRIVES COMPETITION

One of MiFID's strongest principles is the 'Best Execution' requirement.

**Firms must take all reasonable steps, when executing orders, to obtain the best possible results for clients, taking into account price, costs, speed and other factors relevant for the execution of the order.**

This principle adapts to varying client circumstances and product types in an inherently more flexible approach than one based purely on price. This is especially important in fast moving markets or in times of financial stress where factors, such as speed and/or certainty of execution, play a more important role than price.

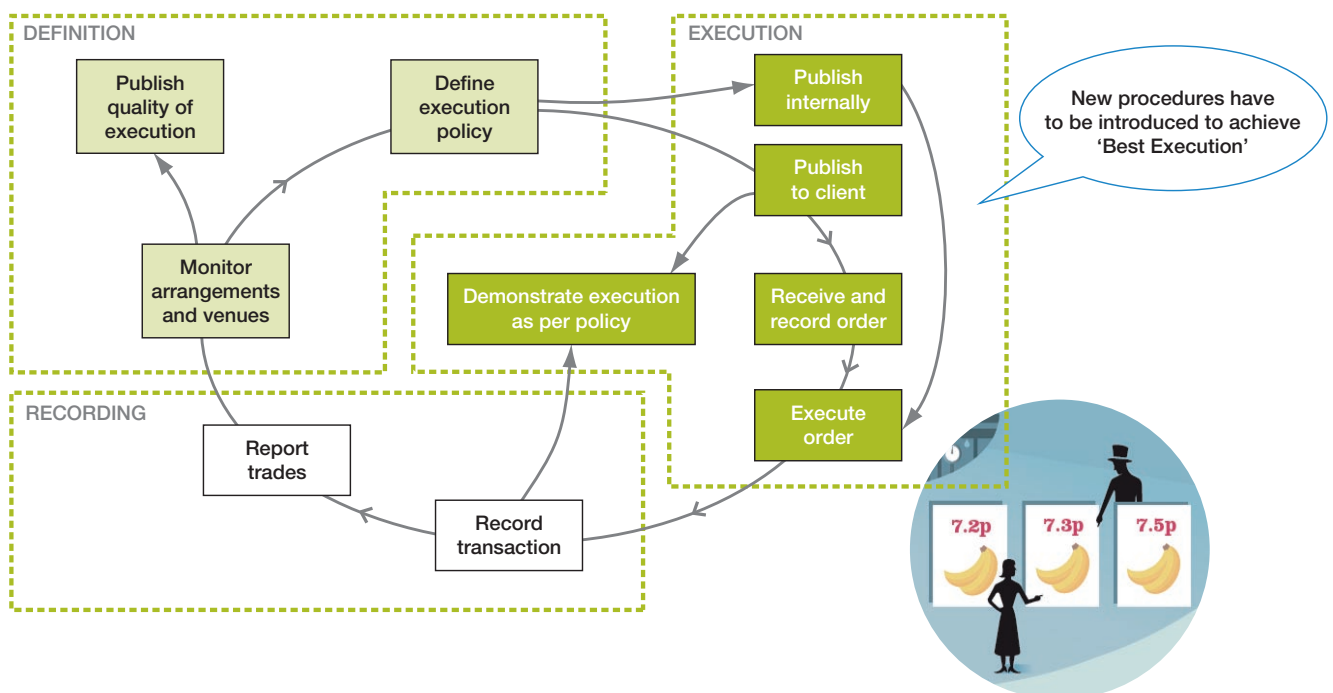
Buy-side asset managers are generally requesting to be treated as professional clients, who are owed 'Best Execution' under MiFID.

There are four stages for achieving 'Best Execution':

1. Defining a firm's execution policies
2. Managing trades according to the execution policies, using smart order routing and other technology
3. Monitoring the effectiveness of execution policies
4. Being able to demonstrate 'Best Execution'.

Technology solutions can best address all four stages through continuous improvement and feedback. For example, monitoring the effectiveness of an execution policy through Transaction Cost Analysis and Reporting can help firms to better differentiate themselves in the market.

