THE MiFID REVIEW; A FRAGMENTATION CHALLENGE IN EUROPE'S SINGLE MARKET?

Abstract

The Markets in Financial Instruments Directive (MiFID) is bound to be reviewed in the very near future. Since its introduction is has been coping with market fragmentation; by some mentioned as a hazardous development for Europe; but will this harm European financial markets? The answer is that the extent of market fragmentation probably is overstated and that precautions are taken to maintain the balance between markets in Europe's rulebooks on securities regulation law. The path of investors has been set out by diverse trading platforms, which follow directives like MiFID, that enhance further trading in Europe and that will take even more measures to ensure fair dealing and competition in Europe, as a expected competing geographical market in the world.

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Introduction

New investments and continuing cash-flow in the financial markets are crucial for their existence. Financial trading venues have to be regulated in order to take into account various essential factors, like risk, liquidity and competition. The market is a trading platform, on which buyers and sellers leave their demands and offers; the same platform has to provide adequate services, if it wishes to obtain its status and competitive role in its future business.

Efficiency in dealings is requested, and even expected; orderly, trustworthy business and investor protection is of the essence, when it comes to making a trading platform an attractive market place for potential investors. Together with these relevant remarks, is the equality of investors, their access to the market and the services provided and regulated in Europe mentionable.

This is the moment that the Markets in Financial Instruments Directive steps into place. The directive provides a legal framework for equal dealings, in which clients are the primary target. Following the Lamfalussy structure, MiFID has experienced many obstacles and will face a review in the upcoming period. The financial crisis, the changing developments and the various innovative investment firms that act on the financial markets are just one of the details that will be taken into account, when drawing up a new directive. The fear of market fragmentation is big in Europe since the introduction of MiFID; will this change after the review? Partitioning the market between Member States, which compete on a global level, can harm the view of equal trading in Europe and fair opportunities on the financial trading platforms. In this paper I will give an answer to the question:

"Is the effect of market fragmentation since the introduction of MiFID, harmful for the vision of the single market in Europe?"

This paper is organized as follows. In Section 2, I will give an introduction about MiFID, a view on the background of this directive, its main components and a small recap on investor protection and market diversity. In Section 3, I will discuss the expected review of the Directive, the incentive for the review and the pending main initiatives for the further change. I will also combine the corresponding factors of transparency, competition and investor protection with the aspect of the unexpected development of continuing and increasing fragmentation of financial markets within Europe. In Section 4, I will set out the characteristics of market fragmentation from an economic viewing point,

In Section 5 I will conclude, give my final remarks and I will end with a recommendation.

2. The Markets in Financial Instruments Directive

The Markets in Financial Instruments Directive 2004/39/EC is a European Union directive that provides harmonized law for investment services across the European Economic Area. This area is comprised of the 27 member-states of the European Union, added up with Iceland, Norway and Liechtenstein.

The MiFID is one of the most prominent legislative guidelines for the capital markets, that has been introduced by Europe's institutions. Consequently, the MiFID can be considered as a challenge[1] for European financial markets; it takes all the protection away from European stock exchanges and in the same time forces investment banks, brokers and dealers to guarantee best execution of their offered services.

2.1 The history of MiFID

If we consider the legal framework of Europe's capital markets as a persistent movement, forcing its way into new boundaries and innovative key areas, then we cannot exempt MiFID as one of the most valuable tools for building the road to get there. In that matter, the background of MiFID and the development of capital markets in the last twenty years were the ideal building stones that led to the directive as we know it today. The regulations on the securities markets in the US had a great influence on Europe's future rulebook on this field of law[2].

The 1990's was a progressive period, which represented stimulation for financial law-making in Europe. The change was predominantly visual in the fact that the financial system was mainly becoming characterized by the rules that complied with the market[3]; legislative innovations like minimum harmonization and mutual recognition were developed and applied to financial services. This was mainly pushed forward because of a revision of the treaty of Rome (1957), the European Single Act (1986), that eventually led to the establishment of the European Union that came into force in 1993. This structural enhancement and approval amongst the European states was in that time vital, and a very rare development for the mere existence of cooperation between states in the world.

