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MiFID: Markets in Financial Instruments Directive Implementation in the Czech Republic

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Poděkování

Chtěl bych tímto poděkovat PhDr. Martinu Kubíčkovi, že mne k této problematice přivedl. Velké díky patří PhDr. Adamu Geršlovi, PhD., za jeho velmi podnětné a cenné rady, kterými mne vždy dokázal přesně nasměrovat při psaní práce.

Prohlašuji, že jsem tuto práci vypracoval samostatně za použití uvedených pramenů a literatury.

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Contents

Abstract

Markets in Financial Instruments Directive is at the very heart of EU's Financial Services Action Plan to integrate markets for financial services in the EU. We begin by investigating MiFID from a broader context of the FSAP and in comparison with its predecessor as a starting point for the changes MiFID introduces. Then the most important and revolutionary provisions of MiFID are described. We then analyze MiFID from the cost-benefit side by listing and discussing the reults of the Cost Survey undertaken by the UK's Financial Services Authority. To gather some empirical data, a survey among Czech investment firms investigating expected qualitative impacts of MiFID has been organized. Institutional side of MiFID's impacts is being discussed. Based on the FSA's Cost Survey, we try to estimate upper bounds for compliance costs for the Czech investment industry. The conclusion is that some of MiFID's provisions are controversial and will be difficult to implement and enforce. It will also likely have significant impact on market infrastructure and distribution of profits.

JEL Classification: F02, G15, K23.
Keywords: MiFID, FSAP, financial markets regulation, compliance costs.

Abstrakt

Směrnice o trzích finančních nástrojů (MiFID) je jádrem plánu Evropské Unie plně integrovat finanční trhy v EU, tzv. Financial Services Action Plan. Úvodem zkoumáme MiFID v širším kontextu FSAP a ve srovnání s jejím předchůdcem jako východiska pro změny, které MiFID zavádí. Poté je uveden popis hlavních a nejvíce přelomových ustanovení MiFIDu. Dále je MiFID analyzován z pohledu nákladů a výhod uvedením a diskusí Cost-Benefit analýzy, kterou provedla britská Financial Services Authority. Abychom získali nějaká empirická data, byl sestaven dotazník zkoumající kvalitativní stránku očekávaných dopadů MiFIDu mezi českými obchodníky s cennými papíry. Diskutovány jsou institucionální charakteristiky dopadů směrince. Na základě britské Cost-Benefit analýzy jsme se pokusili provést horní odhad celkových nákladů českého sektoru finančního zprotředkování. Docházíme k závěru, že některé ustanovení MiFIDu jsou sporné a bude složité je zavést a vymáhat jejich dodržování. Směrnice také s velkou pravděpodobností ovlivní strukturu trhu a rozdělení zisků.

JEL Klasifikace: F02, G15, K23.
Klíčová slova: MiFID, FSAP, regulace finančních trhů, compliance costs.

1 Introduction

Financial markets integration has been high on the agenda of the European Union for decades now. Efficiently functioning and integrated financial markets are an inevitable part of wider economic integration. Actual progress of financial markets integration has been rather slow until the 1990s, when increased pace of globalization and information technologies advancement started to put increased demands on EU regulators and law-makers to keep up with rapid developments.

The European Union, in its efforts to achieve full integration of markets for financial services, has launched the Financial Services Action Plan in 1999. It was a reaction to the development of the markets, when previous regulatory framework ceased to be adequate. Its aim was to achieve full integration of financial markets in the European Economic Area[1] by 2005 through the means of 42 measures.

The Markets in Financial Instruments Directive (MiFID)[2] is at the very heart of this endeavour. It replaces the Investment Services Directive from 1993, which could not cope with rapid developments of financial markets in that decade anymore. This new piece of legislature comes with a lot of new and revolutionary concepts of financial market regulation, which gave rise to heated debates and disputes throughout the EU, as some of these concepts are rather controversial.

In this thesis, we would like to describe and analyse the Directive itself, changes it brings and possible repercussions in the markets. We also take a specific point of view of the Czech Republic and try to analyze the process of implementation and impacts in our specific conditions. This thesis is organized as follows.

In Chapter Two, we give an overview of academic literature on international financial integration, its benefits and risks. Then we have a look at the effects the creation of European Monetary Union had on the pace of financial integration in the EU. We describe the predecessor of MiFID and try to find reasons why it failed. Later, the Financial Services Action Plan comes onstage as the groundwork of MiFID. Finally, we give a preliminary description of MiFID, a brief comparison with ISD and a short assessment of the Lamfalussy procedure through which the Directive has been adopted.

[1] Further in the text, we use the term European Union or European instead of European Economic Area. It is because the Directive has been drafted and adopted by EU officials and most of the debate that both preceded and followed the adoption took place within EU. However, we do not think that this should create any ambiguities or doubts.
[2] The Directive for the purposes of this thesis.

Chapter Three contains a more detailed description of the provisions of MiFID and its main characteristics.

Chapter Four gives an analysis of possible impacts MiFID could have on the operation and behaviour of markets and firms. It also gives an overview of possible costs associated with MiFID, as estimated by the UK's Financial Services Authority.

In Chapter Five, we analyze MiFID under the assumption of specific conditions of the Czech Republic. Later, we present the results of a survey done among seven representatives of Czech investment firms on expected impacts of MiFID. In the last part of this chapter, we give estimates of upper bounds of total costs associated with MiFID and a discussion of a few expected broader market effects.

Chapter Six concludes.

2 Financial markets integration

The idea of a single European financial market dates back as far as to the Treaty of Rome in 1958, when the principles of free movement of capital and non-discrimination on national basis were outlined. The actual progress of liberalization and uplifting of restrictions differed across the fields, from fully liberal FDI flow to persisting restrictions on acquisition of shares by non-residents etc.

Since 1973, single European market for financial sevices has been under construction. However, the process of achieving this goal advanced rather slowly with respect to meeting the demands on regulatory framework the pace of global financial market change created. The need for decisive action emerged only after the world had witnessed a ground-breaking development of financial sector during 1990s and with the intention to introduce the euro, which put pressure on the EU-representatives to adopt measures ensuring a competitive and integrated financial market which would prevail against newly emerged threats of globalized markets. In this chapter, we give an insight into the theory of international financial integration and how it evolved in the Euro area.

Firstly, we will present an overview of academic literature on financial markets integration and its costs and benefits. We will try to identify main problems and difficulties related to and arising from this type of integration, as well as its benefits for the countries involved.

Efforts to create monetary union had remarkable impact on financial markets across the EU. This influence on financial integration cannot be omitted. Hence, we present a summary of effects that the intended, and later realized creation of monetary union had on the integration of European financial markets, as is given in various academic sources.

Next, we will try to evaluate antecedent regulation from an academical point of view, its advantages and flaws. MiFID reacts to the development of markets that was detrimental to the idea of single European market for financial services and which then-regulatory framework failed to capture. The architecture of former regulation had, therefore, distinct impact on MiFID.

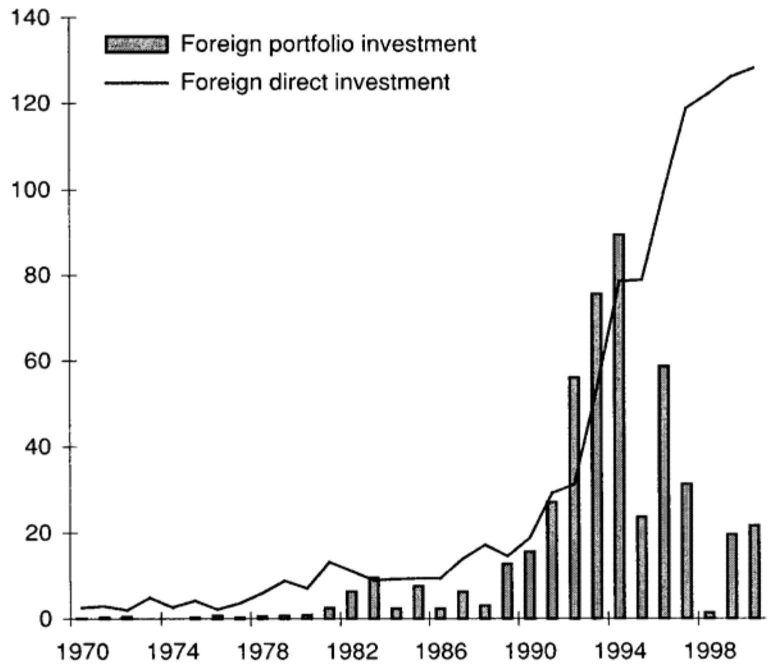
In the last part of this chapter, we discuss the new approach to financial legislature adoption and enforcement promoted by the Commission, namely the Financial Services Action Plan and the Lamfalussy procedures. A brief overview of main changes MiFID brings about is also included.

2.1. International financial integration

International financial integration (IFI) is perceived as yielding potential positive growth effects for the parties involved. In a neoclassical framework, which we will discuss here, switching from financial autarky to full financial openness is associated with direct and indirect effects. These are both on the beneficial side as well as on the costly one. We will try to give a summary of their assumed magnitude and scope.

The pace of IFI has accelerated significantly in the late 1980's and in 1990's. International financial flows grew nearly exponentially in the environment where a significant number of countries dismantled restrictions on capital flows as a part of their market-oriented reforms (Central Eastern European Countries, East Asia, Latin America). This openness has been accompanied by a surge in private capital flows to these countries (Agénor 2001), as can be seen in *Fig. 1.* These flows were encouraged by the possibility for the investors to achieve higher risk-adjusted rates of return and international risk diversification. On the receiving side, financial openness is expected to increase borrowing opportunities, thereby giving the opportunity for consumption smoothing, which implies counter-cyclical nature of international capital flows. However, as we will see later, this assumption is somewhat exaggerated.

Fig. 1. Net Flows of Investment to Developing Countries, 1970-2000 (in billions of US dollars)



Source: Agénor (2001)

Economic theory provides us with conflicting conclusions as to the growth effects of IFI. Some theories predict a positive effect of international risk-sharing on product specialization, capital allocation and economic growth (Obstfeld 1994; Acemoglu and Ziliboti 1997). Furthermore, capital flows from developed countries to capital-scarce countries are expected to have positive output effect on the receiving country's economy (Edison et al. 2002). Having a look at the estimated magnitude of the growth effects of IFI in reality, no clear picture emerges. Some authors estimate the effect of IFI to increase consumption by 1% permanently for an average non-OECD country, arguing that cutting the productivity gap has much larger estimated effects than mere IFI (Gourinchas and Jeanne, 2003). Other authors, e.g. Henry (2003) or Bekaert, Harvey and Lundblad (2002) estimate opening the stock market for foreign investors to add up to 2% of economic growth for five consecutive years. On the other side of the range, authors like Rodrik (1998) or Edison et al. (2002) find no direct link between opening capital account and economic growth.

Some authors argue that if IFI has important growth effects, then these must be indirect and manifest themselves through channels that are not covered in the neoclassical framework (Gourinchas, Jeanne 2003) by raising productivity and putting more pressure on institutional architecture, namely responsible macroeconomic policies, prudent regulation and adequate legal measures (Edison et al. 2002; Gourinchas, Jeanne 2003).

IFI is also assumed to have important impact on the functioning of capital markets. It ought to boost equity markets liquidity (Levine and Zervos 1998b, Henry 2000), increase their breadth and depth and lower transaction costs in the process, ultimately promoting investment through decreased cost of capital (Edison et al. 2002; Baldwin and Forslid 2000). Easing restrictions on foreign participation in capital markets can therefore boost economic growth (Bekaert et al. 2001).

On the other hand, IFI is not associated with solely positive effects. It is argued that in the presence of pre-existing domestic distortions, IFI can hamper economic growth, implying the need for antecedent institutional soundness (Edison et al. 2002). Another strain of argumentation is led along the lines of macroeconomic stability. High degree of openness can be associated with overshooting of investors' reactions to changes in fundamentals, as short-run flows are highly dependant on risk perception, going hand in hand with herding and contagious effects (Chang and Velasco 2000; Agénor 2001). IFI can result in significant problems when capital flows are of short-run and speculative nature, implying high volatility of capital account (large reversals of short-term capital caused by speculative motives). Large capital inflows are effectively monetary expansion if not sterilized and can cause sudden real and nominal exchange rate shocks (Agénor 2001). It is also argued that these short-term flows are of pro-cyclical nature. A country can gain access to loans in "good" times but can be refused a loan during "bad" times, which makes the assumption of consumption smoothing a fiction (Agénor 2001).

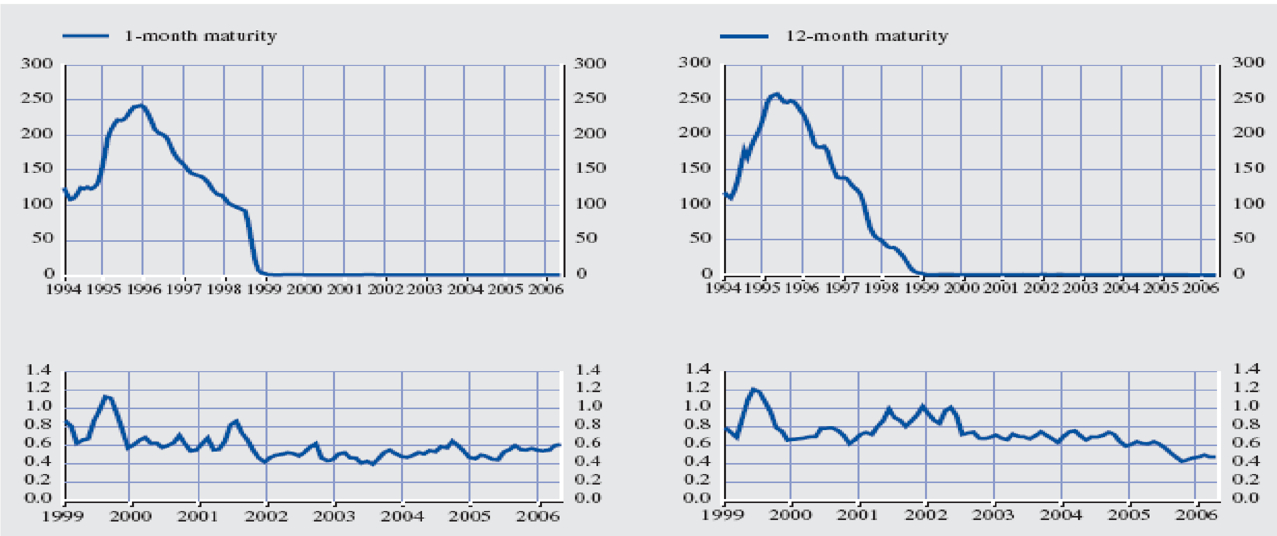
2.2. European Monetary Union and financial integration

Plans to create a monetary union among the Member States have had quite a long history. They started to acquire tangible contours in 1990's with the creation of EMU and subsequent introduction of common currency.

