

Markets in Financial Instruments Directive (MiFID): Broad Reforms to EU Financial Services Regulation

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About the Author

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Introduction

The Markets in Financial Instruments Directive (MiFID), 2004/39/EC, which takes effect November 1, 2007, represents a sweeping reform of financial services regulation in the European Union. It replaces the Investment Services Directive that was adopted in 1993. MiFID is a central element of the European Commission's Financial Services Action Plan, which is intended to create a single market for financial services across the EU.

MiFID was developed pursuant to the Lamfalussy process of regulation. This process, developed by Baron Alexandre Lamfalussy, Chair of the European Advisory Committee, is used to create financial regulations in the EU. The process envisions the adoption of a framework or core Directive, followed later by the adoption of an implementing Directive to fill in the interstices of the framework. Other levels of the Lamfalussy process involve CESR and enforcement.

The core or framework for MiFID is Directive 2004/39/EC, while the implementing Directive is 2006/73/EC. In this white paper, reference to an Article or Directive can be assumed to be a reference to the core or framework Directive, while the Implementing Directive will be denominated as such.

Overview

MiFID is a far-reaching piece of legislation that sets out a comprehensive regulatory regime covering investment services and financial markets in the European Union. It contains measures that will change and improve the organization and functioning of investment firms, facilitate cross-border trading and thereby encourage the integration of EU capital markets. At the same time, it will ensure strong investor protection with a comprehensive set of rules governing the relationship that investment firms have with their clients.

MiFID is being implemented because the old Investment Services Directive is out of date and does not work well in many areas. It is being updated to eliminate barriers to cross-border trading and inject fresh competition into the European investment services industry. Also, investor protection needs to be enhanced to attract new investors to EU capital markets. Financial services regulation had to be modified because new services, such as investment advice, and new financial instruments, such as derivatives, need to be brought within the scope of European legislation in order for these products to circulate freely

MiFID was designed in accordance with the better regulation principles and embodies a principles-based approach. The aim is not to tell firms how to run their businesses, but rather to set out the principles they must adhere to. The European Commission has also rejected the one size fits all approach. MiFID recognizes the diversity of market structures and service providers. For example, there are many provisions where the

requirements vary according to the nature, scale and complexity of the particular investment firm and its business, as well as different categories of retail and professional customers.

The Commission's overriding objective is to provide a single, predictable set of rules for firms operating throughout the EU and greater security for consumers buying investment services. In an effort to avoid gold plating, MiFID establishes a highly harmonized regime under which it should not be necessary for Member States to add supplementary rules over and above what is in the Directive. Indeed, they are only allowed to do so in exceptional and strictly defined circumstances to address national or emerging issues that affect investor protection or the stability of their markets.

MiFID abolishes the concentration rule, which means that Member States can no longer require investment firms to route orders only to stock exchanges. Thus, exchanges will be exposed to competition from multilateral trading facilities (MTFs), which broadly are non-exchange trading platforms and systematic internalizers, such as banks or investment firms who systematically execute client orders internally on their own account rather than sending them to exchanges. According to the European Commission, a firm can be a systematic internalizer for derivatives since the definition of systematic internalizer does not make any reference to a specific financial instrument. Thus, an investment firm can be a systematic internalizer for all types of financial instruments, including derivatives.

MTFs and systematic internalisers will be subject to similar pre- and post-trade transparency requirements as the exchanges. This should ensure a level playing field between the exchanges and their new competitors, as well as full information on trading activity to the market.

The Directive also updates the single passport for investment firms. It extends the list of services and financial instruments covered to bring it into line with the new market realities. For example, investment advice is covered for the first time. This reflects modern trends since more and more retail customers are investing in securities and seeking advice from their bank or their broker. The new regime will allow investment firms to provide services across the EU on the basis of a single authorization from their home Member State. At the same time, investor protection rules are strengthened and harmonized at a high level so that investors can feel confident in using the services of investment firms, wherever those firms originate from in the EU. Ensuring investor confidence is critical for pan-European trading to deepen.

MiFID is also good news for consumers. They will have a bigger choice of investment service providers, who will be required to conform to high standards of behavior to their clients. This should allow them to seek out services of the best quality at the cheapest price. Firms will be subject to greater competition forcing them to be more responsible vis-à-vis their clients and to offer a better level of service. More generally, small-scale and retail investors will have a bigger choice of products and services to choose from and equities and bonds to invest in, thus allowing them to maximize the returns on their savings.

Consumers will enjoy the same level of protection whether they choose a domestic service provider or a foreign one. And the level of protection they will have will be high. The measures build in a range of tough safeguards for consumers. For example, there will be strict limits on the inducements that banks or financial advisers can receive in respect of the services that they provide to their clients. When executing client orders, firms will have to take all reasonable steps to deliver the best possible result, which is best execution. For retail clients, the emphasis will be on ensuring that they get the best price for the instrument and the costs associated with the execution.

The approach is not to flood consumers with reams of information that may not be relevant to them and that they may have difficulty in understanding. Instead, the emphasis is on the fiduciary duties of firms towards their clients, which is their duty to always put their client's interests first. This will include a range of measures, including a modern and thorough approach to the identification and management of conflicts of interest. Firms are also required, when providing investment services, to collect sufficient information to ensure that the products and services that they provide are suitable or appropriate for their clients.

