



# teamwork

## **Giovannini and MiFID - A taste of new European regulation**

*Contributed by a group of industry participants from Europe*

MiFID: Perhaps the most important item of financial markets regulation in the European Union in the last 10 years is now on its way to implementation. MiFID - the Markets in Financial Instruments Directive - was issued at the end of April 2004, just as the European Union (EU) grew from 15 to 25 member-states. MiFID impacts the equities, bonds, derivatives, commodities and money markets, and is an attempt to increase the level of harmonisation of the regulations affecting the delivery of investment services within the EU.

The European financial services industry has not tended to use standards. Implementing industry standards in a single country, like the USA, with one set of national legislation and regulations, is difficult enough. Trying to do the same across many different countries is a task of a totally different dimension. The oldest securities exchanges in the world are in Europe, and yet they have never worked together to produce common standards. In a multi-national, multi-lingual, multi-legislation Europe there is probably a more concentrated need for standards than in any other geography in the world.

Of the 42 countries that make up geographical Europe, the 25 that make up the EU will be directly affected by

MiFID. However, the other European countries are also likely to step-up their own levels of national regulation to become compatible with MiFID, in order to offer markets that are equally attractive to international investors. MiFID is not a "European law", but a Directive to the national governments of all EU member-states that they must implement the necessary national legislation to bring it into force. The target date for implementation is currently 30 April 2006, and the industry is hoping desperately that the European Commission will slide this date backwards. The market cannot yet prepare for MiFID in terms of deploying technological solutions, because there is currently insufficient detail on the eventual rules.

MiFID clarifies some realities that the market has long known. Investors in general do not have access to off-exchange market data to help them to confirm that they are getting the best deal. Trying to get a picture of what is really happening in the market both on-exchange and off-exchange is a mammoth task for any industry participant.

In order for MiFID to achieve its goals, the European Commission and the Committee of European Securities Regulators (CESR) have asked the industry to recommend a common standard that will allow markets to be made more

transparent. A standard is needed that can be used by all investment firms in Europe to publish their pre- and post-trade OTC equity prices in a format that will allow the rest of the industry to have an easily-consolidated view of the market as a whole.

**FIX is now being used more and more widely, not just in the equities sector, but also in fixed income and derivatives, as well as in foreign exchange and market data**

FIX is now being used more and more widely, not just in the equities sector, but also in fixed income and derivatives, as well as in foreign exchange and market data. It starts at the beginning of the STP cycle from the initial Indication of Interest (IOI) and supports Straight Through Processing right through to trade confirmation and allocation. It is used in the exchange environment as well as in the off-exchange environment of ECNs, ATs and other electronic multi-lateral trading facilities (MTFs). It is used by both the buy-side and by the sell-side. FIX is well positioned to be the answer to the market's requirement for a standard protocol to comply with MiFID.

One aspect of MiFID affects all 2,000+ investment firms across the EU. If they trade an exchange-admitted equity off-exchange, they will have to publish the traded price to the market as a whole. Not to the regulator, or to the local stock exchange, but to the market as a whole. A second aspect affects any investment firm that systematically "internalises" a client order for an exchange-admitted equity, i.e. it executes the trade internally rather than forwarding it to a stock exchange for execution. Systematic internalisers will also have to publish their pre-trade bid/ask quotes to the market as a whole.

All of this has potentially enormous consequences for investment firms and service providers alike. Investment firms can publish their information via one or more data vendors or exchanges. The data vendors and exchanges are likely to compete against each other to gather this information, thereby splitting market transparency between them. Investors and traders might need to buy information

from multiple data vendors in order to get an adequate overview of the market as a whole. There is no current industry standard protocol or message format for this kind of data. The complexity involved in complying with MiFID without such a standard would be enormous.

Investment firms will no longer be able to assume that they have achieved "best-execution" for their clients merely by matching or delivering trade execution at the exchange's price. They will need to monitor other trading venues - not just exchanges but ECNs, ATs and electronic trading platforms. And if a different venue can produce a "better" trade for its client, the firm will have to find out how it can get that deal for its client. This could mean that investment firms will have to connect to more trading venues. As each venue classically uses a different trading protocol, this again would add to the complexity and cost of complying with MiFID. The advantages of the industry adopting a standard protocol - such as FIX - are clear.