[1] C. Skinner, The future of investing: in Europe's markets after MiFID,
[2] Elliot Posner, The origins of Europe's new stock markets
[3] J.P. Casey, K. Lannoo, The MiFID revolution

In the years afterwards, development was next to the existing structures also set on many basic rules on a variety of different areas of law. A key directive in the financial sphere was the Investment Services Directive (ISD; 93/22/EC); the predecessor of MiFID.

The ISD was a measure that enhanced the thriving growth of the legal macroprudential framework within the EU, with a 'single-market' approach[4]. Cross-border financial services are in particular specified by this directive. The replacement of ISD, MiFID, was continuing in this line of thinking, since its adoption in the European legal (and financial) framework in 2004. MiFID is different in that way, since it extends[5] the coverage of the services that were provided by the ISD regime; it adds more requirements for firms, especially on the field of their organization and conduct of business.

MiFID can be specified as a part of the Financial Services Action Plan (FSAP), an attempt to enhance the single market-view for financial services in the EU. This plan was created by the European Union in 1999 and lasted until 2004; it is a framework that consists of 42 articles that are related to harmonization in the EU on the field of financial services. MiFID is often mentioned as the cornerstone[6] of the achievement of the FSAP.
As of November 1st 2007, the directive is the official replacement of ISD. The past and the upcoming renewal of these guidelines will proof itself in this paper to be a turning point for some key principal rules in Europe's financial markets.

2.2 Relevant remarks on the directive

The directive consists of a legislative framework that reflects certain developments in the field of the capital markets. The most substantial aspects are:

- *Passporting*. This simplification of doing business on the basis of an easier method, means that investment firms are allowed to offer investment services to clients anywhere[7], by establishing just one physical establishment in Europe.
- *Client classification*. Clients are divided into *retail* (smaller businesses, individuals, less experience[8]) *professional* (possesses the most experience for own investments[9]) and a separate category, the *eligible counterparty* (for a limited range of business[10]).

[4] H. van Houtte, The law of cross-border securities transactions
[5] http://www.mifid.ie
[6] J.P. Casey, K. Lannoo, Europe's hidden capital markets, Centre for European Policy Studies, Brussels, Belgium
[7] Article 31/32 MiFID

- *Transparency*. Concerning pre and post-trading[11] transparency rules.
- *Best execution*. Firms are obliged to pursue the best results for their clients.[12]
- *Systemic internaliser*. These firms (SI's) act on their own account for their clients, and will also be addressed and regulated according to the standards of MiFID[13].

MiFID is significant for its effect on the continuous growth of the boundaries of the financial market; amongst others, in the range of the operation of the 'passport', types of affected firms, matters of transparency, different types of investment services and organizational requirements (*conduct of business*). Maximum harmonization is applied, in contrary with the former ISD, which means that Member states don't have the right to exceed or further adjust the rules from the directive in their own legislation; this emphasizes home state supervision[14]. MiFID applies to every form of legal entity, it provides a platform where the business rules and requirements are set by the undertaken activity of a legal entity.
A difference in financial services in MiFID is made between "*investment services and activities*" and "*ancillary services*"[15]. If a firm performs investment services and activities together with ancillary services, then they are subject to MiFID. If a firm only focuses its business on ancillary services, then they are not subject to MiFID. Investment services are core services; ancillary services on the other hand, are non-core services, what explains the range on which the directive has an affection. In the same way, when a firm only intervenes in non-core services, 'passporting' is not possible, according to the rules set by out by MiFID.

2.3 The relevance of investor protection and market diversity

In particularly, investor protection is one of the aims that can be derived from the intent of the directive; by dividing investors into different categories, the markets provide a better trading platform, this keeps these platforms safe from manipulation and this provides the remedies that are needed against violations and trust/breach of market rules.
Still, when aiming at attracting more investors and a variety of trading platforms, competition between these places can lead to a fragmented marketplace, what can hurt market quality[16].