Investor Protection

MiFID envisages two types of investor protection mechanisms. On the one hand, firms will have to provide their clients with information about the investment firm, the services it provides and the financial instruments that are the object of these services. This is important. If clients receive sufficient information, they should be able to detect and reject inefficiency and unprincipled conduct by firms. However, this mechanism cannot be relied on entirely. It is no good swamping clients with large amounts of complex information and hoping that they will be able to analyze and evaluate it all and then draw the appropriate conclusions.

MiFID therefore also places considerable emphasis on the fiduciary duties of firms towards their clients. It imposes a number of specific obligations on firms, including best execution and the obligation, when providing investment services, to collect sufficient information to ensure that the products and services that they provide are suitable or appropriate for their clients. It also imposes strict limits on the inducements that banks or financial advisers can receive in respect of the services that they provide to their clients.

Scope of MiFID

MiFID applies to investment firms and regulated markets. Investment firm means any legal person whose regular occupation or business is the provision of investment services to third parties and/or the performance of professional investment activities. Investment services and activities within the scope of MiFID include portfolio management, investment advice, transmission and execution of orders relating to financial instruments, and the underwriting of financial instruments.

MiFID exempts from its coverage, among others, collective investment undertakings and pension funds. It also exempts persons providing investment service incidental to the course of a professional activity, as well as persons providing investment services exclusively in the administration of employee participation schemes. Similarly exempted are persons providing investment advice in the course of providing another professional activity not covered by the Directive.

According to the European Commission, the purpose of the exemption for investment services incidental to a professional activity is to exclude from MiFID scope activities that, if carried out on a professional basis, would constitute the provision of an investment service or activity. As all exemptions, this one should be read in a restrictive way to exclude only such services that are provided incidentally in the course of other activity. “Incidentally” should be understood in this context as a service that arises out of is linked to the main activity of the person and it should not represent a significant part of his or her activities. For example, this may be a situation where a client of a tax advisor or a lawyer empowers him or her to buy or sell particular financial instruments on the client's behalf.

In contrast to individual portfolio management, the management of collective funds by a management company is not an investment service and is therefore not covered by MiFID. Such management companies as well as the collective funds are therefore exempt from the scope of MiFID as far as their operations as collective investment undertakings are concerned. However, when management companies provide other activities, such as investment advice, or individual portfolio management for particular clients, this is not covered by the exemption. Such activities require an authorization under MiFID unless they fall within another relevant exemption, such as the exemption for persons providing investment advice in the course of providing another professional activity not covered by the Directive.

Hedge Funds

Hedge funds and their managers benefit from the exemption under Article 2(1)(h), which exempts collective investment undertakings and pension funds and managers of such undertakings. The European Commission has advised that, if hedge fund products, including fund of hedge funds, are sold or advised on by intermediaries, those intermediaries will not themselves be exempt from MiFID unless they are acting in their capacity as managers of collective investment schemes or come within one of the other exemptions from MiFID.

Transactions executed in financial instruments must be reported to regulators, not to exchanges, under Article 25. However, firms can make use of the exchange's facilities in order to report to regulators. As financial instruments, transactions in units in funds of hedge funds would be subject to reporting requirements if executed by an investment firm.

Commodity Firms

MiFID exempts persons whose main business consists of dealing in commodities and/or commodity derivatives from its scope of application. However, if a commodity firm also provides other investment services, such as investment advice and portfolio management, it is not likely to remain exempt since its main business would not simply consist of dealing on own account.

Under MiFID, the concept of a commodity covers goods of a fungible nature, i.e. goods that are capable of being delivered, including metals and their ores and alloys, agricultural products and energy (electricity, gas, oil). See Article 2(1). Goods are fungible, when any unit of a class of those goods is as acceptable as another unit of that class.

The term “spot contract” is used in relation to commodities. Put simply, it is the contract to purchase or sell a commodity. MiFID regulates trading in financial instruments, one category of which is commodity derivatives, but not the trading of commodities themselves. It is therefore necessary to differentiate between spot contracts and derivative contracts on commodities. This can be difficult as the only difference between a spot and a derivative contract can sometimes be just the time of delivery of the commodity. For example, a contract to buy a ton of gold that is to be delivered to the buyer the following day should be treated as a spot contract while a contract to buy a ton of gold in a year's time would be treated as a commodity derivative, a financial instrument subject to MiFID regulation.

Buying and selling commodity derivatives does not oblige a firm to be licensed. If a firm provides investment services only for its parent or sister company or if it only deals on its account, it is exempt from the scope of MiFID and need not be licensed.

Customer Categorization

The European Commission believes that investor protection should be proportionate and center on the risks that different types of investors are likely to incur. These risks will vary according to the level of knowledge and sophistication of a particular investor. Thus, MiFID distinguishes between three different types of customers, each with a different level of knowledge and sophistication: retail investors, professional investors and eligible counterparties. The obligations that firms will have towards these different categories of client will vary, with the least sophisticated investors receiving the most information and protection and the most sophisticated receiving the least because they are professional experts. Firms must adopt written internal policies to categorize their customers.

