

The Association of Corporate Treasurers

# **Briefing note:**

MiFID (Market in Financial Instruments Directive) for Corporate Treasurers

TREASURY, RISK  
AND FINANCE  
PROFESSIONALS

**ACT**

Prepared with assistance from

**SLAUGHTER AND MAY**

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## **The Association of Corporate Treasurers**

The ACT is the international body for finance professionals working in treasury, risk and corporate finance. Through the ACT we come together as practitioners, technical experts and educators in a range of disciplines that underpin the financial security and prosperity of an organisation.

The ACT defines and promotes best practice in treasury and makes representations to government, regulators and standard setters.

We are also the world's leading examining body for treasury, providing benchmark qualifications and continuing development through education, training, conferences, and publications, including *The Treasurer* magazine.

Our 3,500 members work widely in companies of all sizes through industry, commerce and professional service firms.

For further information visit **[www.treasurers.org](http://www.treasurers.org)**

Guidelines about our approach to policy and technical matters are available at **<http://www.treasurers.org/technical/resources/manifestosept2006.pdf>**

This briefing note was drafted by Slaughter & May and the ACT's Policy and Technical Department (e-mail: **[technical@treasurers.org](mailto:technical@treasurers.org)**) and commented on by members of the Policy and Technical Committee and others to all of whom thanks are due.

*This guide is written in general terms and its application to specific situations will depend on the particular circumstances involved. In addition this guide does not attempt to include all points arising from MiFID. Readers should therefore take professional advice. This guide should not be relied upon as a substitute for this advice. Although the ACT and Slaughter and May have taken all reasonable care in the preparation of this guide, no responsibility is accepted by the ACT or Slaughter and May for any loss, however caused, occasioned to any person by reliance on it.*

ACT  
51 Moorgate  
London EC2R 6BH, UK  
Telephone: +44 (0)20 7847 2540  
Fax: +44 (0)20 7374 8744  
Website: **[www.treasurers.org](http://www.treasurers.org)**

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## The Markets in Financial Instruments Directive and the Single European Market in Investment Services

### Introduction

The Markets in Financial Instruments Directive, or MiFID<sup>1</sup>, is one of the centrepiece legislative measures in the European Union's Financial Services Action Plan (FSAP). It is effective in the UK from 1 November 2007 (which is also the deadline for all 30 EEA Member States<sup>2</sup>; the deadline will not be met in most cases).

The implementation of MiFID will have an impact on the securities markets and investment firms of all member states. The measures in the Directive are primarily targeted at regulated firms operating in the financial markets, but MiFID nonetheless will have an impact on corporates who are active in the markets as customers of regulated firms. Treasurers therefore do not need to be experts on MiFID but they do need to be aware of the implications for their companies. This Guidance Note explains the specific practical changes that will affect corporates. Additionally it goes into the technical details of MiFID as useful background for the Treasurer, in-house lawyer, or company secretary.

### How to use this note

**For the quick guide on the essentials for treasurers read the executive summary**

**To understand the key concepts in a little more detail concentrate on:**

- Will corporate treasuries be regulated under MiFID? on page 12
- Client status and categorisation section on page 17
- Best execution section on page 21
- Appropriateness and suitability section on page 22

**To understand the whole picture** – some of the subtleties, the legal background and so on:

- Read the document as a whole, including all Appendices.

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<sup>1</sup> Directive 2004/39/EC.

<sup>2</sup> The European Economic Area or EEA is constituted by all 27 EU Member States along with Norway, Iceland and Liechtenstein, which are members of the separate European Free Trade Association, or EFTA. By operation of the EEA Agreement formed between the EU and the EFTA States and in force since 1994, most legislative measures passed by the EU are now automatically adopted by these 3 EFTA States.

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## Executive Summary of MiFID implications for treasurers

MiFID is intended to establish a high level of core business standards across firms who provide investment services or trading in securities and financial instruments in Europe. This is to encourage uniform standards and hence ease of competition across borders. Through regulation of financial firms customers will benefit from a number of protections and the assurance that they are being dealt with in an even-handed way.

The requirements of MiFID are primarily targeted to make sure that retail customers are suitably protected. Corporate treasury operations will for the most part want to be treated as professional customers, in which case slightly relaxed standards of protection will apply but there will be fewer hindrances on doing business quickly and cost effectively and without excessive administrative burdens.

MiFID will come into force in the UK from 1 November 2007 and in theory in the rest of Europe too. However most countries are running well behind the official timetable for implementation.

### What sorts of transactions are included within MiFID rules?

The financial instruments to which MiFID will apply include transferable securities, money market instruments, money market funds, options, futures, swaps, forward rate agreements and all manner of derivatives, although certain commodity derivatives if they can be physically settled and are for commercial purposes are excluded. (For full details see Appendix 1.) Commodity and FX spot deals are excluded as are forward FX deals done for commercial purposes. If a FX forward deal is associated with an investment service such as the acquisition of some foreign currency shares it is within MiFID.

MiFID takes in investment services and activities such as portfolio management, investment advice and importantly the execution of orders on behalf of clients. (For full details see Appendix 1.)

### How will your treasury operations be affected?

**Client categorisation.** The requirements of MiFID fall on the regulated financial firms which we shall for convenience call banks. This means that the way in which your banks deal with you will change, but exactly how they will change will depend on whether you are categorised as a retail client, professional client or eligible counterparty (a sub-category of professional client). At the retail end you would have the full set of protections which reduce if you move to the professional and then eligible counterparty categories. We expect that treasurers will want to be in one of the two less protected categories since they are well able to protect their own interests and at these higher levels the administration and bureaucracy are reduced.

How the banks categorise you will depend on certain size criteria (on a stand alone rather than group basis) although for existing customers there will be an automatic transition from the existing private customer category into retail, from intermediate into professional and from market counterparty into professional too.

