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MiFID implementation in the Baltic States

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MiFID (in full the "Markets in Financial Instruments Directive") was introduced as a cornerstone measure to Financial Services Action Plan, proposed in 1999 as a list of measures to ensure integration of the EU financial markets.

The *raison d'etre* for the existence of MiFID is the willingness of the EU to change the level playing field in securities trading and thereby increase competition and efficiency in the EU financial markets. First, MiFID means to ensure that the EU-wide single passport is indeed a single passport instead of being an instrument, which makes the investment services providers to answer to several regulators at a time. Second, MiFID attempts to introduce competition between investment firms, incumbent stock exchanges and other trading venues – naming three trading venues – regulated markets, Multilateral Trading Facilities (MTFs) and systematic internalisers. Third, MiFID attempts to ensure more investor protection by requesting "best execution" and provision of more detailed information to the clients, as well as classifying the clients according to their status as retail clients, professional clients and eligible counterparties. The requirement for more investor protection is complemented by requirement for more transparency in publishing pre-trade and post-trade information, which is of course needed to be monitored if the investor protection principles and the competition is indeed in place. Increased transparency in pre- and post-trade information should also prevent fragmentation of liquidity in different trading places, such as internalisers, OTC trades or the stock exchanges.

The introduction of MiFID created an uprising in the EU financial markets, most of voices naturally coming from London given the relatively high market activity there. During the review of the MiFID's draft, some of the largest players came up with joint initiatives in order to benefit from the implementation of MiFID, such as project Boat aggregating trade and market data, project Turquoise attempting to be an exchange competing with the incumbent European exchanges, and Equidict offering reporting service with "best execution". At the same time, it remains to be seen what

overall impact the implementation of MiFID at the end of November 2007 will have on less liquid and concentrated parts of EU financial market, which include also the Baltic countries.

While, as shown further in this article, the banks and investment firms have certainly faced some of the challenges presented by MiFID, that could not be said about the potential competition to the incumbent exchanges. Historically, the consolidation of the trading platforms in the Nordic and Baltic region led to a situation where OMX controlled stock exchanges of Stockholm, Helsinki, Copenhagen and Iceland and three Baltic countries, as well as the securities depositaries (the providers of clearing and settlement services) of the three Baltic countries. Recently OMX group was acquired by NASDAQ, the alternative to the New York Stock Exchange, and is now a part of NASDAQ OMX Group, Inc. Thus, the incumbent exchanges are now part of a global group while any talks about competing trading venues, which after implementation of MiFID sound more realistic, have remained on theoretical level, to a large extent of course due to the overall slowdown in securities trading. Thus, what concerns the Baltic countries, for now it could be stated that the implementation of MiFID has mostly affected the daily activities of the banks and investment firms, not so much the incumbent securities trading venues. That brings us back to practicalities of the implementation of MiFID.

It is more than a half-year since the MiFID provisions were implemented into the Baltic States respective statutory legislation. In Latvia, additional sections were added to the Financial Instruments Market Law, implementing MiFID almost in compliance with the implementation deadline. In Estonia, major rewriting of the Securities Market Act was undertaken and the amendments took effect as of 19 November 2007. In addition to that several decrees of the Minister of Finance were adopted as of the same date in order to implement MiFID in necessary detail. And in Lithuania MiFID was implemented by passing the Law on Markets in Financial Instruments, which together with the Law on Securities amended previously effective the Law on Securities Markets. The Law on Markets in Financial Instruments took effect as of 8 February 2008, however, provisions of the said law setting forth new requirements upon persons providing investment services and/or regulated markets and their operators that had not been provided for in the previously effective Law on Securities Market came into force only on 1 November 2007. In addition to that several decisions of the Securities Commission, the Financial Supervisory Authority, were adopted in order to implement MiFID. The MiFID implementation process for the banks and investment firms was quite complicated and there are still some unsolved problems on how to apply some particular MiFID provisions.