MiFID establishes which clients are considered as professional by listing clients that are per se professional, such as investment firms, credit institutions, pension funds,

commodity dealers, and other institutional investors. Retail clients are defined in the negative. They are investors who are not professionals. In other words, any person not listed in MiFID as a professional investor is considered to be a retail investor. It is therefore fairly easy for an investor to know what kind of client they are. Even so, the Directive states that clients should be told which category they have been classified in and be made aware of the legal consequences of such classification, for example that they will have higher or lower levels of protection.

MiFID clarifies that a distinction should be made between the way that the rules are applied to retail clients and the way they are applied to professional clients. Most of the specific rules only apply to retail clients, since professional investors should have the expertise and resources necessary to protect their own interests in the market. However, the fact that they are not covered by most of the measures does not reduce or in any way modify the protection afforded to professional investors by the principles set out in MiFID.

The situation is slightly complicated by the existence of the third category, the eligible counterparties, who are actually a sub-category of the professional client category. In other words, eligible counterparties are all professional investors but not all professional investors are automatically eligible counterparties. Article 24(2) of MiFID sets out a list of per se eligible counterparties, that is, those entities that are automatically recognized as eligible counterparties. Among the entities on the list are investment firms, credit institutions, insurance companies, pension funds, central banks, and national governments.

MiFID also gives Member States the option to recognize other entities as eligible counterparties upon request. The Implementing Directive, Article 50, specifies the requirements that such entities need to meet in order to request treatment as an eligible counterparty. Since eligible counterparties are considered to be the most sophisticated class of investors, they are afforded the lowest level of protection. When they receive certain types of services, they do not benefit from the protections afforded retail investors.

Under Article 28(3) of the Implementing Directive, an investment firm can unilaterally decide to treat any or all of its clients as retail clients if it chooses to do business on that basis. Firms that choose to do so are likely to be able to simplify their internal processes relating to, and dependent on, client classification.

Moving Between Categories

Once classified in one category, clients may change this classification if they meet certain criteria and comply with a particular procedure. Thus, for example, a retail investor who believes that he or she has a high level of experience and can manage with a lower level of protection might decide to become a professional investor. Equally, professional

investors who feel that they need a higher level of protection might ask to become a retail investor. The firm must make their customers aware of the option to change their classification. When a client requests a different categorization, the investment firm has the choice whether to provide services on that basis. If the firm does not agree, the client will need to source services with the desired level of protection elsewhere.

When a retail customer requests treatment as a professional customer, the firm must take reasonable care to ensure that the client is able to pass a qualitative and quantitative test. The qualitative assessment requires the firm to undertake an adequate assessment of the client's expertise and knowledge to give reasonable assurance, in light of the transactions and services envisaged, that the client is capable of making his or her own investment decisions and understanding the risks involved. See MiFID Annex II.II.1. Further, the client must satisfy a quantitative test by meeting at least two of the following criteria:

- The client has carried out significant market transactions on an average of ten per quarter over the four previous quarters.
- The size of the client's financial instrument portfolio exceeds EUR 500,000;
- The client has worked in the financial sector for at least one year in a professional position requiring knowledge of the transactions and services envisaged.

Retail customers must state in writing that they wish to be treated as professional clients. Also, the investment firm must give a clear written warning of the rights the client will lose by changing its status. And the client, in a separate document, must state its awareness of the consequences of waiving the retail protections.

Information Provided to Customers

Before making an investment decision, a firm's customers must receive adequate information so that they can make their choice on an informed basis. That is why the Directive specifies the exact type of information that needs to be provided to retail clients. For example, retail clients have to receive: general information about the investment firm and its service; sufficiently detailed information about the specific type of financial instrument; and information about the costs and charges that the client has to pay.

Additionally, the Directive determines when the client has to receive this information. The paramount principle here is that the client has to have sufficient time to read and understand the specific information provided before making an investment decision. Under Article 30 of the Implementing Directive, investment firms must provide retail clients with the following information:

- the name and address of the investment firm, and the contact details necessary to enable clients to communicate effectively with the firm;
- the languages in which the client may communicate with the investment firm, and receive information from the firm;
- the methods of communication to be used between the investment firm and the client;
- a statement of the fact that the investment firm is authorized and the name and contact address of the competent authority that has authorized it;
- where the investment firm is acting through an agent, a statement of this fact specifying the Member State in which that agent is registered;
- the nature, frequency and timing of the reports on the performance of the service to be provided by the investment firm to the client;
- if the investment firm holds client financial instruments or client funds, a summary description of the steps that it takes to ensure their protection, including summary details of any relevant investor compensation or deposit guarantee scheme that applies to the firm by virtue of its activities in a Member State;
- a description, which may be provided in summary form, of the conflicts of interest policy maintained by the firm in accordance with Article 22;
- at any time that the client requests it, further details of that conflicts of interest policy in a durable medium.

Further, when providing the service of portfolio management, investment firms must establish an appropriate method of evaluation and comparison such as a meaningful benchmark, based on the investment objectives of the client and the types of financial instruments included in the client portfolio, so as to enable the client to assess the firm's performance.