Customers are able to opt up and down categories, and indeed can opt to have different categories for different group companies, between different banks and even applicable to different instruments, although this latter flexibility may not be offered in practice.

**Best Execution:** The banks will have responsibility to ensure best execution of client orders. This concept includes placing the order through the market that might be expected to give the

best price, speed of execution, certainty of successful settlement or the like. The duty of best execution does not apply to eligible counterparties.

If a bank is not acting “on behalf of” a client then best execution does not apply. This means that many OTC transactions or dealer markets where there is no reliance on the bank to go and find a deal, will not be subject to best execution. For this reason most routine treasury dealing can be expected to be exempt from best execution.

**Appropriateness and Suitability:** These are two key elements of client protection.

- The appropriateness requirement means that the bank must assess your knowledge and experience of the relevant investment field – this is assumed for professional clients and is not required for eligible counterparties
- Suitability goes further and means that the bank must also make sure that the product or service is suitable for you given your particular financial position and investment objectives. Suitability applies for all clients but comes into play only for investment advice or portfolio management, so in such cases you might expect your bank to be seeking extra information from you. However if the bank is giving you a good service to start with it will probably already be gathering sufficient information in order to do its job properly so that in practice there will be no extra burden. In the case of investment advice, the bank may assume that a professional client (other than one who has opted up to professional status) is able to bear any financial risk.

### **Will your treasury operations themselves become regulated?**

Fortunately for most treasury departments you will not be directly regulated. If you are currently unregulated under the Regulated Activities Order (RAO) you will be able to continue unregulated. In MiFID there is an exemption for those who are regularly dealing for their own account as long as it is ancillary to their main business considered on a group basis.

Provision of services intra-group should not cause a problem since these can be performed without regulation if provided to group companies using the accounting definition of group found in the Companies Act (50% holding or dominant influence). However this will mean that if performing investment services or activities for joint ventures or external parties you may need to become regulated under MiFID.

### **What can you expect to happen next?**

In the run up to 1 November 2007 existing clients of banks will find that they are being notified of their automatic transition to a MiFID client categorisation and are being given details of the main differences between the categories and consequent implications. You may then wish to consider if that is the right level or whether you want to opt up or down.

Banks will have to provide you with details of their arrangements and a summary of their policy for achieving best execution (where required) and to receive your agreement to those arrangements. You will also be notified of the bank’s costs and fees, arrangements for handling client assets, policies on conflicts of interest and various risk warnings. These will need to be acknowledged as received and understood.

Depending on the sorts of activity you have been doing with your banks, or perhaps are thinking about doing, the banks will want to perform some due diligence around your circumstances so that they can comply with their suitability and appropriateness obligations.

These sorts of enquiries and provision of information will end up being replicated to each of your subsidiaries that are likely to be dealing or using an investment service, not forgetting your pension schemes too. If you are establishing a new special purpose financing company it will not have any track record and if not of sufficient size may end up being treated as a retail client and unable to deal with the wholesale section of your bank. You can handle this by dealing through your normal group company which has wholesale status with the bank and doing a back-to-back internal deal with the new subsidiary.

### **Express consents**

MiFID requires banks to get the express separate consent of their clients in respect of certain matters. Be prepared, therefore, to receive a request from your bank to give your specific consent to:

- Using the Internet to provide information required to be given to clients by FSA rules;
- Effecting off market transactions on your behalf; and

In respect of equity trading, you giving an express instruction not to make public any "limit" order which is not immediately executed.

The first request for consent would appear to be unproblematic, provided that the treasurer is happy to monitor the bank's website at regular intervals. The second request for consent allows a bank to engage in OTC dealings off its own book or with third parties. In the wholesale debt markets, having this flexibility is essential. The third consent request will be of limited application to treasurers as it relates to share dealing only.

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## The aims of MiFID

“MiFID as a whole is a ground-breaking package of measures. It will transform the landscape for the trading of securities and introduce much needed competition and efficiency throughout Europe’s financial markets.”<sup>3</sup>

There are a number of headline consequences which will have a significant effect on the investment services industry as a whole:

- the regulated investment services sector will expand, with the addition of important new regulated investment services and products;
- as a result, the European investment services passport will enable firms to export a wider range of investment services;
- national-level barriers within the single market will be reduced;
- important core business standards will for the first time be prescribed in detail at European level; and
- the rules applying to different securities-trading venues will be harmonised, laying the foundations for a wider range of regulated trading venues with more extensive trading transparency.

The European Commission’s deadline for the transposition of MiFID into the national law of each Member State is 31 January 2007, but a further 9-month period expiring on 1 November 2007 has been allowed for implementation, at which time the rules of the national regulators giving effect to MiFID requirements must become effective.

## Background

Since 1995, the Investment Services Directive<sup>4</sup> (ISD) has provided a limited degree of harmonisation across the EEA<sup>2</sup> investment services sector. The ISD sets a minimum level of regulation for investment firms across the EEA and at the same time establishes the passporting regime for those regulated firms, enabling an investment firm regulated in one EEA Member State to establish a branch in, or provide certain of its investment services cross-border into, any other Member State – this is known as the “ISD passport”.

But the ISD has not been as effective as it might have been in establishing the framework for a single European market in investment services. There are two principal reasons for this lack of progress: first, the scope of investment activities to which the ISD applies is narrow; and second, while Member States are required to permit EEA-regulated investment firms to passport into their jurisdiction, they are not prohibited from imposing additional local rules (“super equivalence”) which regulate the manner in which those services may be provided. MiFID has come about as an update and extension of the ISD with the long-term intention to reduce additional local rules.

<sup>3</sup> Charlie McCreevy, EU Commissioner for Internal Market and Services, Speech at the Institute for European Affairs given on 30 June 2006.

<sup>4</sup> Directive 93/22/EEC

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## Will corporate treasuries be regulated under MiFID?

