Katten
Katten Muchin Rosenman Cornish LLP

Client Briefing

MiFID Demystified: An Introduction to the EU Markets in Financial Instruments Directive (MiFID)

October 2007

By Edward Black, Special Counsel, Katten Muchin Rosenman Cornish LLP
This article appeared in the August/September edition of the MFA Reporter.

Much has been written and heard about MiFID, but its specific impact appears to be something of a mystery to those in the US and other so-called "Third Countries" which are outside MiFID's direct ambit. MiFID is certainly the most significant piece of financial services legislation that the EU has enacted and one which will directly affect every investment firm which is regulated in any EU member state. MiFID is also a process, not an event. Although some of its provisions require systems changes to be in place by November 1, 2007, MiFID is not like Y2K. Its effects will begin to be felt on its November 1 implementation date, and it will continue to impact all investment business within its scope carried on by EU regulated investment businesses thereafter.

Various US firms, such as hedge funds, Commodity Trading Advisors ("CTAs") and other Third Country Firms doing business with EU regulated entities may be impacted in matters related to best execution, management of conflicts, new customer categorization rules, transaction reporting and suitability.

This article presents an overview of what MiFID is and does – both with respect to the EU regulated firms that it affects directly and US and other non-EU investment managers and marketers that it affects indirectly.

1. What is MiFID?

MiFID is the EU Markets in Financial Instruments Directive (2004/39/EC). It seeks to go much further than the EU's first attempt at a single market in financial services directive, the 1992 Investment Services Directive, which was implemented in 1996. MiFID aims to create a true single market in financial services across the 27 EU and 3 EEA member states which are collectively referred to as the "**EU**" in this article. (The full list of the 30 affected countries is set out in the box below).

EU: Austria, Belgium, Bulgaria, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden, and United Kingdom. **EEA:** Iceland, Norway and Liechtenstein.
Note: Switzerland is not included, nor are Guernsey or Jersey (the Channel Islands), Russia and the rest of the former USSR; along with the US and all other countries from Australia to Zambia, they are considered "**Third Countries**."

MiFID implementation will require every EU regulator to make changes in its financial services regulations which apply to investment business within MiFID's scope. This will have direct consequences for entities regulated by those regulators and indirect consequences for US and other Third Country Firms doing business with EU customers and counterparties but not directly subject to EU regulation.

MiFID sets out a framework of key regulations which will be implemented into the domestic law of each EU member state. This is intended to harmonize the key regulatory requirements applicable to financial services businesses across the EU for investment business within MiFID's "scope".

2. How will MiFID Impact Non-EU Firms?

US and other Third Country Firms carrying on MiFID scope business subject to regulation in any EU member state will be subject to the same new rules as EU-incorporated entities. This is so even though they do not benefit from the passport and will be required to obtain separate authorization from each EU member state in which they intend to carry on business.

MiFID implementation is likely to further narrow the scope for carrying on cross-border business into the EU from Third Countries without being regulated in an EU member state – a process which began when the Investment Services Directive was introduced in 1996. MiFID does not require EU jurisdictions to pass regulations which affect managers, advisers and marketers who do not have offices in any EU jurisdiction. However, increasingly, exemptions which permitted limited marketing and other activity by entities unlicensed in any EU jurisdiction are being eliminated. The UK's "overseas person" exemption which permits Third Country Firms without a UK place of business to carry on certain transactions and activities with UK institutional customers is not paralleled in many other EU jurisdictions. Even the UK permits very limited business to be done with retail clients by Third Country Firms which are not regulated in the EU. Increasingly the use of a locally regulated firm is being required in EU member states in order to do business with local residents – as has long been the case in the US.

US and other Third Country Firms doing business with EU regulated entities will also see the impact of the areas summarized in section 6 below: best execution; management of conflicts; new customer categorization rules; transaction reporting and suitability. For example, EU-based counterparties doing business with US firms may seek enhanced rights and protections to mirror new EU norms.

3. What is the Scope of MiFID

Any of the activities below carried out in relation to any of the investments listed below is within MiFID's scope:
Activities: (a) Reception and transmission of orders; (b) Execution of orders on behalf of clients: (c) Dealing on own account; (d) Portfolio management; (e) Underwriting; (f) Investment advice; and (g) Placing of financial instruments.
Investments: (a) Transferable securities; (b) Interests in collective investment products (funds); (c) Money market instruments; (d) Financial futures; (e) Interest rate, currency and equity swaps; (f) Commodity derivatives; and (g) Options on the investments listed above.

All investment business within MiFID's scope carried on by entities located in the EU will be subject to the newly harmonized rulebooks of regulators across the EU. Entities carrying on "MiFID scope" business will also benefit from the so-called "passport." Portfolio management and investment advice are within MiFID's scope and UK and other EU hedge fund managers will be "investment firms" covered by the new MiFID rules. Marketing and distribution of fund products are only within MiFID's scope if the marketer also accepts and transmits orders.

As a general rule, a MiFID scope firm will be subject to the regulatory capital requirements of the EU capital requirements regime set out in the Capital Requirements Directive ("CRD") which came into force on January 1, 2007. This means that advisers and commodity firms coming within MiFID's scope for the first time will see increases in their capital requirements.