Also, when investment firms propose to provide portfolio management services to a retail client, they must provide the client with information on the method and frequency of valuation of the financial instruments in the client portfolio and details of any delegation of the discretionary management of all or part of the financial instruments or funds in the portfolio.

Under Article 31 of the Implementing Directive, investment firms must provide customers with a general description of the nature and risks of financial instruments,

taking into account the client's categorization as either a retail client or a professional client. That description must explain the nature of the specific type of instrument concerned, as well as the risks particular to that specific type of instrument in sufficient detail to enable the client to make informed investment decisions. The description of risks must include, where relevant to the specific type of instrument concerned and the status and level of knowledge of the client, the following elements:

- the risks associated with that type of financial instrument including an explanation of leverage and its effects and the risk of losing the entire investment;
- the volatility of the price of such instruments and any limitations on the available market for such instruments;
- the fact that an investor might assume, as a result of transactions in such instruments, financial commitments and other additional obligations, including contingent liabilities, additional to the cost of acquiring the instruments;
- any margin requirements or similar obligations, applicable to instruments of that type.

Under Article 32 of the Implementing Directive, investment firms holding financial instruments or funds belonging to retail clients must tell them where the financial instruments or funds of that client may be held by a third party on behalf of the investment firm and of the responsibility of the firm for any acts or omissions of the third party and the consequences for the client of the insolvency of the third party.

Similarly, when the financial instruments of the retail client may be held in an omnibus account by a third party, the firm must inform the client of this fact and give a prominent warning of the risk. Also, the firm must tell the retail and professional clients when their accounts are subject to the law of a jurisdiction other than that of a Member State and tell the clients that their rights relating to those financial instruments or funds may differ accordingly.

An investment firm must also inform retail and professional clients about the existence and the terms of any security interest or lien that the firm has over their financial instruments or funds, or any right of set-off it holds in relation to those instruments or funds. Where applicable, it must also inform the client of the fact that a depository may have a security interest or lien over, or right of set-off in relation to those instruments or funds.

Before entering into securities financing transactions in relation to financial instruments held by it on behalf of a retail client, the investment firm must in good time before the use of those instruments provide the retail client, in a durable medium, with accurate

information on the duties of the firm with respect to the use of those financial instruments, including the terms for their restitution, and on the risks involved.

Finally, under Article 33 of the Implementing Directive, investment firms must provide their retail clients with information on costs and associated charges, including such of the following elements as are relevant:

- the total price to be paid by the client in connection with the financial instrument or the investment service, including all related fees, commissions, charges and expenses, and all taxes payable via the investment firm or, if an exact price cannot be indicated, the basis for the calculation of the total price so that the client can verify it;
- where any part of the total price is to be paid in or represents an amount of foreign currency, an indication of the currency involved and the applicable currency conversion rates and costs;
- notice of the possibility that other costs, including taxes, related to transactions in connection with the financial instrument or the investment service may arise for the client that are not paid via the investment firm or imposed by it;
- the arrangements for payment or other performance.

All information provided to customers must be fair, clear and not misleading. The Implementing Directive sets out (Article 27) the specific objective standards that specify how information provided to clients must meet these three criteria. The information, required by Article 19 (3) of the Directive must be provided to clients in a durable medium. The term “durable medium” means any instrument that enables a client to store information addressed personally to that client in a way accessible for future reference for a period of time adequate for the purposes of the information and that allows the unchanged reproduction of the information stored. See Article 2 of the Implementing Directive.

With regard to providing information in a durable medium, said the European Commission, firms may provide the information to their clients on a web site only if certain conditions are satisfied. The client must have chosen expressly to receive the information on the web. Additionally the firm has to notify the client of the relevant web address. Finally, the information has to be published continuously on the web to ensure that the person to whom the information must be provided is able to look over it and reproduce it.

The requirement for the information given to clients to be fair, clear and not misleading also applies to marketing communications. However, there are many ways in which a marketing communication can reach a client or a potential client. This is why firms and

regulators need to take proper account of the means of communication, as well as the information contained in marketing communications, when applying the regulations.

Given the large number and diverse range of communications that are covered by these requirements, MiFID clarifies that it would neither be appropriate nor proportionate to apply such requirements to marketing communications that contain only a very limited amount of information (such as the logo or image of the firms).

Regarding professional clients, the general approach is that they have a sufficient level of knowledge to enable them to identify themselves the information that is necessary for them to make an investment decision. Investment firms are therefore only obliged to provide professional clients with information if they request it, unless the provision is explicitly directed to all types of clients, for example, some parts of Article 32 of the Implementing Directive.

Suitability and Appropriateness

MiFID requires firms to act in a client's best interest (Article 19(1)). This obligation finds expression in different specific obligations, including the suitability and appropriateness tests. Thus, firms must assess whether the service they provide to a client is suitable or appropriate for the client's needs and personal circumstances on the basis of information about the client that they have to collect. Firms must assess the suitability of a service or transaction when providing services that entail an element of recommendation on the part of the firm, investment advice and portfolio management. See Article 19(4).