Pace of integration of European financial markets gradually increased in 1990's in the anticipation of monetary union. Delors Report[3] outlined the pathway of aims to be achieved before the introduction of single currency. This period was characterized by regulatory harmonization, convergence in bond yields and inflation rates and prudent fiscal policies across the euro area countries. The introduction of the euro has improved transparency, standardized pricing and reduced transaction costs (Hardouvelis et al. 2006) and simultaneously, increased willingness to trade cross-border.

High degree of convergence of money and bond markets has been achieved by late 1990's (Fratzscher 2002). Actual progress can be seen in following figures.

Fig. 1 Cross-country standard deviation of unsecured interbank lending rates across euro area countries.

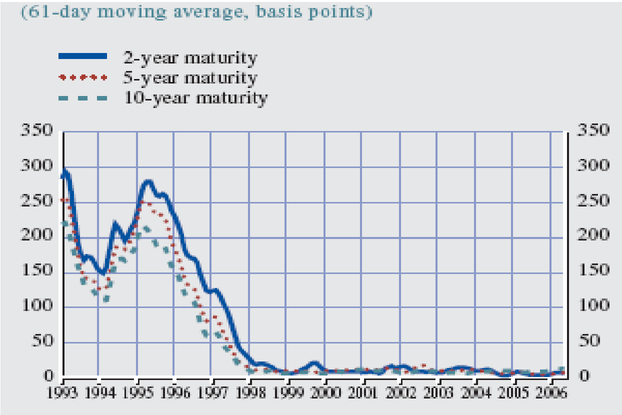


Source: ECB (2006)

[3] http://ec.europa.eu/economy_finance/the_euro/road_to_emu9383_en.htm

Fig. 2 Standard deviation of government bond yield spreads for two, five and ten year maturities.

Source: ECB (2006)



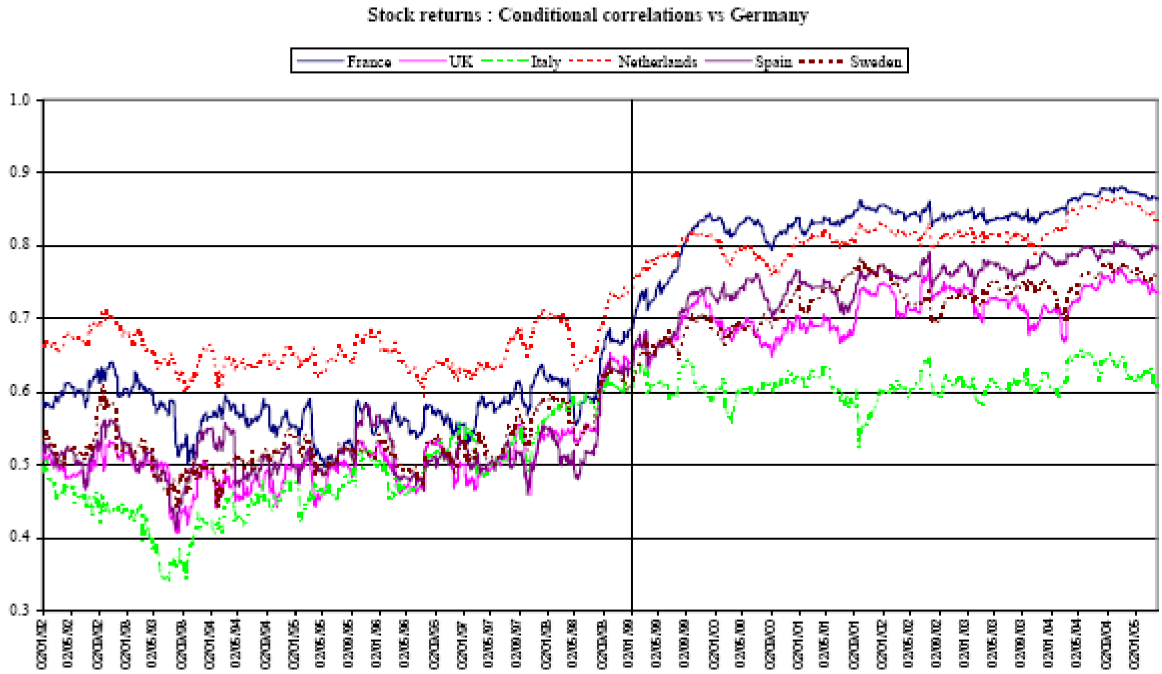
Source: ECB.
Note: As a benchmark, the German government bond yield is taken for ten-year maturity bonds and the yield on a French government bond for two and five-year maturity bonds. Greece enters the calculation of standard deviation for all maturities upon the date of its entry into EMU in 2001.

Some authors like Pagano et al. (2004) or Lane and Wälti (2006) argue that despite legal regulation advancement and single currency, banking market does not show any strong signs of integration. Furthermore, they argue that the degree of integration varies between segments of the market, retail segment exhibiting much weaker degree of integration than the corporate one.

Equity markets across the euro area were showing a substantial increase in correlation of returns after the introduction of single currency. Fratzscher (2004) argues that European stock markets have been increasingly integrated only after 1996 and that this was stimulated mainly by the drive towards EMU. In particular, this was driven by the elimination of exchange rate volatility and uncertainty in the process (Dumas and Solnik 1995; Hardouvelis et al. 1999; Fratzscher 2004). Hardouvelis et al. (1999) find evidence supporting their hypothesis that common currency was the driving force in stock markets integration on the example of UK, which stock markets have not shown increased degree of integration following the euro introduction. They also argue that the integration process in the euro area appears to be a locally specific phenomenon, independent of possible simultaneous global integration. London Economics (2002) have estimated that full integration of European capital and bond markets could cut the cost of capital for non-financial European entities by more than 40 basis points both on equity and debt. Dvorak (2005) finds that EMU has raised the investment rate by five percentage points.

However, among all markets discussed in this section, equity markets show the weakest advancement in integration process, as illustrated in Fig. 3. Despite increased determination of returns by common factors (i.e. euro area-common ones) and decreased home bias of institutional investors, equity markets remain among the least integrated markets in the euro area (Pagano et al. 2004).

Fig. 3. Conditional correlations of equity index returns



Source: Hartmann (2005)
Note: Authors applied dynamic conditional correlation GARCH model by Engle (2002)

2.3. Investment Services Directive

The regulation in force throughout the most of the 1990's was the Investment Services Directive (ISD)[4] adopted in 1993. The key properties of this directive, aside of setting out basic principles of conduct of business and organizational requirements, were the intra-EU passportability of investment services and the concept of "minimum harmonization, mutual recognition". The latter concept turned out to be detrimental to the idea of "level playing field". ISD was, in comparison with MiFID, largely a principle-based directive with no implementing measures, leaving rules of conduct investment firms should observe to be precised by the Member States. „*These rules had to take account of the professional nature of the person for whom the service was provided*"[5]. Hence, the harmonisation effect of ISD was very limited, leaving the implementation of the rules and supervision to the Member State in which the service was provided. That means that investment firms were *"potentially subject to fifteen different interpretations of the general principles set out in ISD*"[6]. Furthermore, the host state could impose more prudent regulation than postulated by ISD if it thought additional requirements were necessary for the "general good". These provisions could, and

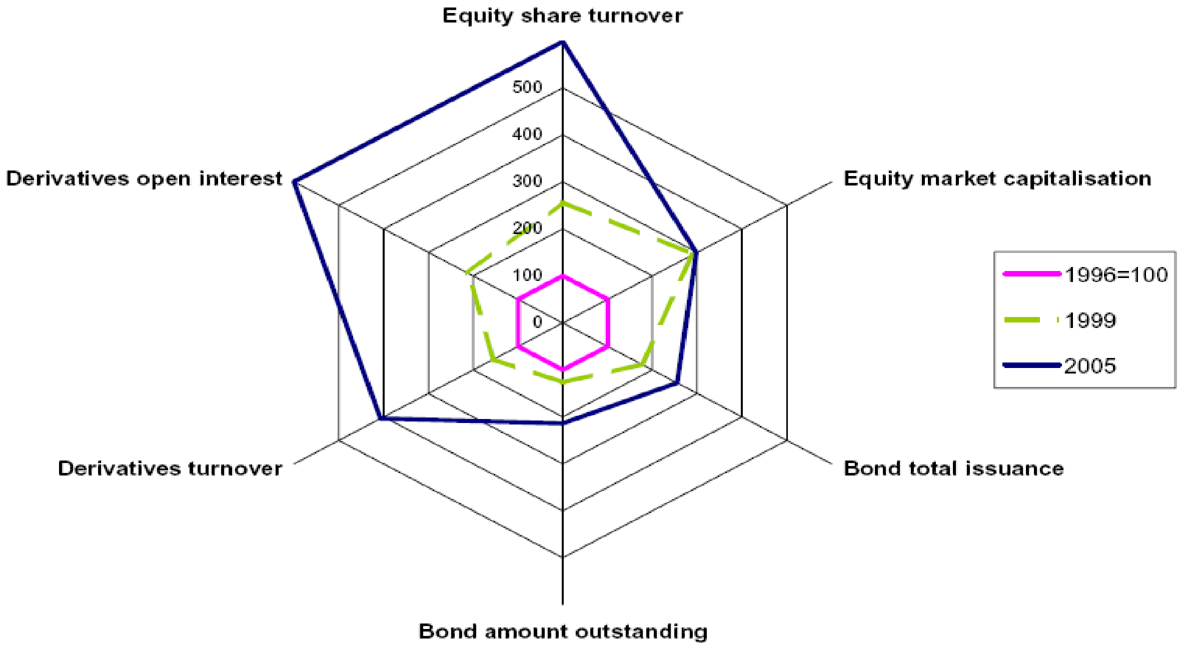
[4] Directive 93/22/EEC
[5] Ferrarini (2005), p. 23
[6] Ferrarini (2002), p. 23

sometimes were, a source of moral hazard. Domestic regulators could use these provisions as a barrier to seal off or at least limit the operation of foreign investment firms in their country.

Moreover, the concentration rule of ISD, by which Member States could require that trades in listed shares be executed on the main exchange or the regulated market, turned out to bring adverse effects. It is based on the assumption that a market in a security can be fair only if all trades in this security are executed in single market. This rule caused a significant portion of trading to evade regulated platforms and be negotiated upon Over-the-Counter (OTC), resulting in market participants having incomplete information and price formation being adversely affected. Exchanges most heavily influenced by this rule were those in France, Italy and Spain.

On the other hand, as we can see in Figure 1 below, during the time when the Investment Services Directive was in force, bond issuance more than doubled, equity market capitalisation tripled and equity share turnover and amount of derivatives contracts grew six times. Markets saw rapid development both in terms of volumes of trade and issuance and in further sophistication and emergence of new instruments. We could observe a shift from a predominantly bank-dominated system to a more market-lead one. Most of the authors who were studying these issues doubt that ISD was influential to this market development. At best, they consider the effect of ISD on the market growth and development to be of very limited nature (Ferrarini 2005; Casey, Lannoo 2006a). Clearly, EU financial markets have benefited from quite a long period of favourable global economic development without any serious turmoil, accompanied by positive externalities of successful efforts to introduce single currency. The introduction of the euro has brought about emergence of much larger, stable and liquid currency area, as we could observe over past ten years. It is difficult, therefore, to distinguish between natural market development and regulatory framework influence.

Fig. 4. EU Securities Market Growth, 1996-2005



Source: Casey, Lannoo (2006)

2.4. Financial Services Action Plan

In recognition of the above outlined development, the 1998 Cardiff European Council invited the Commission to *„to table a framework for action ... to improve the single market in financial services"*[7]. The Commission responded later that year by publishing a Communication[8] that set the main goals to be achieved in order to reap full benefits of common currency and optimally functioning financial markets. After consulting with market participants and other institutional adaptations, the Commission published a Communication[9], endorsed by the Lisbon European Council in March 2000, containing a Financial Services Action Plan (FSAP), a set of 42 measures intended to create the environment supporting the integration of financial services markets across the EU by 2005. The three strategic objectives of the Action Plan are as follows[10]:

- The creation of a single EU wholesale market for financial services and products;
- The creation of a single financial retail market; and

[7] Pt. 17, Presidency Conclusions from Cardiff European Council
[8] COM (1998) 625. 28.10.98: *Financial Services: building a framework for action.*
[9] COM (1999) 232. 11.05.99: *Financial Services: Implementing the Framework for Financial Markets: Action Plan.*
[10] COM (1999) 232. 11.05.99: *Financial Services: Implementing the Framework for Financial Markets: Action Plan.*

- Implementation of state-of-the-art prudential rules and supervision.

2.5. Markets in Financial Instruments Directive

MiFID is the core measure of the Financial Services Action Plan. It brings about significant changes into the way financial markets are regulated as a response to the development of financial markets since the ISD, which it replaces. As with other directives adopted using the Lamfalussy approach (see further below in this chapter), MiFID is comprised of a Level 1 Directive[11] that is intended to serve as the core text outlining main principles of regulation, with particular provisions set out in detail in the Level 2 measures. These comprise of a Level 2 Directive (ID), which is to be transposed into national legal systems, and Level 2 Regulation (IR), which is directly applicable without any changes and, hence, is of a highly harmonising nature.

