Gear up for MiFID

BERNADINE REESE AND **ROB NIEVES** ASSESS THE IMPLICATIONS OF THE MARKETS IN FINANCIAL INSTRUMENTS DIRECTIVE FOR EUROPEAN FINANCIAL MARKETS.

Executive summary

- The Markets in Financial Instruments Directive (MiFID) legislation has been written to ensure consistency across Europe and to avoid "gold-plating" the rules.
- Implementation is less than a year away but financial services organisations lack awareness of MiFID's implications.
- Impact of MiFID across Europe will vary but it is the equity markets that will be most affected.
- Clients are likely to see changes to the nature of the relationship, to the way business is conducted, and the information required of them and provided to them by financial institutions.

The Markets in Financial Instruments Directive (MiFID) is a key component of the EU's financial services action plan and the successor to the 1993 Investment Services Directive. It is set to have a significant impact on the financial services industry. Recognising that the capital markets have changed significantly over the past decade, with greater electronic trading and cross-border services, the EU legislators hope that MiFID will facilitate the more efficient operation of the capital markets while ensuring a consistent level of investor protection across Europe. Some of the changes resulting from MiFID are likely to have an effect on treasury functions where they interact with financial institutions.

MIFID IN PRACTICE Now that the EU legislative process has completed the level 2 requirements (see box overleaf), the Financial Services Authority (FSA) in the UK is facing the task of incorporating the MiFID requirements into its handbook. The FSA is taking this opportunity to move to its stated intention of greater principles-based regulation (that is, incorporating less detailed prescriptive rules) in line with its focus on "better regulation" and the simplification of rules. The EU legislation is tightly framed to try to ensure consistency of rules across Europe and avoid the so-called 'gold-plating' of the rules in certain member states.

There is already considerable activity surrounding the new legislation, but is it sufficient given the significant changes that MiFID will bring to the European financial markets?

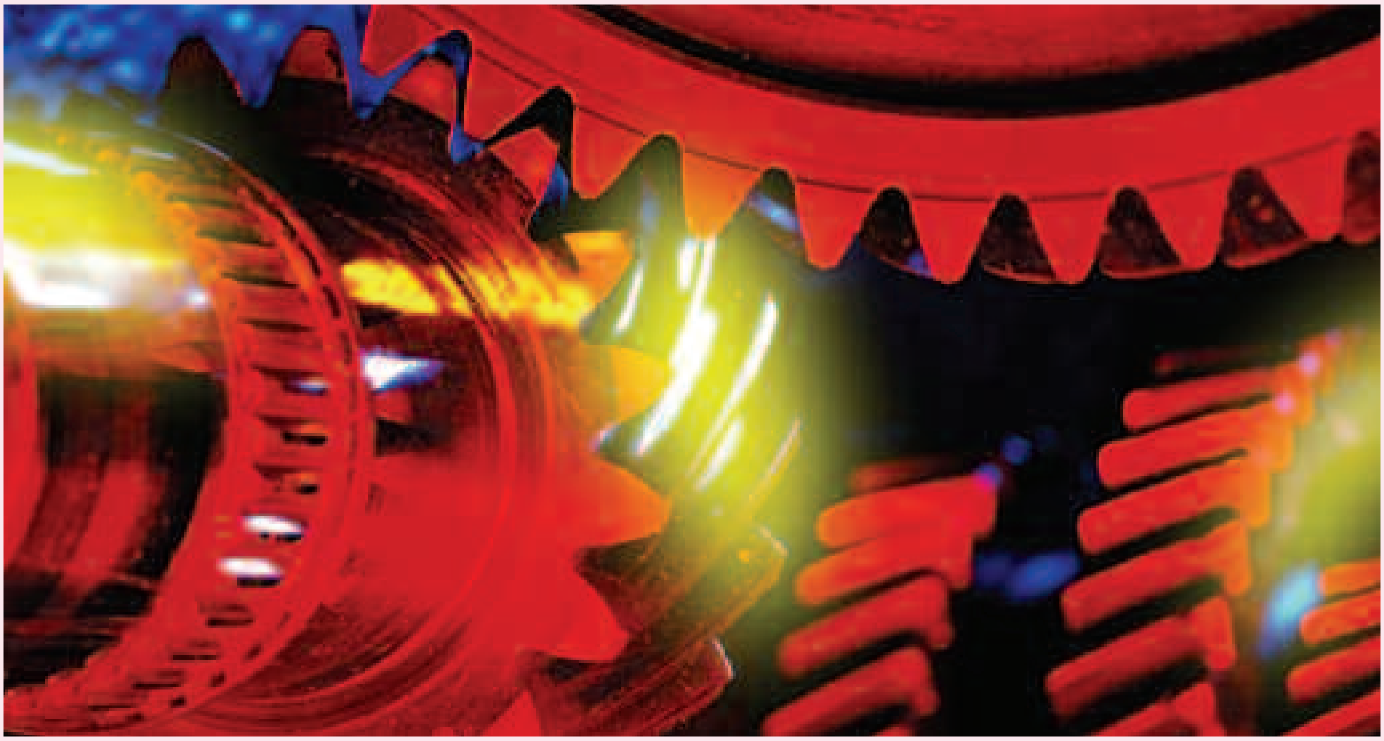
According to KPMG's survey conducted in co-operation with the Economist Intelligence Unit, nearly 50% of board members and senior managers in financial services organisations lack awareness of the implications of MiFID. The implementation date of 1 November 2007 is less than a year away but the implementation challenges facing some financial institutions mean that they need to have implementation projects already well under way if they are to meet the implementation date.