There is no explicit requirement in the Directive as to the period between the assessment of the suitability and the actual provision of the investment service that is considered acceptable. According to the European Commission, the matter of assessment is on a case-by-case basis. Essential for this assessment is the requirement of MiFID to provide the client a suitable recommendation. That is why, for example, advice provided a very long time after the information gathering may not be suitable any more if changes have occurred in the client's personal circumstances or in relevant financial markets. It is for the firm to ensure that it has provided a suitable recommendation to its clients.

The same principle applies in respect to the appropriateness test. It is the investment firm's responsibility to provide a service that is appropriate for the client at the moment when the service is provided. Under Article 19(5), firms must apply the appropriateness test for other services, where clients do not rely on firms' recommendations (for example execution of orders, reception and transmission of orders).

The two tests are different in the degree of information gathering and the rigor of the assessment that is necessary. The appropriateness test is less wide-ranging than the suitability test in that firms need only assess whether the client has the knowledge and experience necessary to understand the risks in relation to the specific type of product or

service in question. See Article 37 of the Implementing Directive. For the purposes of the suitability test, the firm also has to collect additional information about the client's financial situation and investment objectives.

The regulatory consequences of the two tests are also different. While an investment firm is not allowed to provide an unsuitable recommendation, it may provide a service that it considers as not appropriate, as long as the client is given adequate warning.

Note that investment firms cannot provide investment advice or portfolio management without first carrying out the suitability test. In turn, they cannot carry out this test if they do not have the necessary information. They must therefore obtain this information before performing the service. See Article 19(4).

Article 35 of the Implementing Directive states that, when a client refuses to provide any information, the investment advice or service cannot be provided. Similarly, according to the European Commission, if at the beginning of a relationship the client refuses to give the portfolio manager the information requested by the manager that is relevant for the suitability assessment, the manager may not provide the client with the service, even on the most prudent basis. This is because Article 19(4) states that the manager must obtain adequate information prior to the commencement of the investment service. If there is an ongoing relationship and a client requests a change of mandate to the portfolio manager, the manager must obtain adequate information to be able to effect that change in line with the suitability regime. See Article 35(5) of the Implementing Directive.

The European Commission has noted that the assessment of the client's knowledge and experience is an essential part of the suitability test and it cannot be carved out. That is why Article 35 explicitly stipulates that the client should be able to understand the risks involved in the transaction. If this is not the case, the investment firm is not allowed to provide such a recommendation.

An execution-only service is an investment service that consists only of execution or the reception and transmission of client orders. When carrying out execution-only services, firms are not obliged to assess appropriateness. This has the advantage of allowing clients to receive faster and cheaper services. However, it is important that it does not result in unjustifiable increased risks for the client. That is why MiFID makes the provision of execution-only services subject to several mandatory conditions. See Article 19(6).

First, execution only services are possible only in transactions related to instruments that are considered non-complex. The presumption is that the structure of non-complex instruments is so simple that clients can be expected to easily understand the characteristics and risks associated with them. The appropriateness test should not therefore be necessary. Second, the provision of execution-only services is only allowed if the client has requested it. Finally, the firm must warn the client that it is not going to assess the appropriateness of the transaction and it must comply with the requirements relating to conflicts of interest.

MiFID explicitly mentions (in Article 19(6)) some financial instruments in which execution-only services are possible, for example, shares that are admitted to trading on a regulated market or money market instruments.

According to the European Commission, complexity for the purposes of the Directive is determined by the way that an instrument is structured. The level of complexity of a financial instrument's structure will affect the ease with which the risk attached to the product may be understood. Thus, all derivatives are assumed to be complex because their value is derived from another financial instrument or asset, adding a level of complexity to the understanding of the characteristics and valuation of those instruments.

MiFID allows firms to provide investment services in derivatives and other complex instruments to retail clients. But firms cannot provide execution only services in complex instruments to retail clients. This means that the firm is obliged to assess the appropriateness of the service, that is, whether or not the client understands the risks involved in it.

Best Execution

Best execution means that, when firms execute client orders, they must take all reasonable steps to deliver the best possible result for their clients, taking into account a variety of factors, such as the price of the financial instrument, speed of execution of the order and cost. For retail clients, best possible means the most favorable result in terms of the price of the instrument and the costs associated with the execution.

This means that if, all else being equal, venue A offers an instrument for 100 euros and the costs of executing on that venue (e.g. exchange fees, settlement fees, etc.) amount to 5 euros (making the total consideration equal to 105 euros), while another venue B offers the same instrument for 102 euros with costs of execution equal to 2 euros, the investment firm should execute a client order to buy this financial instrument on venue B, since the total consideration of 104 euros delivers a better result for the retail client.

Best execution is a core principle of MiFID and is fundamental for investor protection. When providing investment services to their clients, investment firms are obliged to act honestly, fairly and professionally in accordance with the best interests of their clients. This fiduciary duty an investment firm owes its client is further developed in the best execution obligations contained in Article 21.

This area is singled out because of the information asymmetry arising between the service provider and the client. Under normal circumstances, clients have very little opportunity to monitor whether the investment firm that executes orders on their behalf has indeed acted in their best interest since they are unlikely to have the access to the relevant information that would help them assess the quality of the service. But even if

such information were freely available, clients would probably not have the time or specialist knowledge to understand or evaluate detailed disclosures related to the execution of their orders, nor the resources to make an effective comparative evaluation of the execution policy of the firm.