Level 2 Directive deals with issues that directly affect investment firms' functioning. These are conduct of business rules such as clients order handling, best execution requirements, conflicts of interests, record-keeping and outsourcing.

Level 2 Regulation applies to investment firms as well as to exchanges. It covers the issues of pre- and post-trade transparency, transaction reporting and derivative financial instruments.

In this chapter, we compare MiFID with its predecessor and review the Lamfalussy procedure.

2.5.1. A comparison with ISD

Let us now compare MiFID with its predecessor. The scope of regulation has been broadened significantly and the Directive comes up with a lot of new concepts and approaches. For instance, investment advice is now included in the list of core investment services. This is a very important and bold change with far reaching consequences (we discuss this in the Tied Agent sub-chapter of the next chapter). Rules of conduct of business and rules of communication with clients have been specified in quite a profound way. The Directive also changes the regime of cross-border cooperation of supervisory bodies. Intensive regulation of the ISD caused, as we have mentioned before, a significant fraction of trading (and information thereof) to evade regulated platforms and remain undisclosed, resulting in market participants having incomplete information and price formation being adversely

[11] Hereafter, we refer to this Level 1 Directive as MiFID.

affected. This was one of the reasons for the introduction of the *best execution* and *pre-* and *post-trade transparency* concepts into the new regulatory measure[12].

Measured by simple word count, MiFID and its implementing measures are five-times longer than the replaced ISD. On the other hand, such a statement could be misleading left alone, since MiFID is much broader in scope compared to ISD and some of the negative effects of MiFID will certainly be offset by the fact that MiFID replaces 25 different regulatory regimes with a unified set of rules. Length itself clearly could not measure the quality of a regulatory measure. However, when we compare the length of provisions governing corresponding areas in ISD with MiFID and its implementing measures, we can see that the length of the ones in MiFID is a multiple of those in ISD[13]. Many authors like Lannoo (2006b) or Ferrarini (2005) argue that the EU has departed the path of light-touch, principle-based regulation and embarked on the detailed, rules-based way.

This complexity contributed to untimely transpositions into national legal systems. Initially, the directive was due to be transposed by 31 January 2007, with an additional delay until 1 November 2007. Seven Member States, representing 1/3 of the EU population (Italy, Spain, Poland, The Netherlands, Hungary, Finland and the Czech Republic), did not meet even the latter deadline. Consequently, the Commission has commenced transposition infringement procedure against them at the European Court of Justice. This can, and is likely to, bring around additional costs concerning transposition and implementation. Nevertheless, this issue is not a concern of this thesis.

2.5.2. Assesment of the Lamfalussy architecture and MiFID

In order to fulfil the aims of the FSAP in due way, a new approach to financial services regulation has been adopted. The so-called Lamfalussy regulatory architecture is based on the reports of the Committee of Wise Men on the Regulation of European Securities Market, an advisory body chaired by Baron Alexandre Lamfalussy, which has been established by ECOFIN on 17 July 2000. The Committee, in its Final Report[14], laid out the new pathway of regulatory process for European securities legislation. This new approach comprises a four-level procedure of legislature implementation process aiming to make this more effective, transparent and timely. Since its creation, a number of FSAP measures have been adopted using this process.

[12] MFCR (B), pp. 9
[13] Casey, Lannoo (2006b), p. 3
[14] Final Report (2001)

The Commission proposes framework regulation which is adopted by the Council and the Parliament (Level 1). This includes most general principles and guidelines[15]. At Level 2, the Commission proposes the implementing measures to the ESC[16], which works as a primarily regulatory body[17], and having the proposal approved by the ESC, adopts the implementing measures for the Level 1 regulation. CESR[18] Committee's task is twofold[19]. Firstly, it works as an advisory body to the Commission at Level 2. Secondly, as an independent body of national regulators at Level 3, seeing to proper and uniform implementation of the Community legislature in each Member State. National regulators act in a network at this point[20]. Final step of the Lamfalussy process, Level 4, is enhanced enforcement of the Community rules by the Commission.

Critical voices regarding the Lamfalussy process architecture and actual development emerged. The biggest concern was the distinction between Level 1 and Level 2 powers. The Lamfalussy Committee suggested that „*Directives and Regulations in the securities area should include framework principles, whilst implementing powers should be delegated to a second level"*[21]. In the Committee's opinion, framework provisions are „*the core political principles, the essential elements of each proposal. They determine political direction and orientation, the fundamentals of each decision"*[22]. Nevertheless, *„Level 1 principles should clearly specify the nature and extent of the technical implementing measures that should be taken at second level…"*[23]. The Committee offered two examples in the Annex to the Report. However, even with these examples, distinction between the core principles and detailed rules and the division of powers between respective authorities remain unclear.

Most of the critique has been led along the lines of excessive and burdensome detail of Level 1 Directive. Many voices, e.g. Ferrarini (2005), expressed their view that European securities legislation in general is affected by problems of exuberant detail dealing with political issues which are ill-suited for Level 1 legislation. The effect is that Level 1 resembles a maximum harmonization regulation with very limited scope for national adjustments. Ferran (2004) argues that despite benefits of maximum harmonization, "*they come at a cost, in terms of rigidity and loss of useful stream of feedback about regulatory innovations which have*

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15 Final Report, n 8 above, p. 22
16 The European Securities Committee
17 Final Report, n 8 above, p. 28
18 The Committee of European Securities Regulators
19 Final Report, n 8 above, p. 31
20 Final Report, n 8 above, p. 37
21 Final Report, n 8 above, p. 25
22 Final Report, n 8 above, p. 25
23 Final Report, n 8 above, p. 25

been tested out at a national level"[24]. On the other hand, the author states that "*though not perfect, the Lamfalussy process is a step in the right direction"* and should be seen *"as a pragmatic solution to a multidemnsional, difficult problem"*. Yet, we should not accept its outcomes uncritically. On the contrary, legislature must be taken under scrutiny to evaluate its effects and propose improvements, given the fact that it was heavily influenced by political negotiations and bargains.

Some authors like Ferarini (2005) or Moloney (2005) argue that this excessive detail of Level 1 Directive has been caused by the fact that when drafting and adopting such an important and broad in scope regulation, all involved stakeholders want to express and incorporate their demands into the legislature[25]. Moreover, as IIMG Third Report (2004) suggests, excessive detail at Level 1 may be caused by residual distrust amongst political agents. Therefore, even if market participants widely endorse dropping responsibilities from Level 1 to Level 2, as originally proposed by the Lamfalussy committee, this might prove itself to be difficult to achieve in practice. Ferrarini (2005) comes to a conclusion that despite the best intentions of Lamfalussy committee, this approach failed to deliver the expected results with respect to MiFID and that this has not been caused by the approach itself, but rather by the resistance of EU institutions in shifting regulatory power below Level 1. He finds the implementing measures too specific and contributing to the re-regulation of conduct of business, while leaving very little room for Level 3 standards. We can conclude that costs paid by the EU in terms of rigidity, complexity and politicisation are significant, while the effectiveness and usefulness of enhanced harmonisation and regulation still needs to be proven in practice.

[24] Ferran (2004), pp. 55

[25] For instance, incumbent national regulated markets expressed the need for preservation of the concentration rule. They argued that if investment firms were allowed to internalize trades, they should be subject to the same regulation as RMs. And indeed, although initial signs that internalizers will be subject to a „light touch" regime, a last minute amendment was made, resulting in current situation. (Moloney 2005). For more information on internalizers regime, see Chapter 3.

3 Provisions of MiFID

3.1. Market Infrastructure

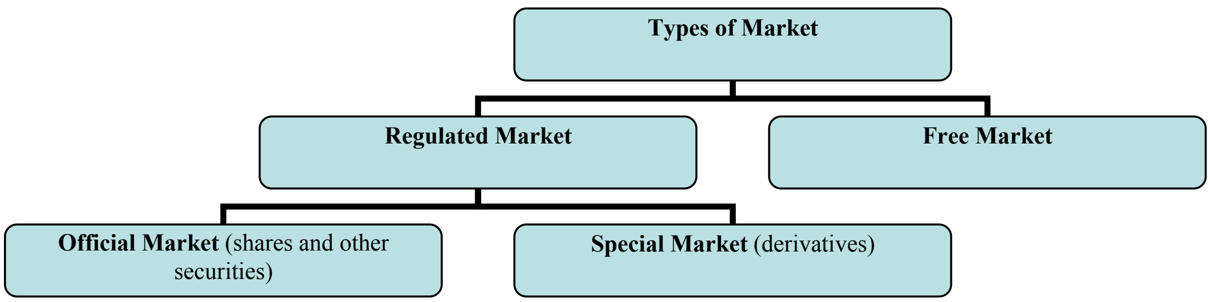
New regulation of market infrastructure was one of the main reasons of MiFID creation. Key principles of the new regulatory legislature are harmonization of regulatory framework for all market platforms and accomplishment of maximum transparency in trading in financial instruments. The ultimate goal is that identical rules are applicable for all transactions in financial instruments, irrespective of the trading methods used to conclude those transactions[26]. This should, in turn, lead to greater competition among trading venues, broadened possibilities of the investors, more innovations, lower transaction costs and increased price formation efficiency, ultimately boosting economic growth throughout the EEA.

One of the intended effects is the abolition of the concentration rule in some Member States, upheaval of exchange monopolies and the cancellation of regulatory arbitrage advantage compared to regulated markets, which was used by less regulated trading venues. Typically, these are various electronic trading platforms (Alternative Trading System, ATS, in the terminology of FSA). Through this, MiFID aims to enhance competition among trading platforms throughout the EEA.

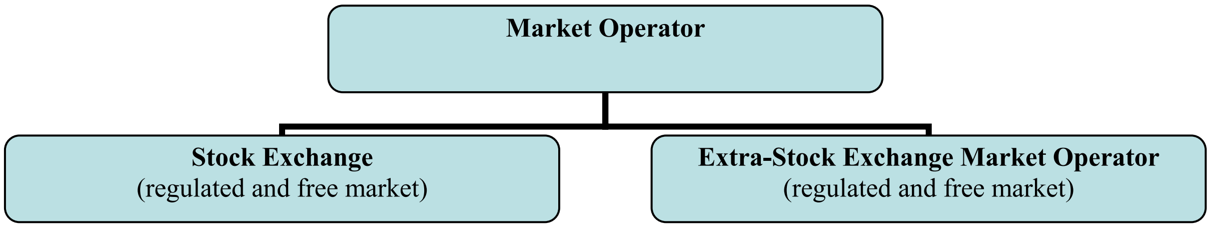
Newly, MiFID introduces MTF's, Multilateral Trading Facilities, as a category of market platform that is now commonly used throughout the EEA as an alternative to regulated market, and SI's, Systematic Internalisers, a category established as a response to the fact that ISD regulation caused significant volume of trades to escape from regulated markets supervision. These new institutions are being dealt in greater detail below.

To have a clearer picture, let us have the following diagram that shows the market infrastructure prior- and post-MiFID:

Fig. 2: Market infrastructure in the Czech Republic pre-MiFID

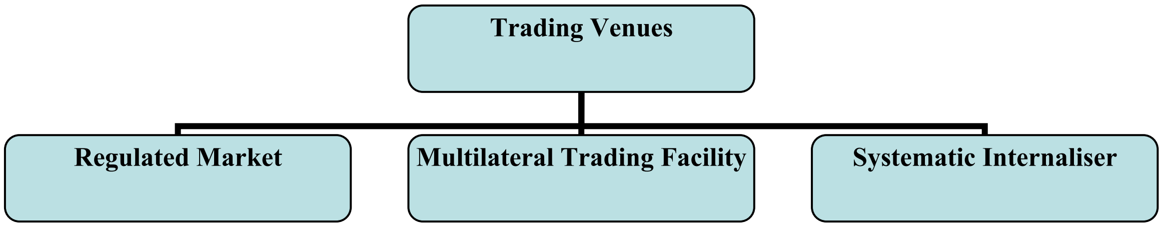


[26] Recital (5) MiFID



Source: MFCR (B), pp. 9

Fig. 3 Market infrastructure post-MiFID



3.1.1. Regulated market

Regulated market is defined as a regularly operating, multilateral system managed and/or operated by a market operator, which brings together multiple third-party buying and selling interests in financial instruments in a way that results in a contract in accordance with non-discretionary rules. The non-discretionary rules of bringing together trading interests, as specified by the Directive, are such that give the Regulated Market Operator (RMO) no discretion as to how interests may interact. Market operator is understood as a person or persons that manage and/or operate the business of a regulated market; it can be the regulated market itself.

MiFID defines who can become a member or a participant of a regulated market. These are[27]:

1. Investment firms.
2. Credit institutions with permission to provide investment services.
3. Other persons under the following conditions: They are fit and proper, have a sufficient level of trading ability and competence and have enough financial resources to meet the obligations and clearance arising from trading.

3.1.2. Multilateral Trading Facilities (MTFs)

Multilateral Trading Facility (MTF) is a term coined in by MiFID that encompasses various trading platforms. It is a response to the boom of electronic trading systems (known as

[27] Article (42) MiFID

Alternative Trading System or ATS in The United Kingdom), which became an alternative to regulated exchanges. These platforms benefited from much weaker regulation and emergence of new instruments. Some of them, such as EuroMTS, compete with exchanges and/or Over-The-Counter facilities in trading in listed securities. The majority of them, however, provide platforms for trading in non-listed securities, derivatives, commodities etc. They face competition from brokers providing OTC or online services and, in some cases, exchanges. Among these, some are set up as independent alternatives to exchanges while some are established primarily as a support of existing brokerage business[28]. MiFID provisions will affect all these types of MTFs, regardless of the financial instrument traded. The goal of the Directive is twofold. Firstly, to dissolve this regulatory arbitrage, and secondly, to enable emergence of these new trading platforms in all Member Countries.

The Multilateral Trading Facility is defined as follows:

a) it is operated by an investment firm or a market operator
b) it brings together multiple third-party buying and selling interests in financial instruments in a way that results in a contract[29].