### **The Giovannini Group report and consultation period**

Another area of legislation that would potentially have a huge impact on the securities industry may result from the consultation process around the Giovannini Group report. The Giovannini Group is an advisor to the European Commission and in 2003 the Group published a report identifying 15 barriers to efficient EU cross-border clearing and settlement. Barrier 1 states that the lack of a common protocol for securities clearing and settlement is acting as a major throttle on the cost-efficiency of the clearing and settlement of securities across the European Union. In summary, the Giovannini Group has asked for the elimination of national differences in the information technology and interfaces used by clearing and settlement providers, through the definition of an EU-wide protocol, with the aim of removing this barrier. The Giovannini Group has tasked SWIFT with ensuring the definition of this protocol, through the Securities Market Practice Group (SMPG). As of 5 January 2005, SWIFT has started a consultation as to how clearing and settlement should be changed in Europe. It has set a deadline of 15 April for responses.

SWIFT's consultation addresses not only the securities sector but also every post-trade activity for every tradable instrument across all asset classes. However, once its consultation is complete and a solution has been proposed,

if this solution suggests that the approach should be to adopt one mandated protocol and one mandated messaging standard in order to increase efficiency, the industry will need time to prepare for this as well.

Over 400 years of cross-border competition has led to each exchange using a different protocol and message format for its trading systems and for its market data feeds, and the same is largely true for settlement through each national central securities depository (CSD). National derivatives and commodities exchanges, having been created more recently, have tended to adopt common standards where they can, while the foreign exchange and money markets are global and have had no central hub that can help to co-ordinate the development and adoption of common standards.

Securities settlement is primarily a domestic business. Most securities trades are executed by firms located in the same country as that in which a security is listed. Domestic CSDs have developed their own protocols and data formats to meet the needs of their own domestic markets. For cross-border securities settlement, which generally requires national CSDs to communicate with each other, if a standard is used it is mainly the non-XML version of ISO 15022 (the XML parts having been spun off into ISO 20022), e.g. by using the ISO 15022 messages carried by the SWIFT FIN service.

Though the ISO 15022 standard is used by CSDs to communicate with each other, they do not generally use it to communicate with their own customers. In fact ISO 15022 needs expanding in terms of its functional coverage to meet the full requirements of CSDs in this regard. Expanding the coverage is included in the work towards ISO 20022 and ultimately this could lead to an increase in usage by exchanges, by investment firms and by data vendors for the delivery of the majority of their post-trade services.

A single protocol for securities clearing and settlement may be the right approach for the securities industry in the EU. One can understand that banks and custodians that have invested heavily in migrating to ISO 15022 would like a future standard protocol to be based on what they use already. The SWIFT consultation allows other industry participants, associations and standards groups to have input into shaping the way that clearing and settlement

efficiency can be improved. FPL and FIX can both play a key role in this process, and by working with SWIFT and other industry groups, can help towards eliminating the Giovannini Group's "Barrier 1".

From an investment firm's pre-trade bid/ask quotes right through to the transfer agent responsible for settling a fund, the European market is expecting major upheaval. One hope is that an outcome of all of the work that changes for both MiFID and the Giovannini report will cause will be a set of standards that the industry can benefit from in the long term. The questions are:

Which standards will be right for the financial services industry and how can different industry groups work together to define the new standards? Which standard will meet the requirements of MiFID in the very near future? Which standard will be best for securities clearing and settlement? And can just one industry standard achieve all of this? The voice of the industry should decide this.

FIX Protocol Ltd is well placed with its experience, membership, vendor-independence, structure and resources to work with the various regulators and other industry bodies to produce appropriate standards. There is still time for all participants in the financial services market to get involved in both the MiFID and SWIFT consultation processes. You will need to speak up if you want the industry to get the standards that it deserves. **FIX**

**More information:**

*The MiFID directive is available on the European Commission's web site at:*

[http://www.europa.int/eurlex/en/archive/2004/l\\_1452004\\_0430en.html](http://www.europa.int/eurlex/en/archive/2004/l_1452004_0430en.html)

*The SWIFT consultation on the Giovannini Group report is available on SWIFT's web site at:*

[http://www.swift.com/index.cfm?item\\_id=43507](http://www.swift.com/index.cfm?item_id=43507)

*CESR's web site can be found at <http://www.cesr-eu.org>*

**Any thoughts on this or other articles?**

Please send any comments, referring to this article as Vol 1 Issue 5 EUR3 direct to Edward at [edward@fixglobal.com](mailto:edward@fixglobal.com)