Most corporate treasury operations currently operate on an unregulated basis, relying on exclusions in the Regulated Activities Order (RAO)<sup>5</sup>. If you are at present exempt under the RAO you will not be affected (as regards regulatory status) by the implementation of MiFID.

### Background

In order to understand the impact of the Markets in Financial Instruments Directive (MiFID)<sup>1</sup> as regards regulation requirements it is necessary to consider the position of corporate treasurers under current law. Generally treasury operations are exempt from regulation by reliance on two principal exemptions in the RAO, namely:

- > Article 15 (dealing on own account but absence of holding out etc);
- > Article 69 (insofar as it relates to dealings with or on behalf of group companies).

Reliance on these exclusions and their equivalents in the predecessor legislation has been complicated by the existence of the superimposed requirements of the Investment Services Directive (ISD)<sup>4</sup>, implemented into UK law in 1996. The effect of the ISD is to “override” certain exclusions in the RAO, including the two noted above, where an entity’s activities mean that it is an “investment firm” providing “investment services”. In November 2007, the ISD will be replaced by MiFID, which is similar to the ISD but more prescriptive and wider in scope.

Under the ISD, an investment firm is a person “*the regular occupation or business of which is the provision of investment services for third parties on a professional basis*”. Investment services include own account dealing, execution of orders and portfolio management, all activities commonly undertaken by corporate treasurers, either for their own account or on behalf of group companies.

### Interaction of the RAO and the ISD: own account dealings in equities and debt

Article 15 of the RAO provides that it is not a regulated activity for a person to deal in instruments (other than derivatives) where the person acts as principal unless (so far as is relevant to corporate treasurers) he “*holds himself out as engaging in the business of buying investments of the kind to which the transaction relates, with a view to selling them*” (Article 15(1)(a)). This provision draws a distinction between professional market participants operating a short-term trading book and others who are more properly regarded as customers of the market, albeit perhaps active customers. Translating this into ISD terms, the professional dealer is providing a “service” to counterparties on a “professional basis”. Corporate treasurers do not usually provide a service to the banks and brokers with which they deal – they are customers, to which services are provided. Accordingly, the line between regulated and unregulated own account dealing can be considered as drawn in the same place for the purposes of both the RAO and the ISD.

### Interaction of the RAO and the ISD: intra-group dealings in equities and debt

The position is less clear in the case of intra-group dealings. In the case of the ISD, a group treasurer could well fall within the definition of “investment firm” with respect to the services it provides to group companies. There is a relevant exclusion in the ISD, but it differs in two significant ways from the equivalent exclusion in the RAO:

<sup>5</sup> SI 2001/544

- The exclusion is available to entities which provide investment services "*exclusively for their parent undertakings, for their subsidiaries or for other subsidiaries of their parent undertakings*".
- The definition of "group" is the accounting definition (found also in the Companies Act 1985), whereas for the purposes of the RAO a broader definition (including a 20% shareholding) applies.

However, a corporate treasurer which relies on falling outside the definition of "investment firm" for its own account dealings will as a result typically be able to meet the exclusivity condition when it provides services to (accounting) group companies. It should be noted that services provided to commercial joint venturers who are not accounting group companies do not have the benefit of any ISD exclusion. In principle the provision of such services will mean that the corporate treasurer is an investment firm and the exclusion for services to joint venture parties also contained in Article 69 of the RAO will be overridden, so that the corporate treasurer would require authorisation.

## **MiFID**

In the MiFID the definition of "investment firm" is:

*"any legal person whose regular occupation or business is the provision of one or more investment services to third parties and/or the performance of one or more investment activities on a professional basis"*.

The main difference between this and the definition in the ISD is the distinction made between "services" and "activities". The distinction is made principally to clarify the position of firms that deal professionally on their own account and are not providing a service in the sense of acting on behalf of someone else. But, on its own, the new definition could cause a problem for corporate treasurers and other regular own account dealers.

However, Article 2.1(i) of the MiFID provides a new exemption for those (mainly treasurers) dealing on their own account in financial instruments "*provided this is an ancillary activity to their main business, when considered on a group basis, and that main business is not the provision of investment services or banking services*".

The group exemption in MiFID reproduces that in the ISD, including the exclusivity conditions. The exemption only extends to "services" and not "activities" but in practice this should not be a problem because this exemption can be combined with the "ancillary dealings" exemption just noted.

## **Derivatives: RAO, ISD and MiFID**

Under the RAO, own account dealings in derivative instruments are exempt if the counterparty or arranger of the deal is itself a professional dealer, such as a bank or broker (Article 16). Where a treasurer deals in derivatives back-to-back as principal, with a professional dealer on one side and a group company on the other, the treasurer will rely on a combination of the group exemption and the exemption for dealing as principal with a professional counterparty.

Under the ISD/MiFID, agency dealings will fall within the group exemption provided that the agent is a customer of the market and not acting as a professional market participant (in which case it may be deemed to be providing "investment services" to third parties and fall outside the terms of the directives' group exemption). Under MiFID, back-to-back and other principal

dealings will be exempt under the ancillary dealing and group exemptions. The “customer of the market” analysis in respect of own account dealings in debt and equity applies also to own account dealings in derivatives under the ISD.

### **Summary**

The combination of the traditional ISD / MiFID group exemption and the new MiFID ancillary dealing exemption should mean that any corporate treasurer which is at present exempt under the RAO will not be affected (as regards regulatory status) by the implementation of MiFID.

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## Implications for Firms and their Clients

One potentially significant development is that the ISD applies only to firms providing “investment services for third parties on a professional basis”<sup>6</sup>, whereas MiFID applies to firms whose regular occupation or business is “the provision of one or more investment services to third parties and/or the performance of one or more investment activities on a professional basis”<sup>7</sup>. This distinction was introduced principally to bring professional own-account dealers within the scope of MiFID, even if their dealing could not be characterised as a “service” to a client. The implication of this for determining if your treasury will itself be regulated is discussed above.