The definition of a MTF resembles that of regulated market. That is intentional, since the creators of the Directive wanted to stress the fact that these platforms are functionally nearly identical. Regarding operating conditions of MTFs, MiFID requires MTF operators to establish and maintain effective and transparent arrangements regarding who may participate in their markets, admission of financial instruments to trading and trading in these[30].

The basic definition of MTF is identical with the definition of a regulated market. However, the differences between them are following:

- MTF can be operated not only by a Regulated Market Operator (RMO) but also by an investment firm.
- As against regulated market, the Directive sets no rules concerning admission of financial instruments to trading at the MTF (except for the general requirements set out in Article (14) of MiFID).
- Lower informational requirements, compared to regulated market, are posed on issuers whose securities are admitted to trading at the MTF.

[28] FSA (06/14), Annex 2, pp. 61
[29] Article 4 (15) MiFID
[30] Article 14 MiFID

3.1.3. Systematic Internalisers

MiFID newly introduces the term *Systematic Internaliser* as a separate category of investment services provision when investment firms trade with their clients against their own books. The origins of this new institution lie in the development of financial markets under the ISD. During the ISD era, traditional exchanges were facing enhanced regulation. As a follow-up, some large businesses, like investment banks and funds, started to evade the stringent regulation and operate as mini-exchanges for their clients. Under this *modus operandi,* they were effectively the only market-maker, serving as the sole buyer and seller of financial instruments. This pattern became widely popular among the clients of these institutions due to lower transaction costs and instancy of execution. However, the flipside of this development was elusion of a large portion of trading information. Since these transactions remained undisclosed, market participants were left with incomplete information regarding trading volumes and prices of shares admitted to trading on the regulated market. Post-MiFID, systematic internalisers will have to conform to the pre- and post-trade transparency rules if they trade in shares admitted to trading in the regulated market. We investigate this below.

The Directive defines the Systematic Internaliser as *an investment firm which, on an organised, frequent and systematic basis, deals on own account by executing client orders outside the regulated market or an MTF*[31]. The IR[32] lists conditions that must be met in order for an investment firm to be qualified as a systematic internaliser. These are:

- The activity has material commercial role for the firm, and is carried on in accordance with non-discretionary rules and procedures.
- The activity is carried on by personnel, or by means of an automated technical system, assigned to that purpose.
- The activity is available to clients on a regular or continuous basis.

The aforementioned activity is not to be classified as systematic internalisation if it is performed on an *ad hoc* and irregular basis with wholesale counterparties as a part of business relationships which are themselves characterised by dealings above standard market size.[33]

[31] Article 4 (7) MiFID
[32] Article 21 (1) IR
[33] Article 21 (3) IR

3.2. Categorisation of clients

MiFID introduces an entirely new concept of categorisation of clients. It recognizes that investors have different level of skills and experience and that this should be reflected in the way they are treated in business relations. The pivotal idea is to grant sufficient level of protection to each category of clients without putting excessive burden onto the investment firms[34].

MiFID recognizes two basic *classes* of clients, retail and professional, and three *categories* of clients, retail, professional and a third, distinctive category for a limited range of businesses: eligible counterparty[35]. MiFID grants these categories different levels of protection in precisely specified areas.

Professional client[36] is a natural or legal person that has sufficient experience, professional knowledge and expertise to undertake own investment decisions and to be able to properly evaluate risks associated with those decisions. Retail client is, in turn, defined negatively in relation to professional client, i.e. a natural or legal person that is not considered to be a professional client.

3.2.1. Eligible counterparties

Eligible counterparty is defined by two means:

a) Subject of business – MiFID enumerates precisely what businesses can be acknowledged the eligible counterparty status.
b) Investment service that is provided to this business. The eligible counterparty status is recognized only with respect to three core investment services, namely reception and transmission of orders, execution of orders and dealing on own account and to anciliary services related to the provision of them.

In short, eligible counterparties are considered to be the most experienced market participants. MiFID defines this specific category to relieve investment firms from some part of the obligations when dealing with these entities. The sense of such a step can be seen in the aforementioned fact that these entities posses enough skills and knowledge and that seeing to all the rules would entail unnecessary formalities. In particular, investment firms entering into transactions with eligible counterparties do not have to meet the obligations as set out in

[34] Recital 31 MiFID
[35] It is necessary to emphasis that eligible counterparty is not another kind of client. It represents a professional client in a specific treatment regime. That is why MiFID distinguishes between *categorisation* and *classification* of clients.
[36] Annex II MiFID gives a list of categories of clients that should be regarded as professionals for the purposes of the Directive.

Article 19 (Conduct of Business rules), Article 21 (Best Execution) and Article 22(1) (Client Order Handling) of MiFID. However, because MiFID treats eligible counterparties as clients, other obligations such as those concerning record keeping or conflicts of interests will continue to apply. Outside the scope of activities defined by MiFID, eligible counterparties are to be treated as a professional or retail client[37] for the purposes of the Directive with all its provisions applicable outright.

3.2.2. Optional regimes and moving between categories

In addition to the categorisation of clients, MiFID allows for clients to be treated as falling within a different category, i.e. increasing or decreasing the levels of regulatory protection. MiFID provides for considerable flexibility to move between categories given that certain conditions are met[38]. All three categories of clients can move between categories either generally, or with respect to one or more products or services or to one or more types of them[39].

When a retail client requests recategorisation as a professional client, several conditions[40] must be met. Generally, these conditions demand that the client has enough experience and resources to be eligible for professional treatment. The investment firm must take all reasonable steps to ensure these requirements were met prior to expressing consent to the request. The idea is to gain sufficient certainty with respect to the client's capability of making own investment decisions and understanding risks incurred by them.

The opposite situation is a little more complicated. When a professional client requests retail categorisation, the procedure depends on the genesis of the professional client.

1) Professional client *per se*: when a professional client *per se* requests transfer to the retail category, the investment firm must agree with this step.
2) Professional client *on request*: in this case, firm's consent is not insisted on.

The option of transfer from the professional client to the eligible counterparty category is left to each Member State's discretion.

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[37] Recital 40 MiFID: „For the purposes of this Directive, eligible counterparties should be considered as acting as clients".

[38] The genesis of the professional client has underlying importance for the determination of conditions under which this client can move into different client categories. However, this genesis does not have any impact on the extent of the Conduct of Business rules that an investment firm must apply in relation to this client.

[39] FSA (06/14), p. 9

[40] Annex II Part II MiFID

3.3. Pre-trade transparency

MiFID sets rules for transparency of trading in shares admitted to trading in a regulated market. Other instruments are not subject to these requirements. These rules apply not only when transactions are executed in the regulated market, but every time when a transaction in aforementioned shares takes place, regardless of the venue. This is a substantial difference compared to previous regulation. The aim of this institution is to provide market participants with true information regarding trading volumes and prices, carried-out and intented, irrespective of the venue they were concluded at.

Current legal arrangement has to be adapted to this new regulation, since MiFID requirements are much broader and deeper. They will encompass more trading venues than until now and be more demanding than current regulation. Presently, the Act does not specify these requirements in much detail. Under MiFID, the RMO will be obliged to publish bid and offer prices and depth of trading interests (number of orders of shares and numbers of shares these orders represent) at each price level for at least the five best bid and offer price levels, depending upon which trading system these are traded.

The information is to be published on reasonable commercial terms, on a non-discriminatory basis and during normal trading hours. Regulated market (RM) can, therefore, use a third person to take care of this or it can do it itself, demanding a reasonable price for the information. Moreover, RM can render these arrangements accessible to investment firms conducting SI, again, on a reasonable commercial basis.

3.3.1. Waivers

MiFID also gives the RMOs the possibility to waive these obligations under certain conditions. Pre-trade information does not have to be published for specific sizes or types of orders and market models. MiFID grants four types of waivers. These are for[41]:

- Crossing systems where the price is determined by reference to a price generated by another system (including one operated by the same RM).
- Systems that formalise negotiated transactions in shares, provided that these transactions are subject to conditions as to price other than the current market price of the share.
- Orders that are held in an order handling facility operated by an RM pending those orders being disclosed to the market.

[41] FSA (06/14) pp. 80

- Transactions larger than normal size (block trade)[42]. This takes into account the fact than trades larger than normal are often executed in a different manner compared to normal-sized.

3.4. Post-trade transparency

Another important matter that MiFID governs is post-trade transaction reporting. The general principle is the same as in provisions discussed above, namely providing market participants with as much relevant information as possible, thereby improving operating conditions of the markets and price-formation process efficiency. MiFID extends the scope of post-trade transparency from regulated markets to MTFs and SIs trading outside RMs or MTFs. IR enumerates in detail, what information about all carried-out transactions in shares admitted to trading on a regulated market must be made public and in what way. These requirements are identical for regulated market, MTF's and SI's trading in shares listed on a regulated market.

3.4.1. Deferred publication

MiFID allows for some exceptions from instant publication rule. RMs are allowed to defer publication of information regarding certain transactions that are large in scale compared to normal market size. Table 5 gives us an overview of the intervals.

For a transaction to be eligible for this deferral, it must take place between an investment firm dealing on own account and its client. MiFID permits deferred publication for these transactions as these might be difficult to execute efficiently in a fully transparent environment, potentially moving the market against the buyer and putting the intermediary's capital at risk. The aim of this provision is to give the intermediary that facilitates its client's large order enough time to oust at least part of the risk.

3.5. Cross-border business and passporting

Cross-border provision and passporting regulation is one of the cornerstones of MiFID, as these concepts embody the much-desired idea of pan-European, freedom-of-movement market for investment services. MiFID pays a great deal of attention to these matters.

[42] MiFID does not define normal size per se, it merely defines thresholds above which an order would be considered larger than normal size.

Presently, firms that are authorised in one Member State can provide services in other Member States either cross-border or through a branch without the need to be authorised separately in each Member State where they intend to run the business. This is known as the "passport". MiFID does not change this concept; it only extends the scope of activities and instruments that can be passported. Firms that currently operate under ISD passport will be granted MiFID passports automatically.

As compared to ISD, MiFID delineates the border between Host and Home States' responsibilities more clearly. Among changes, the most important are:

- Advice that involves personal recommendation has been upgraded to a core investment service. This means that firms providing investment advice solely can passport their activities for the first time;
- Operating an MTF is a passportable activity; and
- Commodity derivatives, credit derivatives and financial contracts for differences are covered by the passport.

An investment firm authorised in one Member State that wishes to provide investment services in other Member States on a cross-border basis has the obligation to inform merely its Home State of the Member State(s) in which it wants to provide services. If the firm wants to provide ancilliary investment services, it can do so only in conjunction with core services, ancilliary services are not passportable *per se*. The Home State of the investment firm, in turn, informs Host State regulator about the identity, intended scope of services and/or tied agents (see further below) of the passporting firm within one month of receiving the relevant information. The passporting firm is then able to commence activities in the Host State. An important change MiFID introduces is that a firm that provides services on a cross-border basis will have to comply with its Home State rules, not with the Host State's ones.

MiFID[43] requires investment firms wishing to establish a branch in another Member State to inform their Home State competent authority about certain facts. Home State regulator has three months to advance the information to Host State competent authority in this case, as establishment of branches represents a more complex issue than cross-border provision of services.

3.6. Best Execution

[43] Article 32 MiFID

Best Execution provisions are part of conduct-of-business rules of MiFID. They aim to maximize the value of client's portfolio by ensuring best possible terms of execution of orders. Unlike, for example, the NMS 'trade-through' rule in the US[44], by which quality of execution is measured against one indicator only, i.e. price, MiFID introduces a more flexible concept of best execution, when it is measured against other factors that could describe terms of execution such as speed, likelihood of execution, transaction costs and other considerations. As long as there is no doubt that this is intended in the best interest of end-consumers, one can remain quite dubious about the enforceability of such a complex concept. We pay more attention to this further below.

MiFID[45] states that *Member States shall require investment firms to establish and implement effective arrangements for complying with* best execution requirements. It further says that firms must adopt an order execution policy that will allow them to obtain best possible terms of execution for their clients. This, however, does not mean that the investment firm must obtain best possible conditions *always*; it just has to have in place such permanent mechanisms and policies that make this possible. In other words, the investment firm is not obliged to ensure strictly best execution for *each and every* order; it is, however, due to ensure that each and every order is executed in accordance with its internal procedures and policies that facilitate best execution.

3.6.1. Setting-up and reviewing

An investment firm must follow a three-step approach when setting up best execution procedures. Firstly, depending on the nature of its clients, it has to identify factors that will be most influential in the determination of execution conditions for the clients in general or for particular group of clients. Secondly, the investment firm has to analyze all possible execution venues and decide which of them fulfil best execution criteria. Thirdly, it must ensure that client orders are routed to these venues on an order-by-order basis. The last step is of vital importance to MiFID's overall market concept, since, in its logic, it is not only in the immediate best interest of the end-customers but it should also promote competition among trading venues by routing trades to those that consistently provide best results.

MiFID also says, what information, regarding its internal execution rules, must the investment firm provide to its *retail* clients, as these are assumed to be the least informed and

[44] Regulation National Market System (NMS) (see www.sec.gov)
[45] Article 21 MiFID and Articles 44-46 ID

have the least opportunities to defend themselves, consequently needing the highest level of protection.

Considering checking-up the procedures, MiFID[46] requires that investment firms monitor, review and adjust their best execution policies and mechanisms at least once a year and after *every material change* that affects firm's ability to meet the best executions criteria. Moreover, the investment firm must review the arrangements on a continuous basis. This means assessing whether adopted rules really facilitate execution on most favourable terms.

[46] Article 46 (1) MiFID ID

4 Analysis and Assessment of MiFID

MiFID introduces many substantial changes into the way markets and investment firms operate, and puts a number of informational and procedural demands onto them. Most of these changes will be costly to introduce, although to a different extent. In this part of the thesis, we will discuss thebbbbbb Cost – Benefit Analysis carried out by the FSA and the most important cost drivers it identified for the investment firms. We also discuss possible impacts of some of MiFID's provisions on the behaviour of firms and market infrastructure. At the end of this chapter, we examine these impacts and cost drivers in our specific conditions, i.e. try to analyse them from the point of view of the Czech Republic. We also try to estimate, based on the findings of the FSA analysis, upper bounds for compliance costs of Czech investment firms.