4. What is the MiFID Passport?

The MiFID passport will enable any entity incorporated and regulated in one EU jurisdiction (including EU regulated investment managers and advisers, and marketers which receive and transmit orders) to provide services within MiFID's scope from its "home state" across EU borders to customers located in other EU jurisdictions ("host states") without being subject to regulatory oversight by host state regulators. Establishing branches in other member states for MiFID business is also streamlined. Business carried on from host state branches will be subject to host state regulations governing conduct of business, but permission to establish a branch is essentially automatic and host state regulators cannot impose additional capital or systems requirements. Conduct of business regulations which apply to branches must be the same as those which apply to firms established in the host state. Host state regulators cannot impose additional requirements on branches.

Investment advice and MiFID regulated activities involving commodity derivatives are passportable for the first time. The passport is only available to entities which are incorporated in EU member states. EU branches of Third Country firms cannot acquire this EU passport.

5. How is MiFID Being Implemented?

MiFID is effectively shorthand for a collection of measures which EU member states are required to implement through their own laws, regulations and rules. This begins with the provisions contained in the so-called "Level 1 Directive" (2004/39/EC) cited on the first line of section 1 above and continues with the more detailed provisions contained in a second "Level 2 Directive" (2006/73/EC) passed by the European Commission. The Commission has also passed a "Level 2 Regulation" (EC/1287/2006) which contains other more detailed provisions which are made directly applicable in member states without needing to be implemented into national law. In the UK, both statutory instruments enacted by the government and rules issued by the investment business regulator, the Financial Services Authority (the "FSA"), have been necessary to achieve MiFID implementation.

The EU Commission's intention was that each member state would publish its implementing laws and regulations by January 31, 2007. This would have given investment businesses a nine month period to put in place the changes necessitated by the new regulatory framework before November 1, 2007 when the new provisions would become law across the EU. Of the leading investment business centres, only the UK met the January date. Final rules are still awaited from such countries as France, Germany, Italy, the Netherlands and Spain. At this stage it is not clear how many member states will have rules in place even by November 1 nor what the exact consequences will be if not all have the required legislation and regulations in place.

6. What are the Significant Areas of Change?

Some of the requirements of the new MiFID regime are familiar to UK fund managers. However, in some key areas, including the five addressed below, MiFID goes much further than the current rules:

Conflicts of interest. Many managers currently use disclosure of potential conflicts of interest as a means of managing them. (This has been the traditional approach used in the US by CTAs.) A key MiFID change is that disclosure can only be used as a last resort. From November 1, managers must take all reasonable steps to identify conflicts of interests likely to adversely affect clients' interests and to prevent them arising. Additional MiFID requirements include establishing and maintaining a written conflicts of interest policy which must be made available to clients upon request.

Best Execution. Under MiFID, firms are required to take all reasonable steps to obtain the best possible result when executing client orders. There is only a limited exception for business which is classified as "execution only." In the UK it has been possible (and customary) for clients other than retail clients to opt out of best execution. From November 1, this will no longer be permitted. Under MiFID, best execution will require firms to take into account not just price but also costs, speed, likelihood of execution and settlement and the size and nature of the transaction. As with conflicts of interest, a documented best execution policy is required. Hedge fund managers will both owe a duty of best execution to their clients and be owed best execution by their brokers.

Transaction reporting. Under the current FSA rules, most managers do not have to make transaction reports. From November 1, all investment firms who execute transactions in any financial instruments listed on an EU regulated exchange (and in related derivatives) will generally be required to make transaction reports to the FSA concerning transactions in such instruments. This will apply regardless of the execution venue. Managers will need to review their arrangements with their brokers to ensure that brokers can and will make the required reports on their behalf.

Client categorization. MiFID introduces a new system of client categorization. The FSA currently has a three-tier client classification system, which determines what conduct of business rules will apply: private, intermediate and market counterparty. The MiFID system, while also three-tier, uses different terminology and new rules for determining categorization. The new categories, retail, professional and eligible counterparty, do not map across to the old ones. Clients which are funds will almost always be the middle category, professional clients, but care needs to be taken over individual managed accounts. It will be very much more difficult than previously to opt up clients who are individuals from retail to the middle category.

Suitability. MiFID introduces new suitability requirements which apply to investment management and advice provided to professional as well as retail clients. A suitability determination based on: (1) investment objectives, (2) financial situation and (3) knowledge and experience is required. Factors 2 and 3 can be assumed for professional clients other than those opted up from retail; for other clients a determination based on all three factors is required.

The impact on marketers will be less than on managers. Key areas will be certain restrictions on marketing which will result from changes in client classification rules and appropriateness rules covering some of the ground of the suitability rules referred to above which will affect distributors marketing to customers who become their clients.

What Must be Done Next?

The impact of the post-MiFID changes will be significant for every EU regulated firm. Third Country Firms doing business in the EU will need to assess whether changes to individual country's rules will affect them and in particular in relation to those of the 30 countries which have not previously had a sophisticated investment business regulatory regime. Each firm will need to review that impact at a senior management level with its professional advisers and to establish a project plan in order to ensure compliance by the November 1, 2007 deadline.

Edward Black is Special Counsel Katten Muchin Rosenman Cornish LLP in London. Admitted in England and New York, he has practiced in both jurisdictions. His specialist experience includes acting for funds, investment managers and advisers, broker-dealers, investment banks and institutional investors in connection with funds, derivatives, securities, financial services and markets and their regulation. Edward can be reached at edward.black@kattenlaw.co.uk and +44 207 776 7624.

Katten

KattenMuchinRosenmanCornish LLP

www.kattenlaw.co.uk

1-3 Frederick's Place • Old Jewry • London EC2R 8AE
+44 (0) 20 7776 7620 tel • +44 (0) 20 7776 7621 fax

10/11/2007