Investment advice (meaning personal recommendations as to particular transactions) now falls under the category “investment services and activities”.

“Ancillary services”<sup>8</sup> are services which, if performed by themselves, do not make the firm concerned an investment firm requiring authorisation under MiFID (although, depending on their nature, the performance of the services may be regulated under local law). But where an investment firm, already performing an investment service or activity, also performs an ancillary service in connection with an investment service or activity (for example, foreign exchange), then the ancillary service will come within MiFID. Certain of MiFID’s conduct of business requirements will then apply to the ancillary service.

“Investment research and financial analysis or other forms of general recommendation relating to transactions in financial instruments”<sup>9</sup> becomes a new ancillary service under MiFID.

The lists of investment services and activities and ancillary services are set out in Appendix 1.

The main additions to MiFID’s list of financial instruments compared with those covered by the ISD are derivatives, particularly derivatives not referenced to an investment or currency, such as commodity derivatives. So commodity forwards, options and swaps are subject to MiFID, but spot dealings in commodities are not, nor are commodity derivatives with physical delivery done for commercial purposes and not traded on a regulated market. This development is also discussed further below.

Unlike the ISD, MiFID sets out detailed and specific requirements in relation to prudential and conduct of business matters for investment firms. Much of this relates to organisational matters within firms which is not the focus of this memorandum since it has little direct impact on customers. However MiFID and its Level 2 Implementing Measures make specific provision in relation to, among other things, outsourcing, customer categorisation, conflicts of interest, best execution and suitability.

### Instruments affected

A full list of MiFID instruments is included in Appendix 1. Many instruments commonly used by Treasurers will be covered, including transferable securities, money market instruments, options, futures, swaps, forward rate agreements and other derivative contracts.

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<sup>6</sup> Article 1(2), ISD.

<sup>7</sup> Article 4(1), MiFID.

<sup>8</sup> Annex 1, section B, MiFID

<sup>9</sup> Annex 1, section B, MiFID

Spot transactions in commodities are not included, while non-commercial forward markets are covered. FX forwards entered into for commercial purposes are not covered (in other words, the position as respects FX remains the same as under existing UK law so far as the requirement for authorisation is concerned). However, FX provided by an investment firm in connection with an investment service or activity is, as mentioned above, an ancillary service and as such may be subject to some of MiFID's requirements.

## **Client Status and Categorisation**

Client status and categorisation is the area of MiFID that will have the most visible impact for corporate treasurers. There will be the administrative chore of documenting agreement with the company's bankers as to which category will apply and to which instruments. This in turn will determine the level of protections given to the company, the extent of any health warnings being given and the overall behaviour of the bank with its customer. The directive allows a client to have a different categorisation for different instruments, although for practical reasons most banks will not be allowing this degree of flexibility.

Where there is a client relationship, MiFID requires investment firms to categorise their customers before dealing with them and to apply differing regulatory protections depending on the categorisation. But whereas the UK's pre-MiFID regime provides for three categories of customer – private customer, intermediate customer and market counterparty – MiFID provides for firms to categorise their clients into one of two main categories: retail clients and professional clients. Within the professional clients category is a sub-category of eligible counterparties, which, in certain circumstances, may be eligible for treatment as, in effect, super-professional clients.

A retail client is any client which is not a professional client; a professional client is defined in Annex II of MiFID and includes, broadly, authorised financial institutions, high net worth companies, regional and local government bodies and certain other institutional investors (these are all called per se professional clients). Any firm which is currently treated in the UK as a market counterparty, and most of those firms currently classified as intermediate customers, will be treated as professional clients for the purposes of MiFID.

High net worth companies are those which meet two of the following size criteria:

- Balance sheet total of EUR 20m
- Net turnover of EUR 40m
- Own funds of EUR 2m

These size thresholds apply on a company by company basis rather than a group basis. Firms can allow a retail client to opt up to professional client<sup>10</sup> where the client satisfies two from the following tests:

- has carried out at least 10 significant transactions per quarter over the previous 4 quarters
- holds cash and financial instruments over EUR 500,000
- has worked or currently works in the financial sector

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<sup>10</sup> An “elective professional client”

And the firm has assessed that the client (or individual trading on behalf of a client entity<sup>11</sup>-e.g. the treasurer) is capable of making his own investment decisions and understands the risks involved.

The client must request the opt-up in writing and must be given a warning of protections and rights it may lose. The client must state in writing, in a separate document from the contract, that it is aware of the consequences of losing protection.

Retail clients are afforded the highest degree of regulatory protection, whereas professional clients are presumed to have sufficient financial awareness to be able to deal without all of the regulatory protections under MiFID. Thus, when investment firms deal with professional clients, certain regulatory obligations are either modified or disapplied: the obligations to supply information to professional clients are less extensive<sup>12</sup>, experience and competency can be assumed when applying the suitability and appropriateness test<sup>13</sup>, the professional nature of the client is taken into account when providing best execution<sup>14</sup> and certain client reporting obligations do not apply<sup>15</sup>.

Any customer classified as a professional client (including an “eligible counterparty”) can request non-professional treatment. The investment firm may then agree to “provide a higher level of protection”<sup>16</sup> – in other words, a professional client may opt to be treated as a retail client.

Investment firms are permitted to provide certain services to eligible counterparties pursuant to a light-touch conduct of business regime under MiFID<sup>17</sup>. When providing execution and/or reception and transmission services to such “eligible counterparties”, an investment firm is not required to comply with MiFID’s detailed conduct of business requirements<sup>18</sup>, the requirement to provide best execution<sup>19</sup> or the “prompt, fair and expeditious execution” requirement<sup>20</sup>.

Accordingly, under MiFID eligible counterparties can deal in the wholesale markets with other participants in a regulatory environment similar to that applicable to market counterparties under the UK’s pre-MiFID regime.