4.1. Creation of MiFID and reactions from the industries

During the process of drafting and amending the Level 1 Directive, there was some serious lobbying from incumbent influential market participants as well as political bargains, resulting in some provisions of Level 1 text being too detailed, as we indicated in Chapter 2. During the preparation of Level 2 text between 2004 and 2006, public consultations were carried out by CESR and national regulators in order to incorporate the opinions of market participants into the final text. These implementing measures were meant to be less affected by difficult political deliberations than Level 1 Directive, as the text was elaborated by CESR and adopted by the Commission and, consequently, to express general opinions of the markets as to how should MiFID be efficiently implemented. CESR has been acknowledged for meeting the technical aspects of its task fairly well, despite having no previous experience. However, Level 2 implementing measures, both ID and IR, confirm the trend in European securities legislation towards more detailed, rules-based approach without leaving much space for national-specific adjustments.

When first draft of implementing measures was published, a wave of disapproval arose among investment banks and firms, stock exchanges and wealth managers. Most frequent critique was led along the lines of excessive protection of end-consumer at the expense of services providers. Market participants claimed that MiFID represents an immense bureaucratic burden that will significantly increase compliance costs while benefits for the clients remain dubious. However, leaving out the nature of particular provisions, it would not be reasonable to expect that market incumbents would praise measures that alter *status-quo* in such a profound way.

The Commission advocated this outcome by the fact that such level of detail is inevitable for creation of a single market for financial services while simultaneously avoiding gold-plating by individual Member states. Further, it justified it by saying that inconsistent implementation across Member states could pose serious risk to the whole idea of MiFID. While some implementing measures are in the form of a directive that is to be transposed into national legal systems, others are directly enforceable through the regulation. The Commission left some space for national discretion in Article (4) ID that says that Member states "*may retain or impose requirements additional to those in the directive"* only in exceptional cases where such requirements are objectively justified and appropriate. Member states are very likely to take advantage of this caveat, or loophole, for the purposes of imposing or retaining national provisions, given the fact that MiFID as a whole leaves them with very little manoeuvring space. This can be expressed as *"if not gold-plate, at least spray paint over"* (KPMG 2006) attitude of most of Member states. It will remain the Commission's task to assess whether these cases really are justified and qualify for this caveat, probably on an *ad hoc* basis.

4.1.1. FSA Cost – Benefit Analysis

In 2006, FSA published several Consultation Papers (CPs) in which it extensively consulted MiFID implementation with market participants. As a part of these CPs, Cost and Benefit Analyses (CBA) and Compatibility Statements were published (we refer to them as a single one because, taken together, they represent a comprehensive whole). FSA had the obligation to publish them on the basis of Financial Services and Markets Act (FSMA). These papers give a very detailed and expert analysis of the cost and benefits MiFID is likely to bring about. We will use this CBA as reference groundwork for our analysis for several reasons. Firstly, because of its broad scope and very detailed discussion of MiFID's costs and benefits, secondly, for its *ex-ante* estimates of compliance costs and thirdly, because no such *ex-ante* analysis has been undertaken in the Czech Republic[47] and is unlikely to be carried out before implementation of the Directive[48].

In addition, KPMG has carried out a survey among 199 respondents from financial sector from the EU as well as extra-EU institutions that have significant presence in the EU

[47] Czech National Bank as a regulator had no such obligation under the law of the Czech Republic in 2007 when the amendments of relevant acts were submitted to the parlament by the Ministry of Finance.
[48] However, we can be quite positive about ex-post analyses of MiFID costs and benefits.

market. The survey targeted a wide range of financial institutions, reflecting the broad scope of MiFID. The study has been aimed at rather qualitative issues, as opposed to the FSA analysis meant above.

4.1.2. Overview

The FSA CBA is structured along the lines that follow key changes on an issue-by-issue basis rather than focusing on individual Articles of MiFID. It gives a brief description of changes introduced by MiFID, followed by the discussion of costs and benefits of the measures. Impacts of some changes have been quantified; some are discussed from the institutional point of view, as these were either unquantifiable or implementing measures were not sufficiently defined at the time of the CBA. We must make an important note here that the analysis was based on drafts of the Level 2 implementing measures. Although there have been some changes to the Level 2 text between the publication of the CBA and adoption of Level 2 measures, these changes were not substantial in nature and would not, therefore, influence the results of the CBA fundamentally.

In subsequent sections, we will focus on particular areas that have been identified as main sources of compliance costs and which magnitude were estimated in the LECG[49] Cost Survey[50] of the UK investment industry. This study has been carried out on the request of FSA and was part of the June 2006 Consultation Paper[51]. It was based on a sample of 33 responses from 50 leading UK firms to a lengthy and detailed questionnaire elaborated in collaboration with them and FSA. Two types of data were gathered: firms' estimates of costs they would incur in complying with MiFID and their view of potential market impacts of new regulation. It must be said here that neither issues such as market transparency and systematic internalisation were within the scope of the study, as the provisions setting out firms obligations regarding these issues were not sufficiently defined at the time of the study. The survey also did not focus on identification and quantification of benefits, as this was done in other parts of the FSA Cost- Benefit Analysis. In each area, key cost drivers were identified and quantified. By cost drivers we mean particular factors that determine compliance costs.

Firms were categorised by both size (small firms with <100, medium 100-500, large >500 employees) and type of business (full service, execution-only, discretionary, other). Two types of compliance costs were elicited, one-off and ongoing costs associated with

[49] Law and Economics Consultation Group, www.lecg.com The paper can be downloaded from www.fsa.gov.uk/pubs/international/mifid_cost_survey.pdf
[50] LECG (2005)
[51] FSA (06/14)

MiFID, as the economic impacts of these two categories are of distinct nature and will have different repercussions in firms' behaviour.

4.1.3. Key findings

Let us begin with some general observations that have been made by the LECG. Firstly, when asked on the preparedness for MiFID on a scale from one to ten, where 1 indicated that the firm has not considered MiFID yet, to 10, meaning full preparedness, the firms on average estimated this to be 4, with most of answers clustered from 3 to 5. We must remark here that this was at the end of 2005, which means that the UK investment industry had still plenty of time. In the end, UK shows the best level of preparation, which is not surprising given the rigorous approach of the FSA and general discipline of market participants in the UK.

When asked whether firms would change their business strategy as a result of MiFID, the answers were almost exactly split. It is noteworthy to add that MiFID is likely to cause a significant percentage of firms to consider revising their strategy. It came together with the question whether firms would exit specific lines of business as a result of MiFID, where the answers were divided as well.

Ninety percent of respondents believed that barriers to entry for new firms would be increased by MiFID. This is a serious finding indicating the overall opinion about MiFID shared by the incumbents. When asked whether they would exit the market at all, 89% responded negatively. The fact that 11% of questioned firms would consider exiting the market is yet another very serious finding, in particular when these were Full Service firms (i.e. those providing a broad scale of services covered by MiFID to different client groups).

The abovementioned figures indicate that there is a predominant opinion in the UK market that MiFID will influence competitive structures and market constitution. To the extent that these figures are illustrative in nature and one could not draw any conclusions from them, they can not be dismissed as utterly indirective.

On the issue of passporting, only 9% of respondents indicated that they would consider taking advantage of this possibility. This might be due to large costs that might be associated with such a step and the fact that UK investment industry is much more fragmented as opposed to the continental model of large financial institutions.

Another potentially significant impact of MiFID is on trading volumes and market shares. Answers of the respondents suggest that they expect a slight decrease in business volumes in the UK, both on firm level as well as on the total industry one. However, respondents were more pessimistic with respect to overall industry volumes. Despite these expectations, 68% of respondents did not expect changes in their market shares. Only large firms were positive in this respect, with 43% of them believing their market share would increase post-MiFID. This could be explained by the fact that MiFID does not include any *de minimis* provisions, so regulatory burden may impact them disproportionately (LECG 2005, pp. 75). Large firms certainly have more room to accommodate costs associated with MiFID, therefore having an advantage over smaller firms which can lose market share in their favour. This was expressed many times throughout the questionnaire and respondents agreed almost unanimously that some firms would be disadvantaged against others as a result of MiFID, particularly small against large ones. Indeed, three firms indicated that they would leave the industry because of MiFID's requirements. Again, despite bearing in mind that these figures are illustrative merely, we should be aware that there are serious worries among market participants about MiFID's adverse effect on their market share and/or presence.

Let us have a look at the estimates of quantitative nature now. LECG have estimated total one-off and ongoing costs for the issues of[52]: Classifying the Client Base, Data Gathering to Meet New Obligations, Two-Way Papering, Best Execution, Suitability and Appropriateness, Staff Training, Record Keeping, Conflicts of Interests, Pre- and Post-trade Transparency and Trade Reporting. From these, the survey has identified following provisions of MiFID as key cost drivers for the investment firms in its sample (three most important in order from the heaviest): Two-Way Papering (i.e. obligations of investment firms to inform their clients via mail and clients' responsibilities for properly fulfilling and returning relevant documents), Best Execution (firms' responsibility to execute orders on terms most favourable to the client) and Classifying the Client Base (grouping the clients into new categories introduced by MiFID).

Considering Two-Way Papering obligations, the study estimated one-off mean costs to be £44.000, £419.000 and £1.316.000 for small, medium and large firms, respectively. Median figures were £22.000, £150.000 and £300.000, respectively. Costs appeared to rise in line with firm's size and number of its clients, which can be identified as key cost drivers.

Effects of the Best Execution provisions were more difficult to estimate. Costs will differ, based on the fact whether a firm has already had a best execution policy in place or will have to establish one. But establishing a policy is not the end of the deal, firms will have to monitor and review their policies on a regular basis to be able to prove that they meet the

[52] We include only the most important cost drivers for the sake of brevity. Full discussion of them would make it only lengthy and unneccesarily burdensome for the reader.

obligations on a continuous basis. This was identified as extremely costly for full service firms operating in the fixed income business. Also, keeping data to be able to prove best execution on request has been identified as incurring significant costs to firms. Estimates of mean costs of monitoring one additional trading venue are following: £100.000, £25.000 (only one observation for small and medium firms) and £105.000. Medians were £100.000, £25.000 and £50.000.

Costs of Classifying the Client Base break down into two categories, basically. Those of classifying simple clients were estimated to be lower than those of of classifying ambiguous clients. Mean figures for classifying simple clients were £26.400, £157.400 and £110.000, medians being £2.875, £20.000 and £12.000, for small, medium and large firms, respectively. Mean figures for classifying ambiguous clients were £11.000, £55.000 and £320.000, medians being £3.750, £22.500 and £200.000, respectively. Firms will also incurr costs associated with opt-ups/opt-downs. Key cost driver here is obviously the number of clients a firm has, with a remark that firms with more diversified (basically, large, full-service firms) client base will be struck more by this provision of MiFID.

Considering total one-off costs of MiFID for the sample of 33 investment firms, the study gave their estimates to be £69 million However, this figure must be taken with caution as it represents the costs for the firms in the sample only. As regards estimates of median overall costs for firms according to their size, small firms reported a median one-off cost of £90.000, stating that the vast majority of that being related to staff costs. Indeed, small firms are not likely to establish complicated and costly IT solutions; rather, they are expected to outsource certain activities and/or deal with them through the personnel. Median estimate of ongoing costs was £23.000 per year. Medium-size firms reported median one-off cost of £2.150.000 with median ongoing costs of £75.000 per year. Large firms reported a median one-off cost of £4.750.000, with vast majority of that being costs associated with IT solutions. Staff costs are relatively less important than in the case of small and medium-sized firms. Median ongoing costs were estimated to amount to £456.000 per year here.

According to predominant economic theory, one-off increase in firms' costs will not translate into ongoing price increases in a competitive environment. One-off costs have been estimated to account for around 5% of yearly revenue across the sample and firms claimed that these will be difficult to pass on to customers (although one may seriously doubt this statement). However, if competitive structure alters, this may not have to be true (LECG 2005, pp. 85).

On the other hand, theory tells us that permanent increase in ongoing costs (i.e., permanent increase in *marginal* costs) without corresponding increase in quality of services would lead to a decrease in volumes (firms reported a median ongoing cost of slightly below 1% of yearly revenue). This is not certainly a positive finding neither for the markets, nor for consumers (LECG 2005, pp. 86).

4.2. Possible effects

4.2.1. Impact of transparency requirements

MiFID brings substantial changes into pre- and post-trade transparency requirements. These are foreseen to have repercussions in the behaviour of firms as well as of markets as a whole. We will discuss these in turn.

In academic literature, an increase in pre-trade transparency requirements should benefit less informed traders at the expense of well-informed ones. This transfer of informational (dis)advantage is very likely to impact on trading volumes, spreads and liquidity, resulting in net overall costs or benefits.

In theory, information is incorporated into prices through trading by informed traders. They incur costs to gather information relevant for the estimation of true value of financial instrument, resulting in price converging to this true value. This allows informed traders to benefit at the expense of uninformed traders (Harris 2002). Evidence also shows that increased transparency enhances the price discovery process, which is often believed to enhance best execution[53]. If pre-trade transparency increases, the opportunity for informed traders to make profit from their informational advantage decreases. The speed and efficiency with which information is incorporated into prices rises. However, this increase makes information about the orders flow less valuable by making them available to all market participants. Lee (2002) argues that this can lead to a widening of spreads because of market makers' reduced willingness to post competitive bid-ask spreads.

There is also a negative possible effect on liquidity. Not all investors are willing to expose their orders to the public. Increased transparency requirements may reduce their willingness to participate, in turn cutting the provision of liquidity. Limit-order traders are less willing to submit orders in transparent markets. Porter and Weaver (1998) provide empirical evidence from a natural experiment on the Toronto Stock Exchange, while Madhavan, Porter and Weaver (2005) give a theoretical explanation.

[53] Best execution is discussed in academic sense here, we do not mean Best execution as defined by MiFID at this particular point.