In fact, financial firms that delay implementation until after the FSA's rule changes are published (by 31 January 2007) will almost certainly be too late to take advantage of the strategic opportunities presented by MiFID. The laggards will need to devote resources merely to ensure compliance with the new regulatory requirements.

MIFID ELEMENTS The FSA agrees that firms should be preparing their response to MiFID implementation now, rather than waiting for the FSA consultation papers due to be published during 2006.

The impact of MiFID on UK financial services firms could be significant depending on their business and operational model. However, the impact in the rest of Europe could be much greater than in the UK.

Many of the regulatory requirements that MiFID will introduce are familiar concepts to UK financial firms. For example, the FSA already requires financial services organisations to classify their customers,



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broadly according to their level of financial sophistication.

While the MiFID categories vary slightly from those used by the FSA, in many European countries there is no current regulatory regime for categorising customers. As a result, these institutions will need to categorise all their existing customers before they can deal with them after 1 November 2007. Yet, if anything, the level of MiFID awareness among European boards and senior managers is even lower than that in the UK.

The impacts of MiFID differ significantly by industry segment and by country. There is little doubt that the equities market will be the most affected. MiFID introduces new equity market participants in the form of multilateral trading facilities (similar to existing alternative trading systems) and systematic internalisers.

Firms executing client orders against their own account in certain "liquid" shares will be required to meet the MiFID systematic internaliser requirements, effectively acting as market makers and with obligations around quoting prices and publishing details of trades. This will have a significant impact in many European countries and opens some European equity markets to greater competition. The opportunities – not to mention the IT and other costs – created by this could be immense.

In other segments, such as derivative trading, commodity derivatives (including credit derivatives and exotic derivatives) will be regulated across Europe for the first time.

MiFID also introduces common investor protection requirements across the EU. Investment advice will now be fully regulated and firms will have to assess the suitability of that advice to the client's circumstances. MiFID sets out to achieve its investor protection goals through two means:

- comprehensive information and disclosure requirements to clients; and
- a requirement to obtain "best execution" for clients.

Although on the surface it may appear that some of the requirements mirror existing FSA rules, there are numerous subtle differences in how firms will be expected to interact with their customers. For example, firms will be required in some circumstances to assess appropriateness (different from suitability) and to achieve the best possible result for clients (rather than the best price) for best execution.

SENIOR MANAGERS BEST PLACED TO ASSESS RISK MiFID adopts the UK position that the senior management of firms, not the regulator, is best placed to assess risks and design controls to manage those risks. The trade-off for the UK's less prescriptive, principles-based rules on organisation, governance and controls is that senior management is held responsible for the governance structure and control environment in each company.

MiFID sets out certain requirements in areas such as risk management, compliance, internal audit, managing conflicts of interest, outsourcing, investment research, inducements, client money and custody. Such requirements are largely familiar to UK companies. But the changes could be more substantial for some European countries, particularly in areas such as inducements, the role and independence of compliance, and outsourcing.