Certain entities are automatically treated as eligible counterparties (per se eligible counterparties), namely investment firms, credit institutions, insurance companies, undertakings for the collective investments of transferable securities (UCITS), pension funds and national governments.

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<sup>11</sup> COBS 3.5.4

<sup>12</sup> See Chapter 6 of COBS, and Article 29, Level 2 Implementing Directive.

<sup>13</sup> See Chapter 10 of COBS and Articles 35 and 36, Level 2 Implementing Directive.

<sup>14</sup> COBS 11.2.6R and Article 44, Level 2 Implementing Directive.

<sup>15</sup> COBS 16.2.1R and Section 4, Chapter III, Level 2 Implementing Directive.

<sup>16</sup> COBS 3.7 and Annex II, MiFID.

<sup>17</sup> Article 24, MiFID.

<sup>18</sup> Article 19, MiFID.

<sup>19</sup> Article 21, MiFID.

<sup>20</sup> Article 22(1), MiFID.

A professional client can be given or can opt up to eligible counterparty status but the rules determining this will be set by the home member state of the firm, which could mean inconsistencies will arise for the same entity dealing in differing states. Under FSA rules<sup>21</sup>, high net worth companies which are professional clients can opt up.

Also under FSA rules, an elective professional client (other than an individual) may request treatment as an elective eligible counterparty in respect of business for which it is a professional client. Before dealing with its customer as an elective eligible counterparty, an investment firm is required to obtain positive confirmation from that customer that it understands that it will be treated in that way. As mentioned above, prior to dealing with retail and professional clients, (but not eligible counterparties) a firm must supply certain information about the firm, its execution policy, its costs and fees, its arrangements for handling client assets and funds and guidance and risk warnings of instruments to be used. The client will be required to acknowledge and confirm its understanding of this information.

New clients or existing clients being recategorised will need to be notified of their categorisation and their right to request a different categorisation and any limitations on protection that that categorisation would involve.

FSA transitional rules ensure that in many cases a client will be automatically provided with the nearest equivalent MiFID categorisation to their previous categorisation. This is without prejudice to a firm choosing to re-categorise a client for MiFID purposes. The transitional provisions work as follows:

- An existing *private customer* becomes a *retail client*;
- An existing *intermediate customer* becomes a *professional client* (but the firm must inform any client which does not in fact meet the MiFID conditions for being a per se professional client about the “relevant conditions for the categorisation of clients”);
- Some *market counterparties* become *professional clients* (and the firm must inform any client which does not in fact meet the MiFID conditions for being a per se professional client about the “relevant conditions for the categorisation of clients”). However per se *eligible counterparties* (see above) can be treated as such without further formality for eligible counterparty business.

Where a client is being categorised as a professional client the “relevant conditions for the categorisation of clients” means a statement of the main differences between the treatment of a retail client and a professional client. This notification will affect a treasurer who is located in a group company which does not meet the size requirements mentioned above.

Although there are no express transitional provisions in MiFID dealing with eligible counterparties, FSA has given guidance in COBS that where an existing corporate client has been dealt with as a market counterparty before 1 November 2007, it may be treated as an eligible counterparty without the requirement to obtain client confirmation which will apply to corporates which are not per se eligible counterparties.

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<sup>21</sup> See COBS 3.5.2R and COBS 3.6.4R

<b>Table : Client categorisation: criteria and consequences</b>			
	RETAIL CLIENT	PROFESSIONAL CLIENT	
			ELIGIBLE CONTERPARTY
<b>Category criteria</b>	Retail is the default category	Based on the clients expertise, experience and knowledge and if they meet two of:  has carried out at least 10 significant transactions per quarter over the previous 4 quarters  holds cash and financial instruments over EUR 500,000  has worked or currently works in the financial sector  <b>OR</b>  Is a per se professional client which includes a high net worth company	For UK is a high net worth company which mean they meets two of:  Balance sheet total of EUR 20m Net turnover of EUR 40m Own funds of EUR 2m  <b>OR</b>  is not an individual and has requested ECP status (an elective ECP)  <b>OR</b>  Is a per se ECP  Note: Rules may vary with home state
<b>Flexibility between categories</b>	Opt up allowed, instrument by instrument	Opt down to retail allowed on request  Opt up allowed (but not for an individual) depending on Member State	Opt down to professional or retail allowed
<b>Pre-dealing general information required</b>	Yes	Yes (but not if a professional client under the transitional rules)	Not required
<b>Best execution required</b>	Yes	Yes	Not required
<b>Appropriateness required</b> (applies to services other than portfolio management or investment advice or execution-only services in non-complex instruments)  <i>(Appropriateness covers experience and knowledge relevant to the product of service offered)</i>	Yes	Deemed met	Not required
<b>Suitability required</b> Applies to investment advice and portfolio management  <i>(Suitability covers experience and knowledge relevant to the product of service offered and consideration of the client's financial situation.)</i>	Yes	Can be assumed that experience and knowledge is met. Still need to cover client's financial situation and investment objectives.	

## Conflicts of Interest

Regulators both in Europe and elsewhere are raising conflicts of interest as a cause for serious concern. MiFID will impose specific and detailed requirements for firms to identify and manage conflicts of interest<sup>22</sup>. Establishing and maintaining systems to manage conflicts of interest is a key organisational principle for investment firms under MiFID, The implementing rules are clear that if a firm's organisational and administrative arrangements "are not sufficient to ensure, with reasonable confidence, that risks of damage to client interests will be prevented, the investment firm shall clearly disclose the general nature and/or sources of conflicts of interest to the client before undertaking business on its behalf"<sup>23</sup>. However a firm will not be able to comply with its obligations under MiFID simply by disclosing potential conflicts to its clients.

Guidance to be included in the FSA Handbook states: "an over-reliance on disclosure without adequate consideration as to how conflicts may appropriately be managed is not permitted"<sup>24</sup>. Clearly the intention is to put a firm's clients into the driving seat with regard to decisions concerning the acceptability of potential conflicts.