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8 Article 4 (1)(12) MiFID
9 Article 4 (1)(11) MiFID
10 Article 24 MiFID
11 Article 65 (1) MiFID
12 Article 21 MiFID
13 Article 27 MiFID
14 Financial Market Supervision: European Perspectives, James K. Jackson
15 Annex 1, Sections A-B MiFID (Level 1)
16 MiFID, Reg NMS and competition across trading venues in Europe and the USA Giovanni Petrella

And if this is deteriorating market quality, is it also opposed to key principles of the European market, like harmonization and mutual recognition? On the other hand, we can see that MiFID was beneficial for the financial market; lower costs, innovations, an efficient speed of business and an environment that is adapted to the electronic era we are in[17]. Can the revision intervene in the (possible) adverse effect of the challenge of market fragmentation?

3. The MiFID review

The European Commission's review of MiFID will acknowledge trading and other market developments that have been an increasing, influential factor since the introduction of the directive in 2004. The EC has its focus on the fact that even though MiFID has yet been applicable for a small number of years, it can be stated that there were static changes along the way, despite the impact of the financial crisis.

3.1 The background

As every detail of legislation, an intense revision of MiFID is expected; the circumstances since its introduction in the capital markets in 2004 have changed, and it needs to develop itself, in order to keep up with swift developments in the financial field.

After a couple of consultations in July and October 2010, the Committee of European Securities Regulators (CESR, now ESMA) provided a technical, long awaited advice for the EC, which embodied a recommendation on possible revisions of MiFID. The MiFID Review[18] as published in December 2010 is one of the most endogenous and extensive regulatory reviews that we have seen so far, as mentioned by some[19].

This resulted in the consultation period that was open for the public until February 2th 2011.

3.2 The intent of the review; a collision with market fragmentation?

Possible market fragmentation is highlighted in the table below; this is however, not explicitly stated as one of the key issues that are lurking from the surface. Of course, it has been subject to matters of trade transparency, but this has neither been addressed in a best-practice question, which could be discussed next to the opportunity of involvement from the public.

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[17] http://www.efinancialnews.com/story/2010-02-08/fragmentation-woes-haunt-buyside-after-mifid

[18] European Commission, Public Consultation review of the MiFID

[19] L. Tabb, View From The Top: MiFID II Could Change The Global Balance Of Financial Markets Power, TABB Group, 19 January 2011

The information in this table has been derived from the consultation paper (MiFID review).

KEY AREAS	**(PENDING) INITIATIVES**
Developments in market structures	Requirements for all OTC, SI's, SME markets
Pre- and post-trade transparency	Extending application equity instruments, **(market fragmentation?)**
Data consolidation	Options for a European Consolidated Tape
Commodity derivative markets	Requirements for derivative exchanges/commodity traders
Transaction reporting	Innovation of reporting items
Investor protection	Conduct of business, authorization/organizational requirements
Removing options and discretions	Tied agents, telephone/recording, super equivalent provisions
Supervisory powers and sanctions	Broader sanction-system and reinforcing these regimes
Access of third country firms to EU Markets	Innovation of an equivalence mechanism
Reinforced supervisory powers	Broader powers in case of products/activities/practices

In the securities markets, there is a division between two types of transparency; these two discrete components are mentioned as pre-trade and post-trade transparency[20]. The first one, pre-trade transparency, includes information that indicates valuable details about the interest (like quotations, orders). Post-trade transparency has as its object information, that is related to the size and to the volume of completed transactions, concerning the trade of a particular security. Increasing transparency can be beneficial for lowering costs and market-valued prices, but the fragmentation of trading venues has had an unexpected effect. Where before a financial institution had the ability to receive information from a few exchanges, currently they have the possibility to receive information from various exchanges, Multilateral Trading Facilities, Systematic Internalisers, e.g. other trading facilities. This resulted in a larger amount of work to benefit from the transparency, introduced by MiFID.

