

Measuring the impact

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THE IMPLICATIONS OF THE MARKETS
IN FINANCIAL INSTRUMENTS
DIRECTIVE FOR TREASURERS.

Executive summary

- The implementation of the Markets in Financial Instruments Directive will affect the securities markets and investment firms of all EU member states. The measures in the directive are primarily targeted at regulated firms operating in the financial markets, but MiFID will also have an impact on corporates active in the markets as customers of regulated firms. Treasurers do not need to be experts on MiFID, but they do need to be aware of the implications for their companies. With this in mind, the ACT has published a guidance note that goes into the full technical details of MiFID as useful background for the treasurer, in-house lawyer, or company secretary. This summary article explains the specific practical changes that will affect corporates.

MiFID is a key part of the European Union's Financial Services Action Plan and is intended to establish a high level of core business standards across firms which provide investment services or trading in securities and financial instruments in Europe. The aim is to encourage uniform standards and, as a result, 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 the Markets in Financial Instruments Directive (MiFID) are primarily intended 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. Apart from some additional paperwork and admin, treasurers should not notice any significant changes in their normal day-to-day dealing activities.

MiFID will come into force in the UK from 1 November 2007 – and, in theory, in the rest of Europe too, although 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. Certain commodity derivatives, if they can be physically settled and are for commercial purposes, are excluded. Commodity and foreign exchange (FX) spot deals are excluded as are forward FX deals done for commercial purposes. If an 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.

HOW WILL YOUR TREASURY OPERATIONS BE AFFECTED?

Client categorisation The requirements of MiFID fall on the regulated financial firms – which, for convenience, I will refer to as 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 have the full set of protections, which reduce if you move to the professional and then eligible counterparty categories. Treasurers will probably 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 size criteria (on a standalone 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 the current 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, and 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 over-the-counter 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 the 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 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 to do its job properly, so 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, 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 (a 50% holding or a dominant influence). However, this will mean that if you are 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 be notified of their automatic transition to a MiFID client categorisation and 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 best execution policy (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 engaged in with your banks, or perhaps are thinking about engaging in, the banks will want to perform some due diligence around your circumstances so they can comply with their suitability and appropriateness obligations.

These sorts of enquiries and provision of information will be 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; if it is not of sufficient size it 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 company.

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 as required by FSA rules;
- Effecting market transactions on your behalf; and
- In respect of equity trading, 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 over-the-counter 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.

The ACT's MiFID for Corporate Treasurers briefing note has been prepared with assistance from Slaughter and May and is available on www.treasurers.org/technical/mifid.cfm

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