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Regulatory challenges to the Financial Markets - MiFID and consequences for Foreign Exchange

Over the last decade the financial markets industry has experienced tremendous changes and requirements by regulators, authorities and politicians. MiFID (Markets in Financial Instruments Directives) is currently one of the latest approaches by the European Commission to create a single capital market for the European Financial Markets and will go live November 2007.

On my flight back from Amman to Europe (attending the ICA congress) I summarized to myself a few thoughts on MiFID which still remains a "mystery" to some in the FX markets. MiFID will replace the 1992 Investment Services Directive and the one-off costs for the implementation range between ? 4 Mio to ? 20 million per bank. As is well known the core elements of MiFID are best execution of trades, transparency of trades, client classification amongst others. So what impact will it have on the Foreign Exchange Markets? Although MiFID is supposed to be focused mainly on retail, the reality is that best execution rules apply to most capital market and derivative products and some FX (e.g. options, non-commercial forwards and the FX elements of structured products).

MiFID will not affect the FX-Spot market/trading directly. But best execution in MiFID does mean transparency in terms of getting the best overall deal for the client, to achieve the optimal result for the client portfolio. Consequently, Investment firms will have to make best use of the FX markets. They will have to find the best deals for their clients in terms of price, but also of costs of execution. In other words, investors need to keep a closer eye, how their trades are executed. The difficulty might arise, as most FX business is not Exchange traded. FX is the largest unregulated market in the world. Prices are changing every second – there is not a single price at any time. Thus there always exists different prices from different providers. But how do you measure those prices as a best price? As it might not be possible to value best price in the OTC-market this area will further stay as a "grey-zone" in future.

Beside best price other factors are determining best execution: e.g. third-party fees, market access, sizes of volume, credit-policy, potential cost of trade failures, and so on which will all have an influence on the overall costs. As there are no clear definitions of best execution in our FX markets there will be room for interpretation.

Nevertheless, could these new requirements lead to a Foreign Exchange "Exchange" in the nearer or far future? We all know the power of Electronic trading platforms. The volume of transactions increased steadily and reached already more of 50%. They add liquidity and transparency into the markets. This will be increased further. The younger trader generation grows up with eTrading and Exchanges. Unfortunately the direct contract amongst traders is becoming de-emphasised. When summarizing all those factors and although I am in favour of open and unregulated markets I personally do feel that in the long run the direct business between banks will shrink in some FX segments and business will move to third-party or exchange traded execution.