Growing competition amongst trading platforms in Europe has led to a certain form of fragmentation; to what extent these platforms offer equal protection for a variety of potential investors? MiFID suggests that investment firms should be able to choose on their own behalf, their own possible clearing- and settlement provider. Nevertheless, there is no mention in MiFID of how this choice should be achieved; this creates an open space in the market, in which there is an underlying danger of 'too much competition'. In that matter, competition is safe, when stating that the same information reaches all the potential investors.

[20] Fixed Income Markets and Their Derivatives, Suresh Sundaresan

More competition is always a good effort to attract as many investors, keeping the prices low and the market a popular place to invest; every market-participant has an eager wish to achieve a unique high value of his assets, with the most appropriate methods and with the highest standards of market-access.
Fragmentation of the markets can however, as it leads to a division in trading platforms, also result in a stabile market venue, where low prices are expected and where eventually most investors are bound to set up their camp. It remains questionable whether all of the market-participants can benefit and if they are capable of receiving an equal amount of information.

4. Market fragmentation

Market fragmentation can be described as the spontaneous emergence of new markets, which have their own characteristics, needs and requirements. This means that larger markets are divided into various parts, which all have their own demands and offers.
From an economic viewing point, market fragmentation is an event that namely occurs when the markets split into various segments, in which there are more trading venues with a lesser amount of investors, spread over the various platforms.

4.1 The impact of market fragmentation in Europe

MiFID has caused for market fragmentation to increase within the boundaries of the EEC[21]. The question that is subject to this fact is based on the appearance of a possible division of markets in investment services. One of the goals of European legislation, the 'single market', can be threatened because of this development. Market fragmentation leads to more competition, which is as well one of the goals of unity in Europe. The competition is driven mainly between various trading platforms, like stock exchanges, multilateral trading facilities (MTF's) and systemic internalisers.

It is still highly questionable which aspect takes the lead; the view of one single market or an expansion of competition, within Europe. Competition, investor protection, transparency, the 'European passport'; the vision of one market in just one layer is hidden, in my opinion.
If we look at the ruling of the 'European passport'; this means that cross-border transactions are widely enabled, by providing more services and products from one Member State to

[21] The Trade Magazine, Oct-Dec 2009, No. 22, Impact of market fragmentation on liquidity

another on the basis of one system of evidence. In the case of investor protection[22], the idea is about the equal protection of investors across Europe, the idea of equal treatment directly underlies this goal of the directive. You may ask yourself, whether an everlasting differentiation between markets is good for the economy, do we all benefit from it?

4.2 The other side of the medallion; an economics point of view

Experts in law and economics differentiate in the opinion, whether a certain market should be regulated properly or if the market has been priced enough for its quantitative volume.
What is more important, the rules or the scale on which the costs are measured?
One issue from both of these sciences can be aligned; the prosperous market, that is a safe place for all to invest in. Underlying the obvious synthesis of these two professions is the MiFID directive; in which the result of market fragmentation was not a goal, nor an aim.

"*He who will not economize will have to agonize*" – Confucius; this is as truthful as the efficiency of rules that are made up by various legislators. Economy-wise thinking brings us to the theory of '*economies of scale'*; the increase in efficiency of production, as the number of goods being produced increases. Considering that the MiFID is trying to increase its range and to expand its boundaries, this will in the same time mean that European legislators have to take several risk-factors into account, namely that their markets will not be visited by many investors, as before. This line of competition and fragmentation is according to ordinary economics a simple matter of time, or as some would mention, a 'survival of the fittest'.
The market will be steering the wheel of legislation, instead of the other way around; laws on certain securities will be adjusted on the basis of the wishes of the market.