On the other hand, spreads may narrow because information reaches more participants and market makers are forced to offer more competitive bid-ask spreads (Lee 2002, Harris 2002). Moreover, increasing pre-trade transparency will diminish market makers' motives to hedge against informed traders by posting wide spreads. As Bagehot (1971) first noted, if suppliers of immediacy are to avoid losses, uninformed traders must pay a spread sufficient to compensate them for losses incurred in trading with informed traders. Therefore, increasing pre- and post-trade transparency could, in this logic, make spreads narrower.

Post-trade transparency is also enhanced by MiFID. It is broadened, as described in Chapter 3, while still maintaining the possibility of delayed publication for large trades. The extension of scope of transparency obligation is seen as a mean of providing the markets with more information as all trades executed off-exchange will have to be reported. This will certainly give a better picture of overall trading activity, resulting in better-informed decisions. However, meeting these transparency requirements is widely acknowledged as entailing significant costs (FSA (06/14), LECG 2005, MFČR (B)).

Delayed publication of large trades, as described in Chapter 3, trades off market maker's interest in ousting the risk, to which the market maker is exposed by this large trade, with other participants' interest in not being put at informational disadvantage. Should the delay be reduced, market makers might face additional risks and, consequently, demand wider spreads and/or decrease the provision of liquidity. However, regardless of the effect of delays on liquidity and spreads, information about large trades seems to leak to the markets anyway, leaving price efficiency unaffected (Gemmill 1996, Harris 2002).

To conclude, generally, the increased transparency imposed by the MiFID should lead to more liquidity and lower spreads in the markets. However, there will certainly be some kind of trade-off of profits between more and less informed market participants. Unfortunately, we are not able to provide reliable estimate of its magnitude. In this light, and taken into account the above-discussed arguments, the risk that increased transparency requirements will negatively impact provision of liquidity and spreads can not be dismissed as groundless.

4.2.2. Fragmentation

By acknowledging and codifying systematic internalisation and providing much space for MTFs, MiFID could cause serious adverse effects of market fragmentation in future. As market fragmentation is often associated with preferencing, and internalisation is a form of preferencing, this may lead to enhance evasion of orders from regulated market towards

MTFs and SIs. Furthermore, by allowing the absence of pre-trade transparency requirements for "non-liquid" shares[54] and trades above the standard market size, space has been created for „pockets of opaqueness"(D'Hondt, Giraud 2007), or dark liquidity pools. This would negatively affect price formation and discovery process, decreasing overall market efficiency. Drafters of MiFID bore this in mind and clinched against it by enhanced transparency and best execution requirements. In the Commission's opinion, MiFID will facilitate greater competition between trading platforms while simultaneously prevent adverse consequences from any resulting liquidity fragmentation. Ergo, sufficient aggregation of trade data and efficiency of best execution should offset these possible fragmentation effects.

In this respect, trade data aggregation will be of utmost importance. Only consolidated trade data from all relevant venues for each share can effectively prevent fragmentation of liquidity from occurring. It is also an inevitable prerequisite for true financial markets integration. We identify one concern here. Currently, trading data has to be reported to one recognized trade data monitor, usually local stock exchange. This entails a significant positive externality of data consolidation. MiFID leaves open by whom and how trade data will be consolidated, it only says this be done on a reasonable commercial basis and as close to real time as possible.[55] It now remains a question, given that trading data vending is clearly a for-profit business, whether socially optimal level of consolidation and quality of trading data will be achieved post-MiFID.

It will remain the task of national regulators and CESR to ensure that MiFID rules are implemented and enforced consistently to minimize the scope for such effects. As long as the above outlined scenario is a pessimistic one and its odds are rather low, we have to be aware of such a possibility and stress the need for consistent implementation and enforcement once again.

4.2.3. Markit BOAT (Project BOAT) and Project Turquoise

Under MiFID, large institutions like investment banks[56] will be in position when they can arrange their own trade reporting facilities and charge other market participants for the data. In late September 2007, a group of originally nine investment banks[57], nowadays

[54] Article (22) IR gives the definition of liquid shares.
[55] Article (28) MiFID
[56] In fact, basically any investment firm can establish its own data consolidation platform. In reality, only the large ones will be able to sacrifice substantial resources needed for this task.
[57] ABN AMRO, Citigroup, Credit Suisse, Deutsche Bank, Goldman Sachs, HSBC, Merrill Lynch, Morgan Stanley and UBS, later joined by Bank of America, Barclays, Bear Stearns, BNP Paribas, Calyon, CA Cheuvreux, Dresdner, JP Morgan, Lehman Brothers, State Street and Royal Bank of Scotland. Some consortium members wished to remain in secrecy.

twenty-two participants, have formed a consortium called *Markit (or Project) BOAT*, an initiative to create a pan-European trading data reporting and publishing platform. The intention is to cut trade reporting costs significantly while consolidating the data. These activities represent a serious amount of money, yearly data reporting spending is estimated to be around €2 billion.[58] Since price transparency could possibly reduce bid-offer spreads and margins, hence cutting profits of these institutions, creating such a platform as a for-profit enterprise is a way to offset this loss. One can also be positive, once this project is clearly a for-profit one, that the participants will be committed to maximizing profits. Because smaller players are likely to find establishing their own market data processing facilities prohibitively costly, availing themselves of such third-person facilities like Project Boat would then seem like a convenient way of meeting MiFID's transparency obligations and a win-win strategy in this respect. However, only time will show to what extent this project would be viable and successful in breaking stock exchange trade reporting monopoly.

Another way to look at this is to consider the benefits for the parties involved outside the transparency and consolidation realm. Large banks, by being forced to establish a pan-European cooperation network, can in turn benefit from increased attractiveness in competing for world's largest enterprises. In this respect, the whole FSAP is a big opportunity for these multinational banks. Certainly, their benefits will be at the expense of small players, regulators and infrastructure across Europe. And we should add that the cost paid might be very high, given the strength of these institutions.

Corporate side might benefit from this project as well. A single, pan-European network enables them, *inter alia*, to have only one account to run business in Europe or easier access to liquidity pools. This should entail considerable cost savings and benefits for them and, in the end, for the end-customers in lower prices and better services.

One another great private venture, similar in some respects to the abovementioned BOAT, is the so-called Project Turquoise, a pan-European hybrid trading platform that should enable its clients trading on and off traditional exchanges. It has been formed by nine major investment banks[59], has been based in London and should commence activities in fall 2008. It promises faster and cheaper execution of orders than currently.

[58] *Mifid Breaks the Exchange Monopoly on Trade Reporting*, Wall Street Technology, October 20th, 2006

[59] BNP Paribas, Citibank, Credit Suisse, Deutsche Bank, Goldman Sachs, Merrill Lynch, Morgan Stanley, Société Générale and UBS.

4.2.4. Market feedback on Best Execution

Let us now review the Best Execution concept in greater detail, as this provision has given rise to most serious and unresolved disputes and ambiguities throughout the EEA. Best Execution concept has been widely criticized as taking customers' side too boldly. It has been advocated as a rule that would improve market efficiency, encourage competition among trading venues and investment firms and increase fragmentation of orders, ultimately promoting the interests of retail customer. However, market participants throughout the Member states have raised many critical remarks and concerns regarding this concept.

As has been mentioned in Chapter 3 on Best Execution, there remains a question about the enforceability of such a complicated and multi-layered concept. When one compares the obtained conditions of a transaction against one benchmark, i.e. price[60], it is by far easier to assess the quality of execution than when a whole bucket of variables are used. And even with a single criterion, it remains difficult to prosecute execution lapses in practice. Therefore, one can judge, given the abstraction of some of the concept's criteria, that it will be highly complicated to translate it into practice.

When we have a closer look at the assessment and adjustment of investment firms' best execution policies obligation, there arises a question whether orders should not be measured against certain standardized benchmark. For example, UK's FSA induces, from this provision of MiFID, the necessity to set a benchmark against which executed orders will be measured. However, the mere concept of any yardstick used as a reference measure is at least problematic here, given the complexity of best execution requirements. Czech Ministry of Finance, in its Consultation Paper[61], states that experts, who were questioned on this matter, resolutely discourage from any attempts to construct such benchmarks as they consider it to be of limited or no avail to the customer. The idea was that firms, in collaboration with IT solutions providers, could be able to implement such benchmarks for liquid instruments but hardly for illiquid and exotic instruments. The other end of the rope is the fact that this would certainly increase costs incurred by the investment firm, eventually resulting in passing these costs through onto the customers.

One may identify a common concern in connection with best execution assessment and benchmarking, namely the issue of firm's response to a *material change* in its business conditions. Here, again, arises the necessity to determine precisely what a material change is. It is straightforward to realize that a *material change* will be of different nature and scope for

[60] This has been the practice in the UK or USA.
[61] Cons. Paper, Unit A, pp. 69

a small investment firm relying heavily on the behaviour of large investment banks and other major market participants than for these players.

The approach to best execution benchmarking and assessment is highly inconsistent across the Member states. UK's FSA has undertaken extensive consultation collaboration with UK investment industry, by far most exhaustive consultation work among EEA members, and still has raised questions that can not be answered at national regulatory level. Given the expertise and experience of the FSA, one can have serious concerns as to how will less sophisticated national regulators answer these complicated questions. If they do not cope well with these issues, MiFID will fail to introduce level playing field across the EEA on time. Hence, if this comes true, of which one can be almost sure given the implementation progress among the Member states, best execution rules will be a mere manual or a reference book. But we can assume that eventually, MiFID level playing field will prevail with the introduction of sophisticated and tailored IT solutions for reviewing and monitoring of transactions and through the enhanced competition by MTFs and SIs.

5 Implementation and Impact in the Czech Republic

5.1. Changes to current legal arrangement and process of transposition

The changes that MiFID introduces have to be transposed into Czech legal system. Some provisions are directly applicable through the Implementing regulation, but the largest bulk of changes will have to be adopted by the Parliament.

Amendment of the Act via which MiFID is implemented in the Czech Republic[62] are very profound and manifold. We do not give an exhaustive description; this has been done by Jekl (2008), which is a summary of changes from the legal point of view. We point out only those changes that are substantial for market operation and infrastructure.

MiFID brings a substantial change into admission regulation. At the moment, the Act says, who can be a member of the stock exchange, whereas membership in extra-exchange markets is not regulated at all. In contrast, MiFID does not put any strict restrictions onto stock exchange membership but precisely states who and how can run an MTF or SI. In a nutshell, MiFID broadens the scope of stock exchange membership and restricts that of extra-exchange one.

This is related to MTF provisions. In the case of the Czech Republic, there will be no operational distinction between the Prague Stock Exchange and the RM-System after MiFID is implemented. Current enforceable lay-out codifies „free market“ that can be operated by the RMO. Although this is a national lay-out that did not stem from the ISD, the definition of the free market, as written in the law, does fulfil the definition of the MTF to a large extent. Hence, no substantial changes, either to the law or market operation, will be necessary to meet the needs of the MiFID, as stated by the Ministry of Finance in its Consultation Paper[63].

Considering transparency provisions, presently, according to the Act, the information about the transactions is published with 15 minutes delay and this applies only to regulated market, whether it is the stock exchange or not, ergo the law will have to be adapted to this expanded scope of regulation and enhanced transparency requirements.

The Ministry of Finance published a series of four consultation papers covering vast majority of changes MiFID introduces. It has been acknowledged by market participants as

[62] Act coll. 256/2004 on Capital Market Undertakings (Zákon č. 256/2004 Sb., o podnikání na kapitálovém trhu ve znění pozdějších předpisů).
[63] Cons. Paper, unit B

very useful and to the general good. Feedback came from many professional organisations and large institutions. We would like to point out the feedback from the Czech National Bank (CNB 2006 a-d), as this institution will be responsible for the supervision and surveillance of the new requirements. CNB is also responsible for a number of implementing measures that will form local environment. Its opinion could help us draw a picture of how it will approach regulatory obligations and what stance towards MiFID it is likely to take.

The CNB's approach can be labelled as a liberal one. For example, the CNB stated that it will recommend availing ourselves of the provision of admitting as many shares into the liquid share as possible, as this could enhance the capital market attractiveness, credibility and have positive impact on market transparency with respect to systematic internalisers. Further, it advised not to apply transparency and reporting obligations to any other instruments than shares. An important part of this feedback was the part on client classification and handling rules. The CNB suggested, *inter alia,* allowing retail clients to be granted the eligible counterparty status on request and, generally, not to apply any further restrictions when moving between categories *on request*, i.e. to grant the market participants freedom when they want to change their classification themselves. The CNB also endorsed the opinion of the Ministry of Finance not to introduce any elaborate benchmarking yardsticks and obligations for best execution evaluation. It also disagreed with the FSA's proposed solution (see afore) and advocated this by not seeing any value-added for the end-customer.

As of May 2008, when this thesis has been submitted, MiFID has already been transposed into the Czech legislature. The Amendment of the Act on Capital Market Undertakings has been adopted by the Parliament on 9 May 2008. However, the Commission had begun the implementation infringement procedure against the Czech Republic (and against Hungary, Poland and Spain) for delayed implementation (the Directive was to enter into effect by November 1st, 2007). We can only hope that the case will not end up at the European Court of Justice, which would probably result in fines for the delay.

What does this delay mean for market participants? Certainly a significant competitive disadvantage compared to subjects in other countries that met the deadline. There are even voices that Member states that are delayed in transposition could face legal proceedings from market participants for putting the companies and customers at disadvantage.

5.2. Specific Czech conditions

First of all, when we want to discuss implementation and impacts of MiFID on Czech economy, we have to take into account our local specifics. Despite almost twenty years of democratic development and day-to-day endeavours towards capitalism and market economy, there may still be some specific features of our financial markets that hinder our ability to avail ourselves fully of the possibilities that MiFID offers.