For example, according to Article 20 of Directive 2006/73/EC (the Level 2 directive), Member States must require investment firms to ensure that their external auditors report at least annually to the competent authority of the home Member State of the firm, on the adequacy of the firm's arrangements regarding safeguarding of the client financial instruments and funds.

The main problem of this provision is that external auditors of the banks and the investment firms do not know how to evaluate those arrangements in safeguarding the client assets. The MiFID provisions and the national laws do not stipulate requirements which procedures have to be carried out by external auditors in this respect and what exactly their reports must contain. Currently banks and investment firms are seeking for explanation from the local financial supervisors on how to apply this provision. In Estonia the Financial Supervision Authority has already responded, but only in very general terms, suggesting that procedures to be applied by external auditors have to comply with standards and best practices of their profession.

Currently the Baltic banking industry has also raised several questions on how to comply with the MiFID provisions in relation to the assessment of suitability and appropriateness of investment services to their respective clients. According to the MiFID provisions, investment firms, before providing investment services, are obliged to assess whether the particular product or service is suitable and appropriate to the client. If the investment firm considers that the product or service is not appropriate, the investment firm must warn the client. Neither the MiFID provisions nor the national laws prescribe whether the investment firm may provide investment service to the client, if during the assessment process investment firm has come to conclusion that particular service is not appropriate and has warned the client, but client still wants to receive the particular service. Taking into account that the investment firms are only obliged to warn the client that particular service is not appropriate, it should be deemed that inappropriate service may be provided to the client. However, there is the question whether and how the investment firms would and must record the client's consent to receive inappropriate service.

Investment firms in the Baltic States are also facing the problem of how to comply with the MiFID provisions regarding the best execution requirements. According to MiFID, investment firms must take all reasonable steps to obtain, when executing orders, the best possible result for their clients taking into account price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order. Investment firms pursuant to the client request must prove to the client that their order was executed in accordance with the firm's best execution policy. To certain extent it is exuberantly onerous for the investment firms to comply with such MiFID requirements, if the investment firms are only acting in the small markets, as such are the Baltic States. Therefore, investment firms should also have access to more extensive markets to fully comply with the best execution requirements. Discussions regarding this problem are also ongoing in the other EU Member States.

The definition of prohibited inducements or so-called soft commissions in the Level 2 directive seems to puzzle investment firms in Estonia. Investment firms feel the definition is too wide and have therefore proposed the Financial Supervision Authority to enact a sample list of such situations. No such list has been composed to date but the Financial Supervision Authority has responded that it will consider

adopting an open list of sample situations and until adoption of such list it is ready to consult investment firms on a case by case basis.

Other issues raised by market participants concern, *inter alia*, classification of certain financial instruments (e.g. investment deposits) as complex or non-complex financial instruments, the form in which the investment firms need to keep records of certain client matters, the extent of such records (e.g. in Estonia the investment firms are obliged to record telephone conversations and electronic communications involving client orders in addition to other data required to be recorded under MiFID).

All in all, it seems that the sentiment of market participants in the Baltic countries is positive rather than negative towards the new rules established by MiFID. MiFID helps to clarify the duties of market participants towards their clients and should therefore help to avoid disputes between the service providers and their clients, even more so in turbulent times as the financial markets are currently facing. However, MiFID and its national implementation rules regulate many key aspects of provision of financial services in relatively general terms and many aspects are left for the self-regulation of market participants. It appears that market participants have opted for different solutions and there is no true confidence whether all these can be considered in line with MiFID requirements or some will fail the test. In several cases market participants have asked local financial supervisors to issue more detailed guidance or even unified rules on certain issues (e.g. best execution, appropriateness and suitability test) but the supervisors seem reluctant to meet such requests for the obvious reason of not wanting to limit the applicability of MiFID's principles. Such "flexibility", however, means inevitably higher risk of liability for market participants in case the solutions implemented by them should prove flawed.