## Best Execution and Client Order Handling

Investment firms are certainly familiar with the duty of best execution under existing FSA rules. Article 21 of MiFID applies the duty of best execution to a firm when executing orders for a client, and takes a broader frame of reference to obtaining the best possible result for the client than simply achieving the best price: the obligation is to take all reasonable steps to achieve the best possible result, taking into account price, costs, speed, likelihood of successful execution and settlement, size, nature and "any other consideration" which is relevant to the execution of the order.

Best execution does not apply for eligible counterparties.

Following legal advice put out by the European Commission, FSA considers that the application of the best execution obligation is determined by whether a firm is executing an order on behalf of a client: in other words, when contractual or agency obligations are owed to the client so that the client is legitimately relying on the firm to protect its interests in relation to the terms of the transaction. So in dealer markets, where a client, relying on its own judgment, selects a dealer's quote, best execution would not arise. Where best execution does apply, the Level 2 Implementing Directive provides that in determining the relevant importance of the factors listed above, a firm should take account of the categorisation of the client, the nature of the order and the type of, and venue of execution for, the relevant instrument being traded<sup>25</sup>. Nevertheless, if a client issues specific instructions in respect of an order, a firm will be required to execute orders in accordance with those instructions.

Investment firms are required to establish and implement arrangements for complying with their best execution obligations, including the production and periodic review of a best execution policy. The policy, to which the client must give prior consent, must specify (amongst other things) the execution venues on which the firm will execute client orders<sup>26</sup>.

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<sup>22</sup> SYSC Chapter 10 in Appendix 1, PS06/13, and Article 18, MiFID.

<sup>23</sup> SYSC 10.1.8R and Article 18(2), MiFID.

<sup>24</sup> SYSC 10.1.9G, Appendix 1, PS06/13.

<sup>25</sup> Article 44(1), Level 2 Implementing Directive.

<sup>26</sup> See COBS 11.2.15R-11.2.17R; and 11.2.22R-11.2.29R.

The FSA's interpretation of Article 21 is that it should not be necessary for a firm to be able to demonstrate that it achieves the best possible result for every customer order, but rather that the firm should have in place execution arrangements which lead it to take all reasonable steps to obtain the best possible result for its client orders<sup>27</sup>.

In the case of executing orders for share purchases or for wholesale foreign exchange forwards associated with an investment service or activity where international, liquid and fast moving markets exist a firm may choose a venue that facilitates the fast matching of client orders rather than purely on price. For most treasurers the bulk of their FX dealing is not associated with an investment activity but is related to hedges of the underlying business cashflows, so is outside MiFID. However an FX deal done, for example, to cover the foreign currency cost of settling a securities purchase abroad will be subject to MiFID.

For customised transactions such as OTC derivatives contracts where the transaction is more a bilateral contact rather than an order to be executed best execution will not apply. This means that for the majority of transactions typically done by treasurers in non financial corporates directly with a bank, such as investing in that bank's MMF, the purchase of bonds, CDs or FRAs, swap deals, MiFID best execution will not apply.

Whereas under the FSA's existing regime investment firms have been able to agree when dealing with intermediate customers that they will not provide best execution, MiFID will not permit disapplication for all professional clients, but only those which qualify as eligible counterparties.

In addition to the obligation to provide best execution, Article 22 of MiFID requires investment firms to implement "procedures and arrangements which provide for the prompt, fair and expeditious execution of client orders, relative to other client orders or the trading interests of the investment firm"<sup>28</sup>. In other words, a firm must provide timely execution and fair allocation of order priority. Investment firms in the UK are currently required to provide timely execution under existing FSA conduct of business rules.

### **Suitability and Appropriateness**

Article 19 of MiFID requires investment firms to make an assessment of the "suitability" and "appropriateness" of transactions and services when dealing with clients other than on an execution-only basis in "non-complex instruments" (see below).

The suitability test is to be applied when a firm provides investment advice or portfolio management: the investment firm shall "obtain the necessary information regarding the client's ... knowledge and experience in the investment field relevant to the specific type of product or service, his financial situation and his investment objectives so as to enable the firm to recommend to the client ... the investment services and financial instruments that are suitable for him"<sup>29</sup>. In CP06/19 the FSA stated that, so far as investment advice and portfolio management for retail clients is concerned, it does not expect its proposed use of the MiFID suitability formulation in its new rules to require firms in general to change their approach to assessing suitability, although it points out that there may be a greater impact on firms dealing with professional clients since MiFID applies suitability requirements to these clients for the first time. Treasurers may be concerned that the suitability requirement will impede swift and efficient dealings, but since it applies only to investment advice and portfolio management one

<sup>27</sup> See paragraph 2.16 of DP 06/3.

<sup>28</sup> COBS 11.3.1R.

<sup>29</sup> Article 19(4), MiFID, COBS 9.2.1R.

might expect that firms should naturally have gathered sufficient information in the first place, if they are doing their advisory job properly.

A firm may not advise or exercise portfolio management discretion if it is unable to determine suitability.

The appropriateness test is to be applied when a firm provides MiFID investment services which do not involve advice or discretionary portfolio management<sup>30</sup>, including execution services which do not fall within the new conditions for execution-only business: the investment firm must ask the client to provide "information regarding his knowledge and experience in the investment field relevant to the specific type of product or service offered ... so as to enable the investment firm to assess whether the investment service or product envisaged is appropriate for the client"<sup>31</sup>.

Perhaps unsurprisingly, the obligations in each case are less onerous when an investment firm deals with professional clients because it is permitted to make certain assumptions about the resources, knowledge and experience of professional clients which it cannot make in respect of retail clients. In the case of the appropriateness test, an investment firm may assume the necessary experience and knowledge on the part of its professional clients, thus practically confining the test to retail clients only<sup>32</sup>. If the firm reaches the conclusion that the service or product in question is not appropriate to its client, it must give the client a warning to this effect. The warning can be in a standardised format. If the client nonetheless wishes to purchase the service or product, the firm can then provide it<sup>33</sup>. If a client refuses to provide the relevant information (or provides insufficient information) for an assessment of appropriateness, the firm must warn the client that it has not been able properly to assess the appropriateness of the product or service; if the client nonetheless wishes to proceed, the firm may then do so<sup>34</sup>.