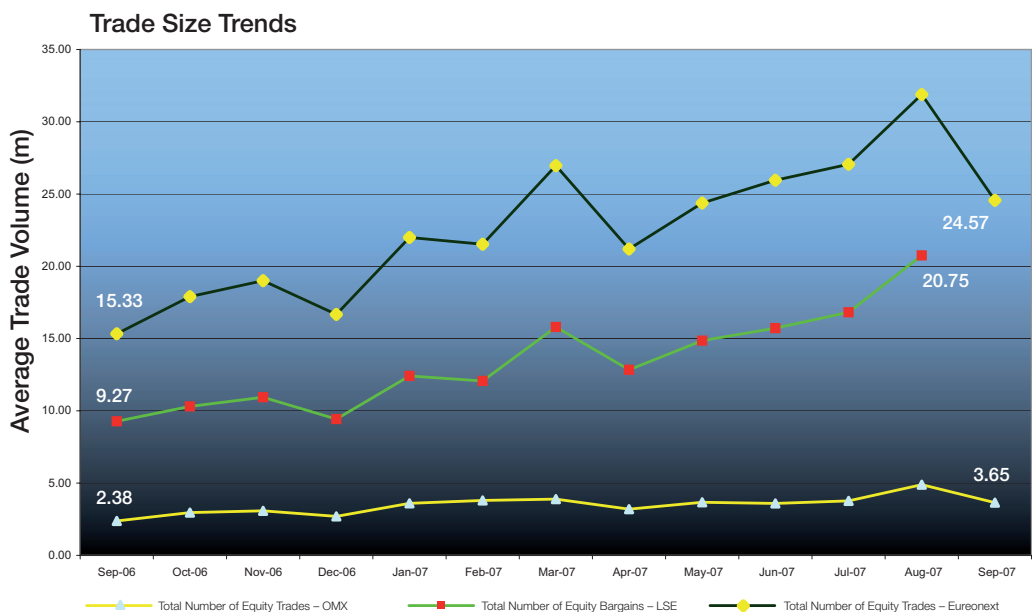
## 'BEST EXECUTION'



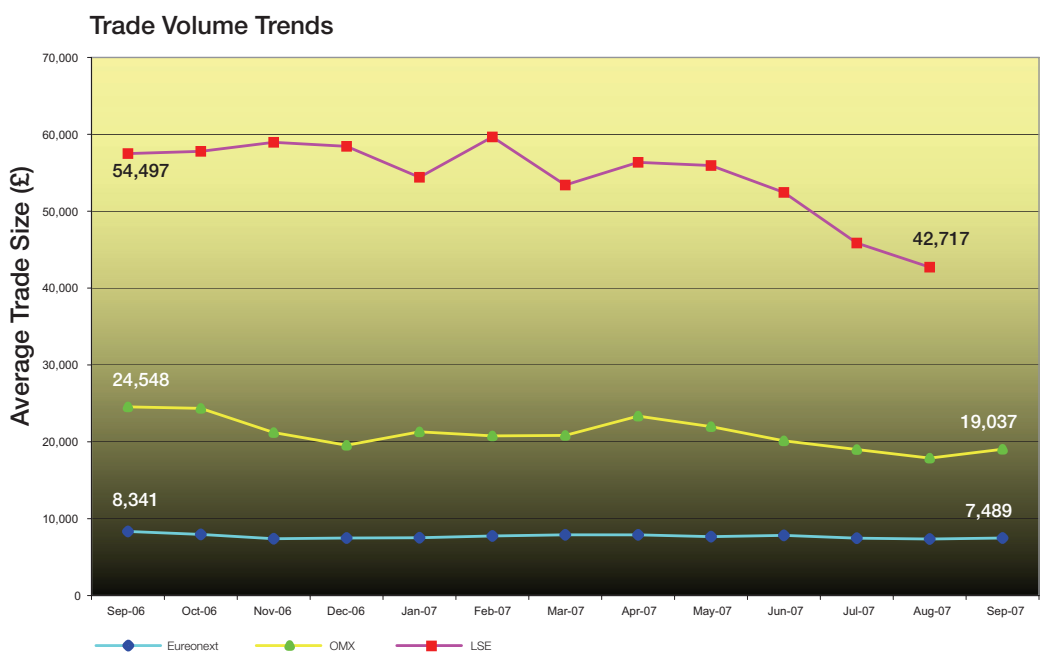
# MIFID SET TO STRENGTHEN MARKET FORCES

In 2007, we are already observing market forces at work in anticipation of the 'open door' to greater competition provided by MiFID.

European exchanges are reporting sizeable increases in 2007 trading volume which is most likely to be the result of smart order routing technology which reduces average order size and distributes orders among multiple venues to reduce the market impact of larger block trades. On the London Stock Exchange (LSE), the total number of equity bargains per month more than doubled from September 2006 to September 2007, with a similar pattern reported by Euronext together with substantial increases on the OMX.



At the same time, average trade sizes decreased on all three exchanges with an average 20% smaller trade size from September 2006 to September 2007.



