



MiFID

Last Updated: 7th May, 2007



What is MiFID and its Objectives?

MiFID (the Markets in Financial Instruments Directive) comes into effect on 1st November 2007. MiFID replaces the existing Investment Services Directive (ISD) and is intended to create a more open, competitive and transparent market for financial services across the European Union. Existing restrictive practices, such as limiting trade in some countries to national exchanges or bourses, will be outlawed.

Who are Affected by MiFID?

The range of products affected by MiFID is much wider than those concerned by the ISD and is therefore of concern to financial services organizations as wide ranging as:

- ▶ Retail Banks;
- ▶ Investment Banks;
- ▶ Insurance Companies;
- ▶ Venture Capital Firms;
- ▶ Stockbrokers;
- ▶ Investment Managers;
- ▶ Proprietary Trading Firms;
- ▶ Corporate Finance Firms;
- ▶ Wholesale Market Brokers;
- ▶ Providers of Custody Services;
- ▶ Operators of multiple trading platforms (MTFs).

What are the Business Implications of MiFID?

To understand MiFID in more detail and its implications for business, let us look at its individual directives/articles and their impact on business processes:

Investor Protection

Protecting the interests of the investor is at the heart of MiFID. The Suitability Test (Article 19(4)) ensures that where an organization provides advice or recommendations (e.g. portfolio management), such advice has been checked for its suitability given the background and aims of the client. The onus (as always with MiFID) is on the supplier of such services to prove that such checks have been carried out and recorded.

Resulting from the Suitability Test, each client will be categorized (the main ones being retail and professional). Such categories are used as a basis in MiFID for selecting whether certain products or services are made available to the client. This is known as the Appropriate Test (Article 19(5)).

Companies are also obliged to identify and minimize areas of conflict between themselves and their clients (Article 18). Before any business is conducted on a client's behalf, an investment company must take every step to minimize any such conflict of interest and clearly make the details of such known.

Best Execution

Before MiFID, financial services companies could decide how and where to carry out sell orders for clients of products such as equities. Organizations could even trade outside of regulated exchanges (e.g. London Stock Exchange (LSE)) and these are known as "Systematic Internalizers".

Article 21 of MiFID dictates that all trades, whether through regulated exchanges or through Systematic Internalizers, are conducted on the best possible terms for the client. This means that each financial organization will have to create a rule or policy for each type of product sold in this way that is shared with the authorities and their clients. The policy will, for each transaction, justify the venue (e.g. the national stock exchange), the sell price obtained and other factors such as the speed and size of sale, and the likelihood of settlement. All such information and the decision making process will need to be recorded for every sale order and be reproducible on demand should a client or the authorities demand it. Under MiFID, companies will be obliged to undertake an obligatory review of the effectiveness of the policy at least once a year and duly inform their clients of any changes that result. Regulators will be under a duty to ensure that this is done.

The Best Execution directive of MiFID also applies to the way the order is handled. Article 22 mandates that orders are sold promptly and fairly. Comparable client orders should be executed sequentially and not aggregated except under special circumstances. Furthermore, proceeds from all sales should be delivered to the client promptly post-settlement.

Integrity

MiFID has onerous implications for record keeping and auditing. Companies will be expected to retain detailed records of all financial instrument (e.g. equities) transactions for a minimum of 5 years. Reports will have to be generated

of all such transactions (including quantities, dates and times) to the local regulatory authorities.

Passporting

Articles 31-34 will allow investment companies to offer their products and services across the EU and gain access to local markets and systems for clearing and settlement (subject to authorization from the home state). This concept of "Passporting" is a part of ISD but has been significantly extended with MiFID to cover more product types.

Transparency

Article 27 of MiFID requires that the details (bid, offer, size, etc.) of all internal trades and quotes between Systematic Internalizers will be made public. This is part of what is known as "Pre-Trade Transparency". The information will have to be made accessible on a continuous basis to other market participants. Information post-trade will have to be made similarly available on a real-time basis according to Article 28. Note that the above do not apply to professional clients and deals with retail clients below 100,000 Euros.

What does this Mean for IT Systems and Testing?