<b>Table: Circumstance when appropriateness and suitability apply</b>		
	<b>Suitability</b> (Test covers knowledge and experience in the relevant investment field AND the client's financial situation and his investment objectives.)	<b>Appropriateness</b> (Test covers knowledge and experience in the relevant investment field.)
Execution only services –non complex instruments	Not applicable	Not applicable
Investment advice/ portfolio management	Applicable	Not applicable
Investment services <b>not</b> involving advice or discretionary portfolio management; or Execution only services – complex instruments	Not applicable	Applicable

*(Note: Suitability and appropriateness are also dependent on the client categorisation, see earlier table)*

<sup>30</sup> Article 19(5), MiFID.

<sup>31</sup> COBS 10.2.1(1)R.

<sup>32</sup> COBS 10.2.1(2)R.

<sup>33</sup> COBS 10.3.3G and Article 19(5), MiFID.

<sup>34</sup> COBS 10.3.3G and Article 19(5), MiFID.

### Execution-only business

Because the “appropriateness” test is applied to some of the services which previously would have been execution only business, there is a narrowing of the category of execution-only business for retail and professional clients under MiFID. Execution-only services may fall outside the appropriateness tests if all the following circumstances are satisfied<sup>35</sup>:

- the services consist only of the execution and/or the reception and transmission of client orders;
- the services relates to any “non-complex financial instruments” including shares admitted to trading on a regulated market or an equivalent third country market<sup>36</sup>, money market instruments, bonds or other forms of securitised debt (excluding bonds or securitised debt that embed a derivative), and undertakings for collective investment in transferable securities (UCITS) which will therefore include Money Market Funds;
- the services are provided “at the initiative of the client”;
- the client has been clearly informed that the firm is not obliged to assess suitability in providing the service; and
- the firm complies with its obligations under Article 18 of MiFID to control or manage conflicts of interest.

The residual category of “non-complex financial instruments” is not defined in MiFID, but instead in the Level 2 Implementing Directive<sup>37</sup>. The criteria which determine whether an instrument is non-complex are that:

- the instrument is not one which gives a right to buy or sell another transferable security and is not any other type of derivative instrument;
- there are “frequent opportunities” to trade, redeem or otherwise realise the instrument at publicly available prices;
- the instrument does not involve any contingent liability other than the initial cost of acquiring the instrument; and
- adequate information on the instrument’s characteristics is publicly available and likely to be understood by a retail client.

CFDs, options, futures, swaps and other derivative contracts relating to securities and commodities will be treated as complex and therefore firms will have to consider appropriateness prior to dealing with such customers. However in practical terms for treasurers in the professional category the appropriateness is deemed met.

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<sup>35</sup> COBS 10.4.1R, and Article 19(6), MiFID.

<sup>36</sup> The Commission will maintain and publish a list of equivalent third country markets which the FSA proposes to refer to in COBS 10.5.4G.

<sup>37</sup> Article 38, Level 2 Implementing Directive; see COBS 10.4.1(3)R.

## **Use of websites to provide regulatory information**

Investment firms may, instead of communicating by traditional means (letter, fax) or even by email, post information required to be given to clients to their website for access by clients, provided that certain conditions are met:

- There must be evidence that the client has regular access to the Internet, such as the provision by the client of an email address for the purposes of the business relationship with the firm;
- The client must specifically consent to the provision of the information by website access;
- The client must be notified electronically of the address of the website, and the place on the website where the information may be accessed;
- The information must be up to date; and
- The information must be accessible continuously by means of the website for such period of time as the client may reasonably need to inspect it.

It is expected that many firms will avail themselves of this facility to save on the time and cost involved in individual communications to their clients.

## Implications for the EEA Investment Services Market

### Home State Regulation of Cross-border Services

MiFID provides that Member States may not impose additional local requirements on an investment firm which relies on the passport to provide cross-border services into that Member State<sup>38</sup>. In other words, if an investment firm provides MiFID investment services and activities from its home state into other EEA Member States, only the home state regulator's conduct of business rules will apply to that activity. MiFID does not prohibit a Member State, however, from imposing local requirements in circumstances where an investment firm seeks to establish a branch in that jurisdiction, but there is a subtle nuance here. The host state can apply its own rules to a passporting branch only in respect of "services provided by the branch within its territory"<sup>39</sup>. If the passporting branch is providing services on a cross-border basis into other EEA Member States it will be subject to home state rules for the activities provided *from* the host state into other states. This may in particular have implications for the provision by non-UK investment banks of investment services from a London branch.

To illustrate with a practical example: a UK investment firm providing investment services into Belgium would be subject to UK conduct of business rules in respect of both its UK and Belgian activities. If the firm establishes a branch in France under the MiFID passport, notwithstanding any prudential supervision of the branch activities by the FSA, the French regulator would apply local conduct of business rules to the activities of that branch within France. If the branch then provides cross-border services into Germany under the passport, UK conduct of business rules would apply to those cross-border activities.

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<sup>38</sup> Article 31(1), MiFID.

<sup>39</sup> Article 32(7), MiFID.

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## Appendix 1

### MiFID, Annex I: List of Services and Activities and Financial Instruments

#### Section A

##### Investment services and activities

- (1) Reception and transmission of orders in relation to one or more financial instruments.
- (2) Execution of orders on behalf of clients.
- (3) Dealing on own account.
- (4) Portfolio management.
- (5) Investment advice.
- (6) Underwriting of financial instruments and/or placing of financial instruments on a firm commitment basis.
- (7) Placing of financial instruments without a firm commitment basis.
- (8) Operation of Multilateral Trading Facilities.