In the first place, we should emphasize the tainted opinion of capital markets among the broad public. The experience of the 1990's with coupon privatization and later developments of investment funds, stock exchange and banks stigmatized the picture of these institutions among the broad public to a large degree. Gradual improvement has been observed since. However, people in the Czech Republic are still reluctant to trust in capital markets and the opportunities they offer to a large degree. There is very weak knowledge and practice in capital markets operation and properties, resulting in low retail clients' participation. The development and current state of capital markets in our country verify these claims. Trading is rather thin and the market is generally quite shallow, resulting in insufficient liquidity. A very important sign of the level of development of capital market in the Czech Republic is the number of Initial Public Offerings (IPOs). This is very low, representing a negligible figure in the whole Central Eastern Europe region.[64] Firms do not use the capital market (stock exchange) as a source of capital and prefer bank finance or bonds issuance, i.e., we still lack the capital market culture as seen in Western Europe and mainly, the United States. An important factor in this development is also the fact that the Prague Stock Exchange is a very small, regional exchange without any significance in broader European context. Large companies that are looking for capital prefer more liquid Western markets, or in the CEE context, the Warsaw Stock Exchange, which has established itself as the most prolific and liquid market among the CEE countries.

From this point of view, possible impacts of MiFID, as described above, could be mitigated by these local conditions. Concerns mentioned above were based on the assumption of perfectly, or nearly-perfectly operating Western markets. It is straightforward to deduce that in our conditions of very small and underdeveloped capital market, these adverse effects on spread, liquidity, trading volumes and market shares should not be as striking. On the other hand, abolishment of the concentration rule could further undermine the position of Prague

[64] Moreover, the recent IPOs have been usually dual listings, i.e. the shares were listed also on some other European exchange such as Paris or Warsaw.

Stock Exchange. Given its size and significance and the fact that increasing percentage of trades is executed off-exchange in the EU, it could well happen that it will loose market share rapidly and become even less attractive than it is now. Our opinion is that it will be forced to merge with other CEE or other European exchanges in order to keep the sense of its existence. This is line with general tendency towards equity market consolidation in Europe. Current situation, with many small, regional exchanges in CEE region, is unsustainable in our opinion. Under MiFID, stock exchanges across EEA will face enhanced competition from MTFs like the abovementioned Turquoise and Sis. This will lead to a further period of consolidation, CEE region likely being the first to go.

5.3. Investment firms and MiFID

Some market participants could be surprised that they are in scope of MiFID, as its scope is much broader than that of the previous regulation both regarding instruments (vast majority of financial instruments is regulated by MiFID) and services (investment advice is in MiFID's scope, see below). This means that MiFID will encompass most of the subjects that deal with or offer services to clients. For the subjects that have not been regulated as strictly as MiFID requires them to be now, this could mean additional costs for meeting the obligations.

And these are rather vast. Firms, for instance, will have to appoint a separate compliance officer responsible for meeting MiFID's requirements and will have to explicitly specify their risk management and internal audit policies and procedures. If further the firm outsources certain activities which are substantial for the quality of services offered to clients or for investment activities, it will have to take all reasonable steps to avoid unnecessary operational risk. Implementation of these provisions will demand a high degree of participation of high executives, since changes are profound and entail strategic consequences for firm's business.

In subsequent chapter we try to analyze the degree of firms' preparedness for MiFID and they attitude towards the new regulation. For this purpose, a small survey was carried out among representatives of the investment firms. Moreover, the subchapter also gives an estimate of upper-bound of compliance costs for Czech companies.

5.3.1. Survey of investment firms: methodology and results

To our knowledge, there has not been undertaken any official empirical study regarding impacts of MiFID in the Czech Republic, either by the Ministry of Finance or the

Czech National Bank, or by any commercial institution. To have at least some data to base our analysis on, we compiled a questionnaire similar to the one by LECG and asked all the members of the Prague Stock Exchange, plus two other investment firms, to fill it out. The questionnaire consisted of twelve qualitative answers, as from our previous experience, investment firms and banks were not willing to fill out any figures regarding costs, turnovers etc. The questionnaire is included in Annex 1.

From 23 requests, we received 7 answers, four from banks and and three form non-banking investment firms. This is certainly an insufficient number to base any firm conclusions on. Anyway, it could help us in drawing contours of a picture of likely sentiments among market participants and their opinions on MiFID. We would like to express our gratitude to following respondents here (ordered alphabetically): **BAWAG Bank CZ a.s.; Cyrrus, a.s.; Komerční banka, a.s.; Raiffeisenbank, a.s.; PPF Banka a.s.; Wood&Company Financial Services, a.s. and X-Trade Brokers Dom Maklerski Spółka Akcyjna, organizační složka Česká Republika.** Their feedback was very valuable for me and helped in understanding the impacts of MiFID better.

Table 1 shows the results of the survey and compares it with the results of the FSA survey, where applicable.

Table 1

	FSA	CZ
Question 1 Preparedness	4	7,7
Question 2 Change of Strategy	13/29	1/7
Question 3 Business Lines		
Change	10/30	4/7
Abandon	13/30	1/7
Question 5 Market Exit	22/28	4/7
Question 6 Barriers to Entry	27/30	2/7
Question 7 Some Disadvantaged	28/29	5/7
Question 8 Effect on Individual Volumes		
Increase	13/30	1/7
Decrease	3/30	3/7
No Effect	14/30	3/7
Question 9 Effect on Profits		

Increase	**1/30**	**2/7**
Decrease	**22/30**	**4/7**
No Effect	**7/30**	**2/7**
Question 10 Overall Trading Volumes		
Increase	**0/29**	**2/7**
Decrease	**19/29**	**3/7**
No Effect	**10/29**	**2/7**
Question 11 Change in Market Share		
Increase	**5/28**	**2/7**
Decrease	**4/28**	**0/7**
No Effect	**19/28**	**5/7**

. In Question One of the questionnaire, we examined the overall level of preparedness for MiFID. Respondents were asked to give, on a scale from 1 (have not considered MiFID yet) to 10 (full preparedness), their estimated degree of preparedness. On average, firms indicated 7,66, with answers ranging from 5 to 10. This is a positive outcome indicating that despite the delay in legal transposition, firms do not wait until the final form of regulation and prepare for upcoming changes. The reason for this can be seen in the fact that all our major banks are owned by large multi-national corporations and are forced to prepare for MiFID by their controlling companies. The explanation for other investment firms could well be that they trade with EU-residents to a large extent and so are forced into duly compliance by market forces and competition. When compared to the results of the FSA survey, Czech investment firms appear to be better prepared, although this might be due to the Czech survey being conducted in 2008, i.e in year in which the MiFID should have been already implemented (while the FSA survey in 2005).

In Question Two, we investigated, whether MiFID causes any change in firms' business strategy. All but one firm stated that MiFID will not cause them to change their business strategy, with three firms strongly disagreeing and three disagreeing. One firm agreed that it will have to change its business strategy as a result of MiFID. In comparison, almost half of British firms were positive about changing their strategies.

Question Three examined the effect of MiFID on firms' behaviour from the perspective of changing and/or exiting any area of their current business. From seven respondents, four stated that MiFID will force them to change the area of their business and one stated that MiFID will result in exit from particular area of its business. This is quite an important finding in our analysis that in a sample of seven, slight majority considers changing area of business. British results tell us that one third of firms consider changing lines of business and slightly above one third abandoning specific lines of business

In Question four, we asked the respondents whether costs associated with MiFID represent a substantial part of their annual administrative costs. All but one firm disagreed. Further, we asked them to give an estimate of costs associated with MiFID as a percentage of annual administrative costs. Three firms provided figures ranging from 1 to 10% of annual administrative costs. One firm stated that MiFID represents 30-40% of their annual costs for legal services.

In Question Five, we asked the respondents whether they think that costs associated with MiFID will cause some firms to cease their activities and exit the market. From seven answers, four were positive, indicating a prevalent opinion of fastidiousness of MiFID's requirements. This is in line with FSA's results, where 22 out of 28 respondents stated that they expect MiFID to force some firms to exit the market.

Question Six examined the issue of market entry post-MiFID. When asked whether they think MiFID will increase barriers to entry for new firms, only two firms agreed. One reported that barriers should not increase but the overall environment will be more competitive. We tend towards this opinion, as barriers to entry for new investment firms are already very high in the Czech Republic. Situation is entirely different in competitive British market, where 90% of respondents are convinced that MiFID will increase barriers to entry.

Qeustion Seven examined whether firms agree with the statement that some investment firms will be disadvantaged as a result of MiFID. Two respondents strongly agreed, three agreed and two disagreed. This is yet another possibly serious finding, indicating the overall image and perception of MiFID among market participants. British respondents were almost unanimous in their answers to this question, showing yet again the huge difference between the capital market in UK and the Czech Republic.

Effect on securities turnover volumes resulting from MiFID was examined in Question Eight. From seven answers, three firms reported that they expect a slight decrease in volumes, three expect no change and one reported expected slight increase. These results are in line with our previous opinion that the state of development of capital market and level of participation are very low in the Czech Republic and consequently, MiFID's effect on trading volumes and participation should not be as accentuated as in Western Europe. UK respondents are more optimistic, with roughly one half expecting volumes to grow.

In following Question Nine, we asked the respondents to estimate the effect of MiFID on their yearly profit. Answers varied between slight decrease and slight increase here, with majority of respondents stating that the effect will be very moderate.

Similar pattern could be seen in Question Ten, where we investigated impact of MiFID on total industry volumes. Answers were almost perfectly divided between slight increase and slight decrease. Argumentation could be the same as in Question Eight here. Situation is much more dismal in UK, with majority of respondents expecting both overall volumes and individual annual profits to decrease as a result of MiFID. Argumentation could be similar to that in question eight, the difference in development and competition levels.

In Question Eleven, we asked the respondents what change in their market share do they expect. Five reported no expected change, two reported a slight increase. One firm advocated this by stating that it expects some firms to cease activities in corporate trading area while other areas being unaffected. The results are roughly the same for the UK, showing similar psychological patterns perhaps.

In the last Question Twelve, we examined firms' opinion on the overall impact of MiFID, in particular whether they think that MiFID will contribute to greater financial markets integration in the EU. Answers covered full scale; five respondents reported either strong agreement or agreement. This is in line with our experience from other countries, where market participants were divided on the overall impact of MiFID.

We must make a note here that these results should not be taken as representative of the Czech investment industry. Seven respondents is far too few for drawing any conclusions but it could be helpful for our purposes of illustrating or sketching the outlines of opinions, attitudes and sentiments of market participants. Furthermore, the task of undertaking a thorough and complete study is outside the scope of a bachelor thesis. We leave this task to respective authorities.

5.4. Investment advice and the TA regime in the Czech Republic

Finally, let us now have a closer look at the industry, or a part of it, that will be especially influenced by MiFID. MiFID's changes will be particularly visible in the investment advice and intermediation business. Investment advice regarding financial instrument is considered as core investment service under MiFID. This provision will have serious repercussions in Czech financial advisory industry. This is because investment advice and intermediation is no longer a craft[65] under MiFID and its practice will be reserved to licensed entities only.

The Czech Republic has, broadly speaking[66], two options. First, to avail itself of the possibility given by Article 3 MiFID, which says that Member states can decide not to apply the Directive to certain types of entities, or to apply Communitary legislature and replace current arrangement with the Tied Agent regime.

Let us examine second option first. If the Czech Republic decided to apply MiFID onto the investment intermediaries in its full scale, this would mean that current Level 1 and 2 investment intermediaries, as defined by current legal arrangement, would be cancelled and replaced by the TA regime as described above. Investment intermediation and advice could be offered only by investment firms and/or tied agents working for them. This would represent increased organisational, personal and technical demands for current Level 1 investment intermediaries who employ Level 2 intermediaries. These companies would have to transform themselves into investment firms for the purposes of MiFID. Moreover, they would have to comply with all the informational and reporting requirements, which would incur significant compliance costs. It would also mean the end of independent advisors, as these could perform their work only as tied agents of an investment firm.

Investment advisors and intermediaries have expressed preference and general consent[67] to the first option above. Current Level 1 investment intermediaries would be transfered into registered investment intermediaries, with the Czech National Bank as their respective authority. Level 2 investment intermediaries would be changed into sales representatives acting on behalf and for the account of the investment intermediary. Investment intermediaries would be fully accountable for the activities of their representatives. It would also be responsible for their expertise and education. Investment intermediaries would be obliged, during the process of registration, to document that their representatives have sufficient skills and that the firm has in place appropriate policies and procedures for screening these requirements.

Roughly half of the Member states, e.g. the United Kingdom or France, have expressed will to avail themselves of the possibility to apply Article 3 MiFID to intermediation and advice business. We can identify several advantages this regime could bring about. For instance, the Czech National Bank will have significantly less (from

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[65] Before the implementation of MiFID, investment advice was regarded as an anciliary investment service and could be provided on the basis of a Trade Certificate.
[66] All the possible solutions are outlined in AFIZ (2007)
[67] AFIZ (2007)

thousands to hundreds) subjects to oversee. There will also be no more discrepancy in the division of responsibilities, as the investment intermediary will assume sole responsibility for the actions of their representatives. Clients will benefit from this clearer division of responsibilities and from enhanced guarantee of representatives' expertise. Last but not least, there will be continuity with current legal arrangement, at least to some extent. In some respect, this continuity could be beneficial as well. The industry in question is still underdeveloped in the Czech Republic and such a bold alteration of the environment could hamper its rosy growth.

5.5. Cost estimates for the Czech Republic

There are no reliable estimates of the overall costs of MiFID implementation in the Czech Republic. In this part, we try to estimate, based on the FSA results, costs associated with MiFID for Czech conditions. We use several indicators of market performance to try to take into account the differences between Czech and UK financial sector and to estimate overall costs of MiFID implementation for the economy.

FSA has estimated total costs for UK investment industry associated with MiFID implementation to be between **£870 million and £1 billion**[68]. We start from the lower figure, as firms as well as regulators tend to overestimate costs associated with changes in *status quo.* We employ various indicators and their ratios to get a set of estimates of what we regard as *upper bounds* for total costs Czech investment industry and regulatory authority will incur as a result of MiFID implementation.

To get an estimate, we express the abovementioned costs reported by FSA as a percentage of respective indicators for the United Kingdom and then we multiply it by the value of the same indicator for the Czech Republic.

We employed following indicators as basis for our calculations:

- Assets of financial sector (monetary financial institutions and other financial intermediaries and auxillliaries, without pension funds, insurance companies etc.).
- Financial assets of households.
- Total financial assets of the economy.
- Gross value added of financial sector.
- Stock exchange capitalization (LSE vs. PSE).

