Post MiFID what next?

The recent (and ongoing) so called Credit Crunch has put the spotlight back on Regulation, Regulators and Risk Management. International regulators must ensure consistency of market rules but it's not easy!

JPSA have taken a step back after the hectic rush toward MiFID implementation in November 2007 and tried to look objectively at the challenges and opportunities in the year ahead.

The regulatory and risk management burden for banks, brokers and fund managers trading in Europe is set to increase this year, as the authorities try to improve their oversight of an increasingly complex business. However, regulators must ensure now more than ever that there is consistency between national and European rules.

The globalisation of the capital markets, characterised by increased cross-border investment, is well-documented but less apparent are the challenges this presents to national and international regulators and the Firms in the various markets.

In Europe, national regulators, such as the UK's FSA, and multinational authorities, such as CESR and the SEC, are increasingly required to work in partnership to ensure consistency between procedures for transacting business within a jurisdiction and between one market and another.

But while they attempt to help market harmonisation, they do not always practice what they preach when it comes to the unification of different regulatory regimes. This has the potential to become a problem this year, with more reforms in the pipeline. Consistency between regulators is sometimes complicated by the different approaches taken by these watchdogs. One of the main tensions is the contrasts between principles-based and rules-based approaches to financial regulation among major financial services centres. Potentially this will inhibit global financial regulatory harmonization which will mean companies that have various branches have issues but also single branch companies for example based in London who access multiple markets also have problems.

The warning bells sounded after the pledge by the FSA to adopt more principles-based regulation this year, a move which many have said is a radical and controversial stand against the trend in financial regulation globally, which is towards rules-based regulation. It goes in the face of the major pressures that affect the financial markets which are consumer protection and political intervention.

The upshot of the various regimes could be that innovative approaches are used in the deployment of technology, and the location of particular business lines and resources. Also financial institutions may use regulatory arbitrage by using principles-based jurisdictions to accelerate implementation of new products or services.

Such regulatory arbitrage would be mitigated, in Europe at least, by a single, centralised EU regulator – a proposal that was discussed last year. For the time being, European finance ministers are working on a comprehensive work programme, which provides for evolution of the existing framework, but in our view the focus will be on practical steps to improve the quality of its output, rather than a leap to more centralised EU arrangements.

Some parts of the market have benefited from the co-operation between different regulators.

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Everyone welcomed the news late last year that the US SEC will consider allowing US companies to use international accounting rules following the regulator's decision that non-US companies could submit accounts using the international standard. The rules eliminate the need for foreign companies to reconcile their financial statements prepared under the International Financial Reporting Standards with the US's Generally Accepted Accounting Principles.

MiFID the trading reforms led by the EC but implemented – or not, as it turned out in some cases – by the local regulator in each of the 30 European countries was generally less well received.

Eleven countries failed to meet the November 1 deadline for passing the trading rules into law in their individual markets, with four countries only partly hitting the target and seven, including Spain, Poland and Portugal, not getting that close.

The Netherlands and Finland left it to the day before to define how the laws would be applied in their domestic markets, despite having originally been set a deadline of January 31 to do so. The regulators have committed to catch up this year but their tardiness is causing confusion for investment companies operating in multiple countries.

These failures by a third of European countries to implement the rules left thousands of firms little time to adjust and make the required system and procedural updates. It is now a critical time for the market, as it has taken the first few steps in the four-year MiFID implementation. On the plus side it allowed banks and brokers to challenge the quasi-monopolies historically enjoyed by European stock exchanges. However implementing MiFID was a great challenge last year for most of the Market and its impact will continue to drip-feed into this year as it is implemented fully across Europe. Everyone is now assessing the full impact of MiFID, particularly looking at new challenges such as liquidity fragmentation.

Recent published research suggests that as many as four in five European banks, brokers and fund managers expect to be questioned over their compliance with MiFID, while two in three of those surveyed think they will be called to task before the end of March.

It is almost inevitable that there will be a MiFID II at some stage, focusing on some of the issues that arose out of the first directive and perhaps adding other asset classes, such as the European debt and derivatives markets. MiFID-related problems have arisen, with brokers complaining about the lack of a centralised list of pan-European stocks, making trading and trade reporting more complex. The emergence of dark pools – alternative trading systems that allow banks, brokers and fund managers to trade anonymously, thereby reducing market impact – is another concern for regulators.

MiFID may have left some of Europe's national regulators wanting but the EC seems to have done rather better with its voluntary Code of Conduct on European clearing and settlement. The code, which came into effect on January 1 with the backing of Europe's top exchanges, clearers and settlement depositories, exemplifies a more flexible approach by European regulators.

Generally the code has been welcomed as clearing and settlement will come into regulatory focus this year, with the London Stock Exchange moving into these services after its acquisition of Borsa Italiana and DTCC, the dominant US clearer, set to come to Europe with its Euro CCP concept.

New regulations – including Solvency II; capital adequacy rules in the insurance sector; Ucits, which determine the practices of collective investment schemes; as well as more MiFID – are being lined up for this year, but market participants are quick to warn the regulators against overreacting to market crises.

It is unclear how global and EU public authorities will decide to respond in the longer term to recent market developments, although the markets like the fact they have tended to refrain from any knee-jerk regulatory response.

The regulatory burden on companies trading in Europe looks set to increase again this year but, unusually, London-based investment banks seem broadly pleased with the scale and tone of regulation in Europe, citing the famous principles-based approach of the FSA as a factor in this success. However, they are quick to warn the regulators against complacency.

In an industry that thrives on innovation, it is the responsibility of regulators to ensure they are matching the pace of change set by the banks and honouring their commitment to protect investors without hampering companies' ability to make money.

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