<sup>9</sup>Source: Euronext, LSE and OMX Monthly reports – 2007

New venues are emerging and capturing increasing market share such as Chi-X, a new electronic venue which is a Multilateral Trading Facility (MTF) under MiFID. Trading data for August 2007 indicated that Chi-X captured between 20-40% of combined primary exchange (the venue where the shares were originally listed) and Chi-X volume for large European firms, such as Philips Kon, ING and Royal Dutch Shell, with an average price improvement of about 2 basis points for the 49% of trades executed within the primary market spread.

We expect this trend to accelerate as more venues come on-line under MiFID. Client expectation of 'Best Execution' will fuel feedback to provide a further impetus to competition, as firms increasingly seek to differentiate their execution policies to attract and retain new clients. Opportunities for automation through trading strategies and systems are likely to further intensify competition by increasing small order flow.

We believe that European cash equity trading may follow a similar pattern to that in the USA, where 'decimalisation', though intending to create greater transparency, pushed liquidity into non-disclosed pools.

"... regulatory efforts by the Securities and Exchange Commission (SEC) to make markets more transparent for retail investors have sometimes had unintended effects. Decimalisation was a prime example. By reducing the price increments for trades and creating more opportunities for traders to 'step ahead' of one another, decimalisation unwittingly forced a large degree of liquidity into the dark as traders tried to maintain their anonymity.

This increase in non-displayed liquidity furthered fragmentation, making it more difficult for institutions to trade large blocks of stocks while preserving anonymity and minimising market impact.

This fuelled the development of next-generation smart routers to deal with pools of hidden liquidity. It also hastened the growth of block crossing networks to handle large institutional orders."<sup>4</sup>

**Chris Rice**

Global Head of Trading, State Street Global Advisors

April 2006

<sup>4</sup>Article entitled, 'New liquidity pools pose latest challenge for Institutional Trades' published at <http://www.ssga.com/library/esps/chrisricenewliquiditypools20060404/page.html>

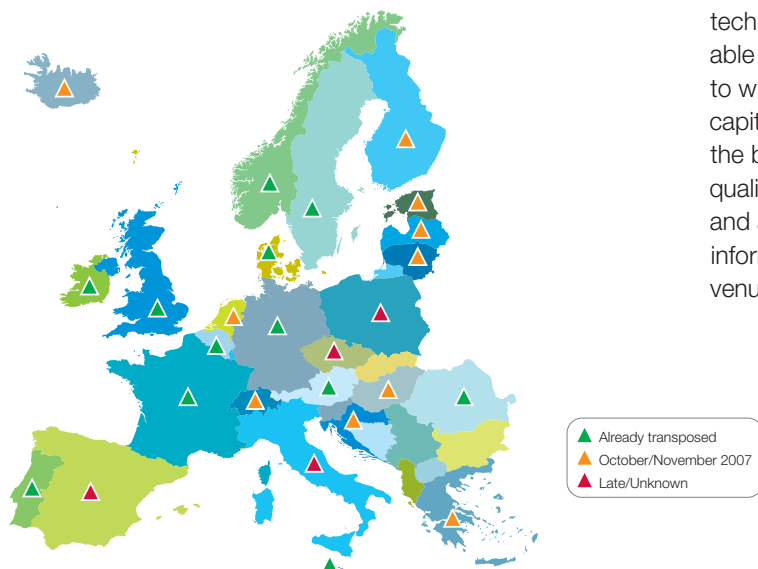
# LATE TRANSPOSITION FOR HALF OF EUROPE

An uneven picture of MiFID readiness is emerging in late October 2007 – half of the countries in the European Economic Area (EEA) are either now in the final stages of transposition or have yet to transpose. In part, this is because MiFID is a complex legislation with some features introducing new requirements such as the regulation of investment advice for various EEA countries.

Another reason for late transposition is that transforming the European Union Directive into national legislation and regulation is part of a political process. Timing of the transposition in some countries has been influenced by political events, such as elections.

## What does this mean?

- > At least temporarily, firms in countries which have already transposed will be able to passport their MiFID-compliant services directly into non-transposed countries where local firms may not be able or lack preparation to compete.
- > Clients may be confused, not knowing whether products or services purchased will benefit from MiFID regulation on conduct of business or client protection.
- > Firms operating in non-transposed countries face non-harmonised conduct of business rules.
- > Uncertainty on the timing of transposition could delay investment in market infrastructure that is needed to deliver 'Best Execution' in the affected countries.



## Investment below expectations

We see a focus on 'bare minimum' spend – MiFID budgets are just large enough to achieve minimal compliance. Research by Atos Consulting into how financial organisations are preparing for MiFID suggests that a 'wait and see' attitude prevails in Europe. Based on analysis of spending patterns at 15 investment banks and comparing them with the cost model that Atos Consulting first published in June 2005 and then updated in February 2006, firms have spent 20-25% less than expected.

