



BANKING CONSULTANT
CHRISTOPHER KARAOLIS
HIGHLIGHTS SOME OF THE
NUANCES SURROUNDING
MIFID AND STRESSES THE IMPLICATIONS
FOR THE CORPORATE INVESTOR.

Most readers will have heard of MiFID, but have probably dismissed it as a European regulatory directive aimed solely at banks, investment firms and other similar financial institutions. However, MiFID also has clear implications for corporate investors.

The European regulatory legislation *Markets in Financial Instruments Directive 2004/39/EC*¹ is more commonly referred to as MiFID and was first published in April 2004 by the European parliament.

Although the aims and objectives of MiFID are far-reaching and varied for an investment firm, from a corporate perspective they can be more succinctly summarised as:

- The harmonisation and extension of the concept of a single European market;
- The need to take into account developments in financial instruments and services; and
- The demand for greater protection for the investor.

REPLACING THE EXISTING INVESTMENT SERVICES DIRECTIVE

With effect from 1 November 2007, MiFID will replace the existing Investment Services Directive (ISD) 93/22/EEC, originally introduced in 1993 to establish some common ground rules within the then European Community. ISD provided guidance to investment firms on how to conduct business when offering products and services to clients.

One of the principal concepts of ISD is that authorisation and legislation of an investment firm is governed by the member state the investment firm operates in. For example, if an investment firm provides its services from offices based in France, it would be

Executive summary

- MiFID will remove local regulatory restrictions and barriers and introduce common reporting requirements throughout the EU.
- The 'passport' rule means that cross-border activities will fall under a single regulatory regime.
- Under MiFID, investor protection is offered on most tradable financial instruments, with the exception of spot FX transactions.
- There will be more pressure to conduct business fairly, honestly and professionally under MiFID, and clients of investment firms will be classified with an appropriate level of protection.
- Investment firms will need to provide an 'order execution policy' statement to clients, have this agreed and keep full records.

regulated by the French regulatory authority. However, if a UK branch of the same investment firm were offered the exact same service and or product, it would then fall under the jurisdiction of the UK regulators, giving rise to possible disparity between regulatory authorities.

When ISD was introduced, the focus was predominantly on the equities market and only for transactions executed on regulated markets such as the London Stock Exchange.

MiFID builds on the basic principles laid down in ISD, extending

them by focusing on certain key areas. First, it concentrates on the removal of cross-border barriers between European member states², enforcing harmonisation and the operation of a single coherent market. Second, it takes into account the fact that there are more products and services now available to the investor, as well as the inherent increase in complexity and risk factors associated with these new products. And finally, it offers the investor an increased level of protection currently unavailable under ISD.

MAXIMISING HARMONISATION One of the key objectives of MiFID is to facilitate the free flow of cross-border activity by removing local regulatory restrictions and barriers. This is more commonly referred to as the concentration rule.

An additional objective is the introduction of common reporting requirements across all member states.

MiFID-approved investment firms will now be allowed to access regulated markets of other member states, without the need to utilise the services of a local operator or to establish a local representation within those member states. This regulation will offer the corporate the capability to transact its business through a single investment firm. Previously, the corporate might have had to use several firms depending on the regulated markets they wished to access. Alternatively, a corporate investor may now consider accessing markets which previously they had avoided because it would have meant dealing with an unknown local investment firm or broker, possible language barriers, or local regulatory restraints.

A term which often crops up within MiFID is 'passport'. A passport is a facility that allows an authorised investment firm, which is regulated by its home state (the country in which the investment firm's head office is registered) to offer services and products to clients in other member states, or 'host states'. However, it is still the home state that is used to determine the regulatory authority under which the product or service is protected and regulated. There may be an exception to this rule in the case of transactions entered where the branch of the investment firm is in the same country as that of the client, in which case the host state regulatory rules would apply but this matter is still under discussion with the relevant authorities.

The benefit to the corporate as a result of this enhancement to the passport rule is that they can now be assured their cross-border activities will fall under the same single regulatory regime rather than under the current arrangement under ISD – regulated by the host state where the transactions take place.

FINANCIAL INSTRUMENTS Under ISD, the scope of products and services being offered protection was limited to the equities market in the main. Under MiFID, the scope of investor protection has been greatly extended to include most tradable financial instruments, both on and off balance sheet items, exchange traded as well as over the counter (OTC) and other hybrids such as contracts for differences, credit derivatives and climatic variables, freight rates emission allowances and so on. The one instrument not included in MiFID is spot foreign exchange (FX) transactions.

For the corporate this expansion of product coverage can only mean good news!

CONDUCT OF BUSINESS MiFID makes it very clear that investment firms providing services to clients "act honestly, fairly, and professionally in accordance with the best interests of its clients"³. Put another way, investment firms have to be nice to their clients or else! This will mean that investment firms will need to look very

closely at how they conduct their business.