There is thus a danger that some investment firms could take advantage of this information asymmetry by giving unfair treatment to their clients without necessarily suffering the usual reputational consequences in a competitive market. This is why MiFID established a clear obligation for the execution of client orders.

MiFID establishes a regime where multiple trading venues will be able to compete for client order flow. Competition between trading venues should lower the cost of transacting financial instruments and thus contribute to the greater efficiency of European capital markets. However, it is well known that liquidity pools are extremely sticky, which means it is extremely hard for new trading centers to attract new business even if they can provide better services than their competitors.

As trades are driven to those venues that can consistently provide the highest quality results, the best execution obligation will help ensure that firms are not able to ignore such venues. Apart from promoting competition, best execution obligations should thus also contribute to greater market integration.

Best execution is not limited to shares but applies to all financial instruments. However, investment firms, though always subject to best execution obligations, are not expected to meet these obligations in the same way for each type of instrument.

Investment firms must implement effective arrangements for complying with the requirement to deliver best execution. In particular, they must establish and implement an order execution policy to allow them to obtain, for their client orders, the best possible result. This execution policy is therefore the firm's key instrument in achieving best execution. It must at least include, in respect of each class of instruments, information on the different venues, such as stock exchanges, but also multilateral trading facilities, where the investment firm executes its client orders and the factors affecting the choice of execution venue. Further, it must include those venues that enable the investment firm to consistently obtain the best possible result for the execution of client orders. The policy should differentiate between different types of client.

When assessing a particular firm's compliance with MiFID, regulators will decide whether the firm's policy is adequate and whether the firm adheres to its policy in practice. The policy will also have to be dynamic. Investment firms must monitor its effectiveness in order to identify and, where appropriate, correct any deficiencies. In particular, firms must regularly assess whether the execution venues included in the policy are actually delivering best execution and make appropriate changes when necessary. For example, the policy may have to be amended to take account of the emergence of new venues.

In most cases, to have a reasonable chance of securing the best possible result for their clients, firms should assess a choice of venues. This will allow them to determine which venue is offering the best conditions and to route the order to that venue. The European Commission has noted that it is possible that a firm using a single venue for the execution of its client orders could comply with the best execution rules, depending on specific circumstances such as type of clients and financial instruments. But the Commission expects that the greatest competition among execution venues will be in the area of share trading. As more venues attract liquidity and compete, reasoned the Commission, it will become harder for investment firms to execute orders at only one venue and still meet the best execution obligations. CESR has published detailed guidance on this subject at www.cesr.eu.

MiFID also obliges execution venues to make available to the public, on a reasonable commercial basis, pre- and post-trade information, which means that execution venues may charge fees for making the data available to third parties. It is conceivable that investment firms will obtain this information directly from the execution venues, but it is more likely that data vendors will consolidate this information to allow firms to evaluate the venues' execution quality

A firm must have access to at least the venues cited in its execution policy. This can be achieved by gaining access to these venues directly, such as by becoming a member of an exchange, or via an intermediary. Clearly, the cost of direct access to a multitude of venues may be high. In many cases, therefore, an indirect access through an intermediary may be the best solution. However, the commissions paid to intermediaries providing access to execution venues can mount up over time and it may become clear that gaining direct access is more economical and efficient than going through intermediaries. Firms will have to monitor and regularly review their execution policy and decide whether direct access or intermediated access is likely to secure the lowest execution costs for their clients.

For their part, regulators will have to decide whether the decisions taken by firms are reasonable. In doing so, they will take into account of a number of factors, including the size and cost structure of the firm concerned. These intermediaries may be numerous, ranging from classical brokers to what one could call best execution package providers, who are service providers specializing in delivering off-the-shelf solutions to best execution. As best execution is composed of many elements, data gathering and analysis, connectivity or access to execution venues, and order routing, it is likely that products that integrate all the different steps of order execution in such a way as to ensure compliance with the Directive will become quite popular. Depending on the investment firm, the type of business it undertakes and the type of clients it serves, investing in such packaged solutions may be one simple way of ensuring best execution.

Under MiFID, investment firms are responsible for best execution even when they do not execute their client orders directly but rather transmit them to other intermediaries who then execute them. In this case, both the investment firm itself and the other

intermediaries who actually execute the client orders will be subject to the best execution obligations. The important point is that the firm that is in contact with the client will always be directly responsible to the client.

Note that the best execution obligation also applies to firms that initiate trades as portfolio managers. See Article 45 of the Implementing Directive. This is because there is no real difference in the duty a firm owes to clients who initiates orders themselves and clients who delegate the decision to initiate orders to the investment firm.

Under Article 21, a firm's customers can define the factors that are important to them for the execution of their orders or tell their broker to execute at a venue of their choice. Firms have to obtain prior consent from their clients as regards their execution policy. Clients may agree to the policy or they may decide to issue their own specific instructions, for example to execute at a single venue of their choice. These instructions always prevail over what is in the policy. When a client gives an instruction relating to just one area, such as price limits, the firm is still bound by its best execution obligations in other areas in which no client instructions have been given.