This doesn't mean that the total cost of implementing MiFID will be less, rather it reflects a degree of 'sitting on the fence' for discretionary spending, for example:

- > There is little appetite among sell-side firms for systematic internalisation. Firms see high costs and risks to capital but are finding it harder than anticipated to estimate the revenue potential.
- > Regulatory disarray has reduced available time for end-to-end testing. As a result the firms risk having to rectify issues in a live environment which should have been identified earlier, had there been an effective testing programme.
- > Firms are waiting to see if fragmented liquidity becomes a reality. Clearly, if fragmentation occurs soon after MiFID, then these firms that have not invested in smart order routing will be disadvantaged.
- > Firms are waiting to see if client demands for 'Best Execution' can be satisfied with existing technology. This is in the expectation that they will be able to quickly reduce the sample sizes of the trades to which 'Best Execution' applies and avoid both capital and operational spend. Such firms will not have the basis for producing robust statistics on execution quality, which may hinder their marketing programme and also may not satisfy their clients' demands for information, when the time comes to review execution venues – no later than October 2008.

# TECHNOLOGY – A KEY DIFFERENTIATOR

Unlike the National Market System (NMS) in the USA, which is prescriptive regulation, MiFID is principles-based, allowing firms to implement their own interpretation of MiFID requirements. Technology will play a key role in firms implementing their requirements and Atos Origin has identified three key areas where technology can help:

- > **Smart Order Routing** – technology which tests latency and liquidity in order to match order flow to the best venue in dynamic market conditions.
- > **Venue Monitoring** – systems and processes which identify new markets including systematic internalisers, multilateral trading facilities as well as regulated markets.
- > **Transaction Cost Analysis** – a framework for capturing trade data to compare the execution of specific trades to prevailing market conditions over multiple venues.

We expect to see greater differentiation between the winners and losers as MiFID takes hold; the winners will proactively deploy technology to reduce trading cost and increase efficiency in spite of larger order flows; losers, meanwhile, will retain a short-sighted cost reduction focus.

## Surviving or Thriving after MiFID

MiFID is much more than a compliance exercise. Financial firms that see MiFID as an opportunity to distinguish themselves from their competitors will thrive. The diagram below shows the attributes and actions of the firms that will thrive, survive and fade out.



### THRIVING FIRMS WILL

- > Differentiate their Execution Policies – standing out from the crowd.
- > Demonstrate ‘Best Execution’ through publication of comparative Transaction Cost Analysis.
- > Be early adopters of order routing technology, maximising order flow volume and reducing marginal transaction costs.



### SURVIVING FIRMS WILL

- > Manage their MiFID programmes to achieve minimal compliance.
- > ‘Fence-sit’ awaiting first moves from market leaders.
- > Delay technology spending, risking loss of clients as market leaders move ahead.



### FIRMS FADING OUT WILL

- > Take no action until regulators threaten enforcement.
- > Adopt ‘me-too’ Execution Policies when pushed, which pass compliance but do not differentiate the products and services of the firm.

## Conclusion

Today, by deferring investment, European financial firms are compliant but not ready to compete in the new market that will emerge on 1 November 2007. If the fragmentation occurs soon after the implementation of MiFID, as predicted, then those firms that have not invested and are not able to produce robust statistics on execution quality, may find that their marketing programme is hindered, when the time comes to review execution venues – no later than October 2008.

### What can firms do today to thrive?

Most firms are already re-writing and distributing client agreements ('repapering') including key details on their execution policies. Rather than distributing a 'me-too' or a one-size-fits-all execution policy, firms should consider tailoring the policies to their key clients, anticipating the factors and venues which provide winning services for that client. Improvements to processes and systems, including the proactive use of transaction cost analysis to demonstrate 'Best Execution', can then be budgeted based on a focused approach to the market.

**For further information please email [compliance@atosorigin.com](mailto:compliance@atosorigin.com)**

## About Atos Origin

Atos Origin is an international information technology services company. Its business is turning client vision into results through the application of consulting, systems integration and managed operations. The company's annual revenues are EUR 5.4 billion and it employs over 50,000 people in 40 countries. Atos Origin is the Worldwide Information Technology Partner for the Olympic Games and has a client base of international blue-chip companies across all sectors. Atos Origin is quoted on the Paris Eurolist Market and trades as Atos Origin, Atos Euronext Market Solutions, Atos Worldline and Atos Consulting™.

## About Atos Consulting

Atos Consulting™, the global consulting practice of Atos Origin, is a leading provider of business, process and technology consulting services. With more than 2,500 staff globally, it focuses on delivering proven, pragmatic solutions to the telecom, manufacturing, financial services and public sectors.