#### Section B

##### Ancillary services

- (1) Safekeeping and administration of financial instruments for the account of clients, including custodianship and related services such as cash/collateral management.
- (2) Granting credits or loans to an investor to allow him to carry out a transaction in one or more financial instruments, where the firm granting the credit or loan is involved in the transaction.
- (3) Advice to undertakings on capital structure, industrial strategy and related matters and advice and services relating to mergers and the purchase of undertakings.
- (4) Foreign exchange services where these are connected to the provision of investment services.
- (5) Investment research and financial analysis or other forms of general recommendation relating to transactions in financial instruments.
- (6) Services related to underwriting.
- (7) Investment services and activities as well as ancillary services of the type included under Section A or B of Annex I related to the underlying of the derivatives included under Section C – 5, 6, 7 and 10 - where these are connected to the provision of investment or ancillary services.

#### Section C

##### Financial instruments

- (1) Transferable securities.
- (2) Money-market instruments.
- (3) Units in collective investment undertakings.
- (4) Options, futures, swaps, forward rate agreements and any other derivative contracts relating to securities, currencies, interest rates or yields, or other derivatives instruments, financial indices or financial measures which may be settled physically or in cash.
- (5) Options, futures, swaps, forward rate agreements and any other derivative contracts relating to commodities that must be settled in cash or may be settled in cash at the option of one of the parties (otherwise than by reason of a default or other termination event).

- (6) Options, futures, swaps, and any other derivative contract relating to commodities that can be physically settled provided that they are traded on a regulated market and/or an MTF.
- (7) Options, futures, swaps, forwards and any other derivative contracts relating to commodities, that can be physically settled not otherwise mentioned in C.6 and not being for commercial purposes, which have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are cleared and settled through recognised clearing houses or are subject to regular margin calls.
- (8) Derivative instruments for the transfer of credit risk.
- (9) Financial contracts for differences.
- (10) Options, futures, swaps, forward rate agreements and any other derivative contracts relating to climatic variables, freight rates, emission allowances or inflation rates or other official economic statistics that must be settled in cash or may be settled in cash at the option of one of the parties (otherwise than by reason of a default or other termination event), as well as any other derivative contracts relating to assets, rights, obligations, indices and measures not otherwise mentioned in this Section, which have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are traded on a regulated market or an MTF, are cleared and settled through recognised clearing houses or are subject to regular margin calls.

## Appendix 2 Lamfalussy Legislation

MiFID has been developed using the Lamfalussy legislative process which is designed to drive forward the key policy objectives while leaving technical details to be finalised later;. This approach to law-making involves the preparation of a framework “Level 1” Directive which establishes guiding principles and requirements. Subordinate “Level 2” measures are subsequently prepared during the Level 1 implementation period. Level 2 measures build technical detail on to the Level 1 framework and are formulated by the Commission with the assistance of advice provided by the European Securities Committee, itself a creation of the Lamfalussy process.

In support of these legislative measures are the Level 3 and Level 4 processes. At Level 3, the Committee of European Securities Regulators (CESR) works to develop recommendations, interpretative guidelines and common standards which aim to ensure the consistent implementation and application of the Level 1 and Level 2 legislative measures across the EU. Level 4 is concerned with supervision and enforcement: in essence, the Commission checks the compliance of Member States with Level 1 and Level 2 legislation and, where necessary and appropriate, takes action to ensure that it is observed and properly implemented.

MiFID is a Level 1 framework Directive. Level 2 Implementing Measures were adopted in August 2006. They are an implementing Directive and an supplementary Regulation<sup>40</sup>

### Implementation in the UK

In the UK, responsibility for implementing MiFID is divided between HM Treasury, which must deal with necessary changes to UK primary and secondary legislation, and the FSA, which must make substantial changes to its Handbook of Rules and Guidance (the Handbook).

The FSA’s implementation process is generally governed by four principles:

- Implementing rules take the form of “intelligent copy-out” of MiFID text (using different terminology only where the directive text is particularly obscure or ambiguous).
- There is a presumption against “gold-plating” – adding to MiFID’s requirements. In any event additional regulation has to be justified under Article 4 of the Level 2 Implementing Directive, as necessary to meet UK-specific risks to investor protection.
- Implementing rules may be extended to non-MiFID business and/or firms (such as the UK branches of non-EEA firms) to avoid unnecessary complexity and to ensure equal treatment in similar regulatory situations.
- In implementing MiFID, the FSA will cut the detail of the existing rulebooks pursuant to its move to more principles-based regulation.

<sup>40</sup> A Directive is a European instrument which requires implementation by each EU Member State before it can have direct effect as a matter of national law; a Regulation is a European instrument which has direct effect in each EU Member State without the need for national-level legislative implementation.

## **Appendix 3 Weblinks**

Full text of the Directive 2004/39/EC

[http://eur-lex.europa.eu/LexUriServ/site/en/oj/2004/l\\_145/l\\_14520040430en00010044.pdf](http://eur-lex.europa.eu/LexUriServ/site/en/oj/2004/l_145/l_14520040430en00010044.pdf)

Level 2 implementing directive

[http://eur-lex.europa.eu/LexUriServ/site/en/oj/2006/l\\_241/l\\_24120060902en00260058.pdf](http://eur-lex.europa.eu/LexUriServ/site/en/oj/2006/l_241/l_24120060902en00260058.pdf)

European Commission - Questions and Answers on MiFID

[http://ec.europa.eu/internal\\_market/securities/docs/isd/questions/questions\\_en.pdf](http://ec.europa.eu/internal_market/securities/docs/isd/questions/questions_en.pdf)

Treasurer article November 2006 "MiFID's implications for European financial markets"

<http://www.treasurers.org/purchase/showres.cfm?resid=2241>