Customers can know how and where their brokers are executing their orders because firms have to report to their clients the details of the transactions they have executed on their behalf. See Article 19(8). This includes the price at which a particular instrument was bought or sold, the venue where the transaction was carried out and the time of the trade. Moreover, clients can demand that a firm show them how it has complied with its best execution policy.

Order Handling

MiFID prohibits brokers from benefiting from the information they get from their clients' order flow. Specifically, brokers must prevent the misuse of all information relating to pending client orders. See Article 47(3) of the Implementing Directive. Investment firms must establish procedures allowing for the execution of otherwise comparable client orders (e.g. orders that are received through the same channel) in accordance with the time of their reception by the investment firm. The Directive provides more detail in relation to sequential order execution in situations where orders come into the firm through a variety of different media, such as telephone or internet.

Client orders should not be treated as otherwise comparable if they are received by different media and it would not be practicable for them to be treated sequentially. This means that it may not be possible to ensure an absolute sequential treatment of orders and, in such circumstances, it may be accepted that some of the client orders are not executed in perfect accordance or sequence with the time of their reception by the investment firm.

Outsourcing

While firms are permitted to outsource functions, MiFID considers outsourcing to be a serious matter and carefully regulates it. Outsourcing must never result in the delegation of the investment firm's responsibility, alter the relationship and duties of the investment firm towards its clients, or undermine the conditions with which an investment firm must comply in order to remain authorized.

These conditions apply to the outsourcing of any investment services or any critical or important operational functions. For this purpose, an operational function is regarded as critical or important if a defect or failure in its performance would materially impair the continuing compliance of an investment firm with the conditions and obligations of its authorization or its other obligations under the core Directive, or its financial performance, or the soundness or the continuity of its investment services. See Article 13 of the Implementing Directive.

Further, when entering into, managing or terminating any arrangement for outsourcing a particular function to a service provider, investment firms must comply with many other requirements. See Article 14 of the Implementing Directive. For example, an investment firm must ensure that the service provider has the ability, capacity and any authorization required by law to perform the outsourced function.

Special conditions apply when an investment firm outsources the investment service of portfolio management provided to retail clients to a service provider located in a third country. See Article 15 of the Implementing Directive. In such cases, apart from complying with all the other conditions, an investment firm must ensure that the service provider is authorized in its home country to provide such a service and that there are cooperation agreements between the competent authority of the investment firm and the regulator of the service provider.

When one or both of these conditions are not satisfied, an investment firm may still outsource the management of retail client portfolios to a third country service provider; but only if it gives prior notification to its regulator about the outsourcing arrangement and the regulator does not object to that arrangement within a reasonable time of receiving that notification. According to the European Commission, the firm to which the service is outsourced, if it is based in a third country, will not be subject to MiFID. Thus, the Directive does not require that firm to be made subject to MiFID obligations by way of the outsourcing agreement. However, the outsourcing arrangement must not result in the MiFID investment firm breaching its MiFID obligations.

Conflicts of Interest

In many cases, acting for two competitors presents a conflict of interest that potentially risks damage to the interests of one or both clients. This will be so where the firm has an

advisory or strategic relationship with one or both clients, and the clients' activities can come into conflict, when, for example, both clients are large investors. Investment firms that provide investment and ancillary services must draw up a comprehensive written policy identifying the steps that will be taken for identifying and managing conflicts of interests that present the risk of damage to client interests. See Article 22 of Implementing Directive.

The conflicts of interest policy must be appropriate to the size and organization of the firm and the nature, scale and complexity of its business. Where the firm is a member of a group, the policy must also take into account any circumstances, of which the firm is or should be aware, which may give rise to a conflict of interest arising as a result of the structure and business activities of other members of the group.

The conflicts of interest policy must include the following content: (1) it must identify the circumstances that may give rise to a conflict of interest entailing a material risk of damage to the interests of clients; and (2) it must specify procedures to be followed and measures to be adopted in order to manage such conflicts. See Article 22 of the Implementing Directive. The procedures to be followed and measures to be adopted must include such of the following as are necessary for the firm to ensure the requisite degree of independence:

- effective procedures to prevent or control the exchange of information between persons engaged in activities involving a risk of a conflict of interest where the exchange of that information may harm the interests of one or more clients;
- the separate supervision of persons whose principal functions involve carrying out activities on behalf of, or providing services to, clients whose interests may conflict;
- the removal of any direct link between the remuneration of persons principally engaged in one activity and the remuneration of, or revenues generated by, different persons principally engaged in another activity, where a conflict of interest may arise in relation to those activities;
- measures to prevent or limit any person from exercising inappropriate influence over the way in which a person carries out investment or ancillary services or activities;
- measures to prevent or control the simultaneous or sequential involvement of a person in separate investment or ancillary services or activities where such involvement may impair the proper management of conflicts of interest.

If the adoption or the practice of one or more of those measures does not ensure the requisite degree of independence, investment firms must adopt such alternative or additional measures as are necessary for those purposes

When the steps taken are insufficient to ensure, with reasonable confidence, that risks of damage to client interests will be prevented, the source of conflicts must be disclosed to the client. For example, an investment firm that underwrites a particular financial instrument may need to disclose a conflict of interests when providing investment advice to its clients in relation to this financial instrument. Sufficient detail must be provided to enable the client to take an informed decision with respect to the relevant investment or ancillary service.