In attempting to ensure the integrity of the European financial markets, reporting transactions to the regulator will enable national regulators to monitor the activities of regulated firms. MiFID may extend the obligations to report transactions in new instruments, such as commodity derivatives.

To encourage market integration and competition across Europe, MiFID further entrenches the concept of "home responsibility" for regulation and adds measures to enhance the effectiveness of the European passport (the ability to provide services across Europe once authorised in one of the member states).

So what changes will treasurers see when MiFID comes into effect on 1 November 2007? The impacts will vary by the nature of the investment services provided, the products involved and the client categorisation. Some expected changes could be:

New client categorisation. Many corporate clients are currently classified as "intermediate customers". Under MiFID, large corporates are likely to meet the criteria for classification as "professional clients", but some (particularly those with a balance sheet size of less than €20m or net turnover below €40m) may find themselves classified as "retail clients".

The greater regulatory obligations that apply to transactions with retail clients may mean that financial institutions look to change the way they interact with such clients; charge more for such transactions; or even look to exit such relationships.

In any case, many clients will need to be informed of their new client categorisation which will be notified in writing or electronically together with details of how to request a change to the suggested client category. Many financial institutions also believe it will be necessary to update contractual arrangements and to re-issue new terms of business.

MiFID backgrounder

The EU legislation is being introduced under the four-stage Lamfalussy drafting process. Level 1 is the framework directive (approved in April 2004); level 2 is the implementing directive and regulation; level 3 will be the legal and regulatory requirements set by the regulators in each of the member states; and level 4 will be enforcement.

Implementation of MiFID is currently scheduled for November 2007, with the Treasury and the FSA intending to have legislation in place by 31 January 2007. This deadline gives the FSA little time to consult on changes to the handbook, and companies even less time to consider how these changes can be implemented.

The FSA has announced that changes to its rules, and guidance necessary to implement the directive's requirements will be consulted on through a focused programme of four consultation papers:

- Systems and controls (May 2006), including organisational requirements for MiFID and the Capital Requirements Directive;
- Implementing MiFID for firms and markets (July 2006), including market transparency, transaction reporting, authorisation, permissions, passporting, enforcement and co-operation;
- Reforming conduct of business regulation (October 2006), including conduct of business requirements and conduct of business simplification; and
- Marketing communications (October 2006), including wider changes from the FSA's financial promotions review.

In addition to the consultation papers, the FSA has also released the following informal documents:

- Best execution discussion paper (May 2006);
- Client classification information paper (July 2006); and
- Approved persons regime consultation (September, 2006).

FINANCIAL FIRMS THAT DELAY IMPLEMENTATION UNTIL AFTER THE FSA'S RULE CHANGES ARE PUBLISHED WILL ALMOST CERTAINLY BE TOO LATE TO TAKE ADVANTAGE OF THE STRATEGIC OPPORTUNITIES.

Best execution. All retail clients and professional clients are entitled to receive "best execution" under MiFID. This differs from the current regulatory requirements, which tend to apply only to retail clients as it is possible to agree not to apply best execution for transactions with intermediate customers.

MiFID requires that financial institutions executing orders "obtain the best possible result for their clients taking into account price, costs, speed, likelihood of execution and settlement" and a number of other factors. How best execution will be provided, and demonstrated, by financial institutions is a subject of considerable and vocal debate at present.

Investment advice. Financial institutions that provide investment advice will be required to obtain sufficient information about the client to ascertain that the advice they give is suitable for the client. Under the FSA's rules, this obligation extends only to private clients. While the MiFID requirements are more onerous for retail clients, financial firms will need to obtain information about their clients (for example, regarding their risk appetite and investment objectives) to allow this assessment to be made.

Execution-only transactions. These may also be affected, particularly for smaller corporates which are classified as retail clients for MiFID purposes. Where a client conducts a trade on an execution-only basis for "complex products"(a MiFID-defined term that includes derivatives or structured products), financial firms need to assess the appropriateness of the transaction for the client. The assessment of appropriateness must consider the investment knowledge and experience of the client and ascertain whether the product is appropriate for the client. Where it is considered inappropriate, a warning must be given to the client.

THE GREATEST IMPACT MiFID is expected to have some of the greatest impact of all financial services legislation introduced in the past decade. The effects on financial services organisations may be very significant – especially in continental Europe, where clients are likely to see changes to the nature of the relationship, the way business is conducted, and the information required of them and provided to them by financial institutions.

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