To keep in front of these – for legislators hazardous – developments, where legislators are set aside, these figures have to maintain their precautious measures when it comes to setting the boundaries and the expected behavior in investment services. Taking risk and other economy-based factors into account, they can merely be added up to the main goals of conducting business properly, honestly and without any comprehensive rules that could perhaps destabilize the provided investment services on the markets.

[22] Guido Ferrarini, E. Wymeersch, Investor protection in Europe: corporate law making, the MiFID and beyond, Oxford University Press, 2006

Looking towards the fragmentation of the markets in Europe, it is doubtable whether partitioning of markets is a negative factor and whether it endangers financial stability.

4.3 Market fragmentation; market quality?

Market fragmentation is a development that is also dedicated to reveal new opportunities on the securities markets. The abolishment of a concentration rule in Europe can have a widespread effect, in which we all can benefit. MiFID also introduced a change in this field, namely because of this development, in which member states had the right to require from investment firms to direct orders from clients through regulated markets. Is this form of 'corporate decentralization' acceptable, fragmentation into different markets harm market quality? High levels of quality of provided services attracts more investors. Various quality factors could be standardized and measured, different trading venues should in that view be compared and evaluated.

In Europe, the diversity of markets is accelerating the movement of investors towards different, cheaper trading venues. Considering this development, the transaction-cost theory[23] has to be taken into account; market prices are just one of the costs that have to be taken into account. This theory that was founded by Ronald Coase, that created a theoretical framework which was aimed at predicting certain economic tasks that would be performed by firms, consequently they would be taken over by the market. This can be aligned with an interest of MiFID; the fragmentation and the quality that is being pursued; predictions about certain investments and used instruments are beneficial for investors. A wider spectrum of possibilities is provided, which is a positive aspect, in case of more locations where trade can be realized.

Taken the growing competition and the single market vision into account; is it obvious to say that we just wish one single investor-friendly, attractive European market?

5. Conclusion and recommendations

The introduction of MiFID and its upcoming review is a development in which Europe is trying to maintain its course to 'simultaneous legislation', when it comes to adjusting the capital markets to potential investors. Along the way, there have been many improvements,

[23] Michael Dietrich, Transaction cost economics and beyond: towards a new economics of the firm,

but the factor remains that legislators constantly need to base these improvements on new developments.
The latest financial crisis that struck Europe and its key financial markets, was a turning point that can be mentioned to have a very empirical effect on further securities regulation law.

Fragmentation of the market in different strongholds that remain competitive amongst each other and across the globe, are a development, which means an adjustment from the legislators that are currently operating the revision of MiFID. The exchange's competitiveness is a factor that is heavily influencing further market fragmentation's development. This is a development that surely doesn't deteriorate competition, since it means an increase of competition for global traders, instead of local traders. Investors are in the same way more interested to deal with parties that have more connections; they admire local entrepreneurship, but respect global activities in which traders present themselves.

The aspect of transparency is expected to be stretched in MiFID II; no trade remains unreported, nevertheless, there is still no central supervisory organ that holds an eye on this detail. In this process, member states are expected to show initiative in becoming competitive amongst each other; resulting in a division, which could lead to a number of superior market places in Europe that could compete with exchanges in the US and Asia.
NYSE Euronext, Deutsche Börse, the London Stock Exchange; a competitive clash between these platforms is the key. The review of MiFID will definitively have an expanding effect on other trading platforms, like MTF's, SI's, as well as *ad hoc* OTC's; these venues will continuously be strengthened and this will result in lower, attractive costs.

The review of MiFID will correspond with Europe's call for unity; as it is expected by many, to become the destination for investors to access its capital markets. A recommendation for the revision of MiFID is to stay on the same path, by reassuring transparency, since this aspect has a greater focus on control of the capital markets; if there is control on the various investment services in different – fragmented – markets, then this would include also a safety measure for (possible) negative market fluctuations.

The unity of Europe does not directly mean a solid, centralized structure; the begin of this development comes with the active role of strong, independent Member States.

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