[68] FSA (06/14)

Following table summarizes our calculations.

Table 2. Estimates of Upper Bounds of Total Costs

UK Total costs≈£870 mil.	UK (£mil.)	Total costs as a percentage	CZ (CZK mil.)	Costs Estimates for the Czech Republic (CZK mil.)
Financial Sector Assets	9 017 000	**0,01%**	4 190 396	**404**
Financial Assets of Households	3 800 100	**0,02%**	2 779 131	**636**
Total Financial Assets	16 860 200	**0,005%**	14 544 783	**751**
Gross Value Added of Financial Sector	96 100	**0,9%**	86 189	**780**
Stock Exchange Capitalization	3 500 000	**0,025%**	2 022 598	**503**

We can see that the results are quite consistent, ranging from CZK 404 million to CZK 780 million. We can observe that figures obtained through comparison with financial sector assets and stock market capitalization are the lowest two among the estimates. This is not *per se*, it is caused by the fact that relative size of financial sector *and* relative size of stock market are much lower in the Czech Republic than in the United Kingdom, resulting in lower conversion ratio and hence, lower estimates.

Average upper bound for estimated costs associated with MiFID implementation in the Czech Republic is CZK 615 million, median figure is CZK 636 million. We consider this to be quite reasonable results, reflecting size and importance of our financial sector relatively to the whole economy.

As has been mentioned afore, the fact that our capital market and whole financial sector are still well underdeveloped, compared to old EU-members, will likely result in MiFID having less accentuated negative effects that are being feared across the old EU-members and that have been described hereinbefore. Total costs associated with implementation will certainly be the case.

A discussion with market participants revealed that although there will be costs associated with MiFID implementation, it is difficult to disentangle the MiFID-related costs form other costs related to ongoing upgrading of IT systems etc. Thus, the costs estimated by the representatives stand for upper bound, as a number of costly measures will probably be undertaken anyway, regardless of MiFID.

5.5.1. Some remarks to costs inference

We would like to remark here that in our opinion, costs associated with MiFID should not be of much interest for the new member states. Surely, it is useful to know their magnitude to be able to evaluate new legislature from the economic point of view. But we want to look at them from another point of view.

The degree of capital markets development among new members is considerably lower than among old members. The catching-up process is always costly, although not to the same degree, depending on the quality of institutional environment, path dependency, reliability and responsibility of political representatives and other factors we described in the part on specific Czech conditions.

Regulation that has been elaborated predominantly by old member states experts and based mostly on experience from their capital markets development should, in our opinion, represent a significant positive incentive for the development of new member states' capital markets, set aside its flaws and imperfections. By this we want to say that the „resolution ability" of new member states' capital markets is much lower and they are much less susceptible to these flaws and imperfections compared to old members' capital markets. When we omit the fact that there *is* MiFID for a minute now and try to imagine what would new members have to do in this area in order to successfully catch-up with their Western counterparts, we must come to a conclusion that they would have to establish and adopt new legislature themselves, with all the risks along the way. This process would be costly as well, probably more than mere transposition of final legislature. In this respect, new member states should not consider MiFID primarily as a source of costs but rather as an opportunity to catch-up with old members and avail themselves of their comparative advantage without the need to elaborate the regulation themselves.

5.6. Broader market effects and some policy suggestions

MiFID could bring substantial positive incentives to the development of Czech capital market. As we claimed above, our capital market suffers to some extent form path dependency and distrust. MiFID is a measure that could help us and our capital market overcome these problems and converge, in operational and regulatory conditions, towards sophisticated Western markets more swiftly. Regulatory development in the Czech Republic has been criticized as not meeting the demands markets created. Switching to European legislature, although by far not a universal remedy, gives us the opportunity to take advantage of more sophisticated and experience-based regulation in comparison with our *status quo.*

Increased investor confidence could be identified as the most important benefit in Czech circumstances. By promoting retail investor as the core interest, MiFID could represent a significant positive incentive for building and strengthening of investor confidence and capital market culture in the Czech Republic. By the means of best execution and transparency, trading costs should fall substantially because brokers will have to give the breakdown of costs to the clients. This could improve confidence in capital markets significantly and induce larger retail investor participation rates, entailing a potentially significant benefit to Czech economy as a whole.

Let us try to find who the winner and loser will be post-MiFID. It is clear that IT solution providers will benefit most from the one-off costs. Requirements on transparency and best execution require, especially large institutions, to establish sophisticated electronic systems that will guarantee ongoing compliance. Investment banks and asset managers will have a big opportunity as well through the means of systematic internalisation and especially, through establishing MTFs, which is already being realised in the example of Project BOAT.

On the losers' side, retail stockbrokers, and generally smaller players, will be hit by MiFID to the largest extent. They do not dispose of sufficient resources to compete with large institutions in establishing their own IT systems. Further, as has been observed in the FSA questionnaire as well as in our own, a significant percentage of firms consider changing their business strategies. Indirect and opportunity costs associated with these changes could easily dwarf IT and compliance costs.

In general, we can observe that those well-prepared will benefit at the expense of the worse-prepared. This has been accentuated many times by many different authors and we agree with this. MiFID represents a high-risk/high reward strategy and can bring substantial benefits for those, who prepare properly, but high costs for those, who neglect it or do not prepare on time.

We would like to add recommendations that we see as very important for the success of MiFID here. Firstly, the need to endorse trade data consolidation as a prevention of liquidity fragmentation; national regulators should encourage reporting to one recognized trade data monitor. In our opinion, only sufficient data aggregation and consolidation can help us avoid undesired consequences of liquidity fragmentation.

Secondly, we want to emphasize that in order for MiFID to succeed, very close and day-to-day cooperation of national regulators will be crucial. MiFID is a complicated and detailed piece of legislature with many controversial provisions. Consistent and thorough implementation will be absolutely necessary to avoid "gold-plating" and to prevent from possible adverse consequences MiFID entails.

Thirdly, as has been mentioned afore, Prague Stock Exchange is suffering from low trading volumes, insufficient investor participation and low number of IPOs. To increase credibility and attractiveness of the PSE, we encourage policy makers to use it as a mean of privatising the rest of state-owned enterprises. It is by far the most transparent way of privatisation and could entail significant positive externalities of increasing capital market credibility and promoting capital market culture.

6 Conslusions

In this thesis, we gave an overview and analysis of the new European financial markets regulation, the Markets in Financial Instruments Directive. It is a cornerstone of the European Union Financial Services Action Plan, the endeavour towards a single market for financial services. The adoption and subsequent implementation have been far from easy and smooth, giving rise to many disputes over the intended and factual effects. We tried to identify main roadblocks and have a look at them from the specific Czech perspective.

Firstly, we reviewed academic literature on international financial integration. We identified main benefits that it brings, like lower transaction costs, easier access to broader and deeper liquidity pools, pressure on productivity increase and economic growth and pressure on institutional improvements. However, international financial integration is not associated with positive effects merely. Among potentially negative effects, we identified increased exposure to short-run, speculative flows that can adversely affect macroeconomic stability through increased exchange rate volatility and the procyclicality of such flows.

Creation of European Monetary Union has clearly contributed to the advancement of financial markets integration in the EU. By, *inter alia,* improved transparency and reduced transaction costs, it increased willingness to trade cross-border. Money and debt markets show signs of nearly perfect integration, as can be seen from interest rates convergence. However, there still remain areas where a lot is to be done. Despite increases in returns correlation, equity markets in the EU are still not fully integrated.

MiFID reacts to developments in European financial markets during last decade. Its predecessor, the ISD, failed to reach the goals set mainly because of the concentration rule, which resulted in an outburst of unregulated and hidden trading known as systematic internalisation, and because of the "gold-plating" of the regulation by the member states that imposed additional requirements and rules. Consequently, the initial idea of level playing field for financial services in the EU was not fulfilled. MiFID aims to make up for that through the means of increased transparency requirements, best execution policy and new typology of trading venues.

We began the analytical part by assessing the creation of MiFID and its implementing measures. We found that both the Directive and its implementing measures were seriously affected by political bargains and lobbying. Furthermore, we argue that the EU has departed the promoted principle-based approach to regulation and embarked onto detailed one, as can be seen in overtly detailed provisions of Level 1 Directive and Level 2 implementing measures. Next, we presented the results of FSA Cost-Benefit Analysis as groundwork for our own attempt to assess costs associated with MiFID for the Czech case. Key findings of this CBA are following: market participants expect MiFID to affect competitive environment to a large degree. Also, market participants expressed concern that large players will benefit at the expense of small players. MiFID is also expected to increase marginal costs permanently, with possible effect on trading volumes and prices.

We then investigated possible effects of MiFID transparency requirements on spreads and liquidity. Increase in transparency could have ambiguous effects on spreads and a possibly negative effect on liquidity provision. We argue that there will be some trade-off of profits from more to less informed traders. Moreover, by codifying MTFs and SIs, MiFID could cause liquidity to fragment, negatively influencing price discovery process and overall market efficiency. Although the drafters accomodated for that by reporting obligations, we argue that trading data consolidation will be absolutely crucial to prevent fragmentation from ocurring and will be more difficult to achieve post-MiFID, as MiFID allows investment firms to report to whom they choose. We also analyse the best execution provisions and come to a conclusion that such a complicated and multi-layered concept will be difficult to implement and enforce on a consistent basis.

In the last chapter, we analyse impacts of MiFID in Czech conditions. We notice that its effects will be of different nature than in Western Europe because of our historical heritage. Given the fact that our capital market is still well underdeveloped compared to its Western counterparties, we argue that previously mentioned effects of MiFID should not be as accentuated in our environment. We also argue that MiFID will result in further wave of stock exchanges consolidation and that, given its small size and importance, Prague Stock Exchange will face pressures to merge with other exchanges from the CEE region to justify its further existence.

To have at least some empirical data on MiFID implementation in the Czech Republic, we organized a small survey among leading banks and investment firms. Although we received only seven replies, our results indicate that firms consider MiFID to be a significant incidence into their business areas. On the other hand, based on the replies, firms do not consider MiFID to be a source of significant costs but think that MiFID will alter competitive structure in Czech capital market.

Based on the results of FSA cost-benefit analysis, we tried to estimate upper bounds of total costs associated with MiFID for the Czech Republic. Applying various indicators of relative financial sector size and economic performance, we arrived at five figures, ranging from CZK 404 million to CZK 780 million. We argue that MiFID could bring significant positive incentives to the development of Czech capital market by strengthening investor confidence and participation rate. In the end, a few policy suggestions are given.

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Annex 1: Questionnaire

Question 1: What is the degree of preparation for MiFID in Your firm?

On a scale from 1 (have not considered MiFID yet) to 10 (fully prepared) estimate Your degree of preperation.

Answer: ☐

Question 2: Will Your business strategy change as a result of MiFID?

strongly agree	☐
agree	☐
disagree	☐
strongly disagree	☐

Question 3: Do you consider changing and/or abandoning any line of business as a result of MiFID?

change	yes	☐
	no	☐
abandon	yes	☐
	no	☐

Question 4: Do you expect MiFID to have substantial impact on Your annual overall administrative costs?

strongly agree	☐
agree	☐
disagree	☐
strongly disagree	☐

If so, please estimate their magnitude as a percentage of Your overall annual administrative costs: ☐

Question 5. Do You think that some investment firms will be forced to exit the market as a result of MiFID?

yes	☐
no	☐

Question 6: Do You think that MiFID will increase barriers to entry for new firms?

yes	☐
no	☐

Question 7: Statement: Some investment firms will be disadvantaged against others as a result of MiFID. Do You agree with this statement?

strongly agree	☐
agree	☐
disagree	☐
strongly disagree	☐

Question 8: What effect on Your trading volumes do You expect as a result of MiFID?

substantial decrease (>20%)	☐
slight decrease	☐
slight increase	☐
substantial increase (>20%)	☐

Question 9: What effect on Your annual profit do You expect as a result of MiFID?	
substantial decrease (>20%)	
slight decrease	
slight increase	
substantial increase (>20%)	

Question 10: What effect on total industry volumes do You expect as a result of MiFID?	
substantial decrease (>20%)	
slight decrease	
slight increase	
substantial increase (>20%)	

Question 11: Will Your market share change as a result of MiFID?	
substantial decrease	
slight decrease	
no impact	
slight increase	
substantial increase	

Question 12: Do You think that MiFID will be to the benefit of greater financial markets integration in the EU?	
strongly agree	
agree	
disagree	
strongly disagree	

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Akademický rok 2007/2008

TEZE BAKALÁŘSKÉ PRÁCE

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Garant studijního programu Vám dle zákona č. 111/1998 Sb. o vysokých školách a Studijního a zkušebního řádu UK v Praze určuje následující bakalářskou práci

Předpokládaný název BP:

MiFID: Markets in Financial Instruments Directive Implementation in the Czech Republic

Charakteristika tématu, současný stav poznání, případné zvláštní metody zpracování tématu:

MiFID is a new directive of the European Union binding the members of the European Economic Area. Its aim is to finalize the process of integration of European markets for financial services and to create more robust and competitive financial markets. Currently, the phase of transposition into national legal systems is underway and the Directive shall be enforceable by November 2007. This new regulation will have significant impact onto financial markets operation. Governmental and non-governmental organisations throughout the EU publish large amounts of consultation materials on MiFID. In the Czech Republic, transposition is in the phase of inter-department amendment procedure and the novel Act on Capital Markets Undertakings is likely to go to the House of Representatives soon. Czech Ministry of Finance has published a serie of consultation papers last year, which deal with MiFID in a complex manner. Novels of further Acts are related to MiFID, e.g. Banking Act, Act on Capital Markets Supervision etc.

Struktura BP:

1. Introduction. 2. Charasteristic of the Directive. 3. Institutional comparison of current situation and MiFID. 4. Impact on other areas of the economy 5. Conclusion.

Seznam základních pramenů a odborné literatury:

Publications of the Czech National Bank and the Ministry of Finance of the Czech Republic. Documents of the European Commission, European Council and national regulatory authorities of member states.

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V Praze dne