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Client Briefing

The EU Markets in Financial Instruments Directive (MiFID)

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What Is MiFID?

The EU Markets in Financial Instruments Directive (2004/39/EC) (“**MiFID**”) is the most significant piece of financial services legislation that the European Union has enacted to date. It does not simply supersede the Investment Services Directive, the EU’s first attempt at a single market in a financial services Directive, which was passed in 1992 and implemented in 1996. It seeks to go much further by aiming to create a true single market in financial services across all 27 EU* member states and the European Economic Area (the “**EEA**”) member states of Iceland, Norway and Lichtenstein (collectively “**EU**”).

This will be achieved by harmonizing the regulatory requirements applicable to financial services businesses across the EU. MiFID extends the range of services which are "passportable" activities and both streamlines the process of obtaining a cross-border business “passport” and rationalizes various issues involved in the supervision of passported firms as detailed below. It also sets out a framework of basic regulations which will be implemented into the domestic law of each EU member state. The deadline for the publication of these implementing laws by the member states was 31 January 2007. Only the UK, Bulgaria and Romania met this date. Nonetheless the MiFID framework is due to become law across the EU with effect from 1 November 2007. At this stage it is not clear how many member states will meet that deadline nor what the exact consequences will be if not all have the required legislation and regulations in place.

How Is It Implemented?

MiFID is being implemented in the UK both by a European directive, which is directly applicable in the UK and other member states and also by UK Treasury and FSA rules published in January 2007. For FSA regulated firms the Treasury material is of secondary importance to the new FSA rules.

What Are the Significant Impact Areas?

- **Reporting requirements** – electronic transaction reporting is required to ensure that FSA has available extensive data in respect of transactions undertaken. Reporting and order management systems must be approved by FSA and are to be continuously monitored. The FSA is, in turn, obliged to make transaction data available to other European regulators.

- **Systematic Internalisers** (“**SIs**”) – firms which, on an organized, frequent and systematic basis, deal on their own account, by executing client orders outside a regulated market or multilateral trading facility (“**MTF**”) are subject to a number of new requirements. These include pre-trade and post-trade transparency obligations. The pre-trade obligation is to provide firm quotes in liquid shares. Those quotes, subject to certain conditions, are binding for trades up to certain thresholds. This means that an SI must, before crossing customer orders internally, publish the relevant quote to the wider market and allow interested parties an opportunity to respond. This pre-trade process must operate continuously throughout the day. The post-trade obligations require SIs to meet the same price transparency requirements to which regulated markets are subject. They will be required to publish specific information about completed transactions in close to real-time in accordance with detailed rules.

- **Best Execution** – firms must establish a best execution policy and best execution procedures (“**Best Execution**”). Best Execution will be obligatory for all customers – a significant change from the current situation where all but private customers may opt out of Best Execution. The new Best Execution standard will take account of a variety of

* Austria, Belgium, Bulgaria, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, The Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden and the United Kingdom.

factors, not just price. These will include speed of execution, transaction costs, likelihood of execution and the size and nature of the transaction. Senior managers will have an ongoing responsibility to continuously review the firm's Best Execution policy and procedures.

- **Client Classification** – the current client classification system of private client, intermediate customer and market counterparty will be replaced by a subtly different three tier classification regime: "retail clients", "professional clients" and "eligible counterparties". It will be harder for firms to "opt up" private customers to the professional client category: Professional clients will need to meet two of the following three tests:

  (a) a balance sheet of at least EUR20 million;

  (b) at least EUR40 million net turnover; or

  (c) at least EUR2 million of own funds.

  For a private client to be opted up to professional client the firm must make an adequate assessment of his expertise, experience and knowledge and he must meet at least two of the following requirements:

  (a) a financial instrument portfolio of EUR500,000;

  (b) an average of at least 10 transactions per quarter of a significant size, on the relevant market over the previous 4 quarters; or

  (c) employment in a senior position in a financial services firm.

- **Communications with Clients** – marketing information and other client communications must all be fair, clear and not misleading. (This is the standard which the FSA currently applies to financial promotions; it will apply under MiFID to all client communications)

- **Obligation to Act** – MiFID introduces a duty to act honestly, fairly and professionally and in the best interest of all clients. This is similar to the FSA's Principles 1 and 2, so should not represent any added obligation to FSA regulated firms.

- **Suitability and Appropriateness** – investment advisors and managers will be required to collect relevant information on their customers. Firms must assess the suitability and appropriateness of all products offered to retail clients. Information must therefore be obtained as to the customers' knowledge and experience, investment objectives and financial position, relevant to each specific type of product or service offered so as to enable the recommendation of a "suitable" service or investment. For investment services where no advice is given, the standard is whether the service or investment envisaged is "appropriate" for the client. In both cases, firms can exclude professional investors from the suitability assessment process but if professionals are not excluded the same duty is owed to them. Suitability does not apply to execution only business in shares traded on regulated markets, UCITS funds and other non-complex instruments or where the investment is undertaken on the client's initiative.

- **Systems and Controls** – similar in general terms to existing FSA requirements but some differences in the detail. Of particular interest are the requirements to have independent and effective compliance, risk management and internal audit functions, formal risk management policies and certain specific recordkeeping requirements.

- **Conflicts of Interest Policy** – firms must have effective systems and controls to prevent conflicts adversely affecting clients' interests. Conflicts can be dealt with by disclosure or information ("Chinese") walls.

- **Outsourcing** – specific considerations must be evaluated when deciding to outsource "important operational functions" (e.g., accounting; back office; IT and information system management; marketing; research; compliance and internal audit and risk control). There must be no undue additional operational risk, no reduction in quality of internal controls and no adverse affect on ability to monitor compliance. Firms must retain the necessary in house expertise to enable them to appropriately supervise the third party provider and to manage any associated risks. All firms with outsourced functions are required to have an exit strategy and to provide details of the outsourced functions to the FSA.

- **Investment Advice** – provision of personal recommendations to a client now within the Directive so passportable and subject to more stringent regulatory framework.

What About Changes to Senior Management Responsibility?

MiFID contains an over-arching responsibility on behalf of senior managers to ensure MiFID is fully complied with. This creates a positive duty on the part of senior managers to continuously monitor (and be aware of) the extent to which the firm is complying with its compliance obligations. How these obligations will interact with the FSA's controlled function regime remains to be seen. When the MiFID changes are looked at together with the FSA's move to More Principle-Based Regulation, it is clear that the ability of senior executives to delegate their corporate governance and regulatory compliance responsibilities is much more limited than previously.

What Must Be Done Next?

Senior managers of regulated firms must evaluate their business to assess which parts are impacted by MiFID. To take advantage of the opportunities MiFID presents, senior managers need to: fully understand the significance of MiFID's impact on their business; address any strategic implications that are identified; organise the implementation of those MiFID requirements which are applicable to their business; and review existing systems and controls to ensure that senior managers can fulfill their obligations both under the FSA's post-MiFID handbook.

The impact of the post-MiFID changes will be significant for every regulated firm. Each firm must 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 2007 deadline.

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