This requirement will certainly affect transactions and services being offered by the investment firm long before a deal has even been struck. Marketing material will need to be clear, not misleading, and include details of the investment firm, its offerings and its services. Investment firms will be required to give their clients details of the financial instruments and investment strategies on offer as well as guidance and warnings as to the associated risks in dealing in such instruments or strategies.

They will also be required to give details as to the associated cost and charges in undertaking the business as well as all possible execution venues that may be used by the investment firm.

All this information can then be used by the client to make an informed decision on the instrument, service or strategy being offered by the investment firm.

While this is good news for clients, investment firms will need to perform a series of checks and validations on their clients before they will be able to offer any services.

The first part of this process is the client classification. This requires the investment firm to classify the client, and notify it. The client can be classified as being one of the following:

- retail client;
- professional client; and
- eligible counterparty.

Each of these classifications will offer the client differing levels of protection under MiFID, with retail being offered the highest level of protection. Clients will have the ability to ask to be moved between the various categories for individual transactions, products or services or as a blanket, subject to certain conditions. The essential point is to give the investor the ability to request reclassification so they can gain the added protection offered under MiFID.

The next step in the process is to "assess suitability and appropriateness". Investment firms may ask the client to provide information with regard to its knowledge and experience pertaining to the service or product being demanded so that the investment firm can decide on the suitability and appropriateness of the product or service based on the client's requirements and objectives. This rule does not apply to shares traded on regulated markets, bonds and other forms of securitised debt and other non-complex financial instruments or when the service is provided on the client's initiative.

BEST EXECUTION The new legislation states that "investment firms take all reasonable steps to obtain, when executing orders, the best possible results 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"⁴.

This means that best execution is not just simply a matter of getting the best price for the client. Investment firms will now be required to state clearly and notify clients of the 'order execution policy' they will be adopting as a result of the new requirements laid down by MiFID.

The policy statement will need to include details on each instrument class about the differing execution venues available to the investment firm and any factors that may affect the decision on which venue would be used. The policy will also require investment firms who deal on an own-account basis to include these as a possible execution venue. Charges and fees will need to be considered as part of the order execution policy and investment firms

will be required not to discriminate unfairly between execution venues because of costs if they are not true costs to the firm for executing orders at a particular venue. As with a number of these rules, the order execution policy can be overridden if this is specifically requested by the client.

Investment firms will be required to maintain records and demonstrate, at the client's request, that they have executed the order in accordance with their own order execution policy statement.

While this will be excellent news for the corporate investor in providing added protection under MiFID, it may not always be easy to prove or disprove whether best execution has been achieved. For instruments traded on liquid and regulated markets there will be a wealth of data available for comparison purposes. This will certainly not be the case for the more complex derivatives products. These tend to be tailored to meet the needs of the individual investor and therefore there is minimal comparative data available, making any disputes much harder to prove or disprove.

Investment firms' order execution policy statements will require prior approval with the client and will need to be regularly monitored and amended in line with either changes in the market, or in the investment firm's or the client's circumstances.

COMMUNICATION A common factor within MiFID is the high dependency on information flows between investment firm and client. MiFID could be the catalyst for a move away from the more traditional paper-based forms of communication. According to Ketan Pandya, CEO of software infrastructure company Ocean, technology will almost certainly come to the rescue in the shape of the internet. Contracts, documentation, best execution and so on are all capable of being delivered in an instantaneous, secure and cost-effective manner through the latest web-based products.

A final thought on this subject from Brian Ford, Senior Consultant at Aptivaa Consulting, is that the hidden benefit of all this compulsory change is the opportunity to radically overhaul the business-to-business and business-to-client communication framework. Having set up these channels with your banks, what else can you use them for? How much can you save in automated processes, reduced need for data security and storage, operating with real-time management information? And, having successfully implemented this sea change in the way information flows to you, how about repeating the trick by replicating how you communicate with your customers?

POSITIVE LIGHT The corporate investor should most certainly view MiFID in a positive light, because it offers a greater degree of protection, especially for the less sophisticated investors, together with access to a much wider European market.

MiFID also requires that the investment firm has a clearer and better understanding and appreciation of its corporate clients and their objectives. More importantly, it offers the corporate the ability to challenge and question the investment firm to ensure that they have achieved best execution in the interest of the investor.

¹ Full text of the directive at http://europa.eu.int/eur-lex/pri/en/oj/dat/2004/L_145/L_14520040430en00010044

² The EU member countries plus Iceland, Norway and Liechtenstein

³ Article 19(1) of MiFID

⁴ Extract from Article 21(1) of MiFID

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