The implications of MiFID for IT will vary from company to company. There will be greater opportunities for many with a more open, level playing field. However, this will come at a significant and unavoidable cost in IT terms. In many organizations, there is a need to analyze, re-engineer, upgrade or even replace key applications. In order to comply with MiFID.

Organizations will depend on IT systems to provide the new levels of regulatory reporting and transparency demanded. But MiFID also represents an opportunity to gain a competitive edge in the highly competitive investment market. The IT implementation to support MiFID is likely to become an increasingly major element of an investment company's competitive differentiation. Timely provisioning and testing of such systems will offer a definite edge in the marketplace.

Investor Protection

Systems containing customer records will need to be upgraded to accommodate the extra information required of the new Suitability and Appropriate Tests. Customers will need to be categorized in various ways including whether

they are classed as retail or professional. Since such IT systems already contain a variety of existing functionality, it is vital to each investment company that the introduction of new functionality and the inevitable changes to the underlying database structure do not have any adverse impact to existing functions. This is best ensured by ensuring a full and comprehensive regression test suite has been designed for these IT systems. These regression tests suites could also be potentially automated using a number of commercially available products from vendors such as Mercury and Compuware. This would provide tremendous benefit to an organization introducing new functionality quickly as the November 2007 deadline looms.

Best Execution

Best Execution has many consequences for the IT systems within an investment company. Significant business logic needs to be introduced into trading systems to ensure that clients receive the best and fair price for their trades on the new wider and open EU market. Orders will be need to intelligently routed to the best venue for each deal. This can only be done by connecting existing IT systems to new market feeds to ensure that all decisions take into account the latest market prices.

The logic involved in arriving at each deal will need to be recorded in addition to the details of the deal such as time, venue, price, and client and deal size. Such information and the need to potentially review a policy annually with a client suggests that existing IT systems will require extensive new reporting capabilities.

Trading and IT systems will need to be significantly enhanced to satisfy the new demands of MiFID to support the Best Execution directive. Again, such far ranging changes carry major risk to an investment company's day to day operations if they fail to perform a comprehensive regression test on existing functionality. Performance testing is also fundamentally important since Best Execution relies on market data being available in real-time with trading systems and market feeds potentially under heavy load.

Integrity

The need to retain details of trades for up to 5 years and the related reporting obligations suggests the need for some kind of data warehouse capability. Fast, reliable and continuous access to data via reliable networks will be necessary. This needs to be performance tested in the short-term and the longer term as the number of transactions grow, particularly if a company expects

to benefit from the newer more open market. Capacity planning and so-called database bulking will be important parts of this testing process.

Passporting

The freedom for investment companies to operate in any EU country and execute trades with venues elsewhere suggests further enhancement of IT systems. Existing trading systems will need to be integrated with yet further data feeds. Further regression tests will be essential before these new enhancements go live. The need to deploy IT systems across multiple locations and even countries with increased numbers of users suggests extensive performance testing and the use of complex staging environments for this purpose.

Conducting business in new countries, particularly those involving trades in currencies not yet supported by current IT systems, has major implications for a system in terms of multiple currency support. The need for software modification and testing could be significant with parallels being drawn with the work involved when the Euro was first introduced.

Transparency

MTFs and investment companies who act as Systematic Internalizers will have to create IT systems that regularly publish quotes – pre- and post-trade. Communications

will also be established with market data providers to ensure timely and reliable reporting of data by all market participants. Since there is a need to report such data in near real-time (as required by MiFID), compliance should be checked by monitoring the required IT system(s) and their live performance. This is best implemented using monitoring products that monitor business processes on a regular basis and provide alerts of any transgression. Drill down capabilities can often be used to identify the source of the problem.

Conclusion

Compliance with MiFID will mean major rework and enhancement of a variety of IT systems within many investment companies across the EU. The pressure is on to comply by the November 2007 deadline without adversely impacting existing functionality in applications as diverse as trading systems and CRM applications. It has therefore never been more important that affected companies plan and execute thorough regression and performance tests, while also deploying monitoring technology to ensure compliance with MiFID once new or enhanced systems go live.

Good planning is essential in order to ensure that the coverage and prioritization of testing meets the needs of the business and reduces the inherent risks involved in complying with MiFID.