Investment firms should identify and manage the conflicts of interests arising in relation to their various business lines under a comprehensive conflicts-of-interest policy. While disclosure of specific conflicts of interests is required by MiFID Article 18(2), the European Commission considers undesirable an over-reliance on disclosure without adequate consideration as to how conflicts may appropriately be managed.

Investment firms must also keep and regularly update a record of the kinds of investment or ancillary service or investment activity in which a conflict of interest entailing a material risk of damage to the interests of clients has arisen or, in the case of an ongoing service or activity, may arise. See Article 23 of Implementing Directive.

MiFID contains specific rules on conflicts management for investment research. See Article 25 of Implementing Directive. These rules apply to firms that produce or disseminate investment research that involves recommendations labeled as investment research or otherwise held out as objective, and that are not tailored to particular services.

A firm producing or disseminating investment research must implement a number of specific steps, which are detailed in Article 25. Generally, all the steps are designed to preserve the objectivity of the analysts concerned by according them an appropriate degree of independence from other parts of the firm whose business interests may conflict with the interests of the recipients of the research. The rules largely reflect the 2003 IOSCO standards for analysts' conflicts.

Specifically, analysts should be isolated from improper influences from at least corporate finance personnel and persons involved in sales and trading on behalf of clients or the firm. The flow of information between analysts and such people should be controlled, and remuneration, supervision and joint activities must be controlled to ensure that analysts' independence is preserved. Analysts and others must be prevented from dealing ahead of investment research, and other personal account transactions restrictions must be implemented. There are also restrictions on inducements, promising favorable coverage and the review of draft recommendations.

In addition, financial analysts should not become involved in activities other than the preparation of investment research where such involvement is inconsistent with the maintenance of that person's objectivity. The following involvements should ordinarily be considered as inconsistent with the maintenance of that person's objectivity: participating in investment banking activities such as corporate finance business and underwriting, participating in pitches for new business or road shows for new issues of financial instruments; or being otherwise involved in the preparation of issuer marketing. According to the European Commission, analysts may not attend or participate in road shows if doing so would be inconsistent with the analyst's objectivity, or could reasonably be considered to be so. Normally, active participation would be unacceptable, while mere passive attendance would be acceptable.

Investment firms that disseminate investment research produced by another person to the public or to clients are exempt from the above requirements if the following criteria are met:

- the person that produces the investment research is not a member of the group to which the investment firm belongs;
- the investment firm does not substantially alter the recommendations within the investment research;
- the investment firm does not present the investment research as having been produced by it;
- the investment firm verifies that the producer of the research is subject to requirements equivalent to the requirements under MiFID.

Corporate Governance

Firms must have a compliance function and a compliance officer responsible for overseeing it. In this context, the term function denotes an investment firm's employees responsible for carrying out compliance activities and is not intended to prejudge any particular organizational arrangements. Sometimes it is possible not to have a specific risk management function or an internal audit function. This will depend on the size and complexity of the business. Nevertheless, firms will always have to put in place proper risk management strategies and have good internal control mechanisms.

All investment firms do not necessarily have to have separate and independent compliance, risk management, and internal audit functions. MiFID's requirements are graduated in such a way as to be adaptable to all sorts of businesses ranging from large global institutions to one-person investment firms. It is expected that global institutions will have separate and independent compliance, risk management and internal audit

functions, while the small firms will benefit from the flexibility clauses and are not obliged to maintain such a high degree of organizational segregation.

It is possible to outsource some of the activities associated with the performance of the compliance, risk management and internal audit functions. However, an investment firm may not outsource the responsibility for those functions and should always retain the necessary expertise to effectively supervise the outsourced activities.

Firms must produce a formal annual report commenting on their compliance activities. And this should be the bare minimum. The European Commission expects a firm's management to receive frequent reports on these matters because it is responsible for the overall sound management of the investment firm, its compliance with all relevant laws and regulation and, in particular, for the proper and effective operation of the compliance function.

Under Article 9, persons who effectively direct the business of an investment firm must be of sufficiently good repute and sufficiently experienced as to ensure the sound and prudent management of the firm. The firm must notify its regulator of any changes to its management, along with information needed to assess whether the new management are of sufficiently good repute and sufficiently experienced. In turn, the regulator must refuse authorization if unsatisfied that the new management is of sufficient experience or repute, or if there are objective grounds for believing that the changes pose a threat to the firm's prudent management.

Employees of the firm may not enter into personal transactions in instruments in relation to which they possess inside information. See Article 12(1) of the Implementing Directive. This means that they may not even advise or procure other people to enter into such transactions. In any case, the firm should be aware of all personal transactions their employees carry out. The restrictions on personal transactions do not apply to transactions that are effected by an employee's discretionary portfolio manager or to transactions in units in collective investment undertakings that meet strict diversification criteria (e.g. UCITS). See Article 12(3).

Risk Management

Investment firms must maintain adequate risk management policies identifying the risks relating to the firm's activities, processes and systems, and where appropriate, set the level of risk tolerated by the firm. The firm must monitor the effectiveness of the risk management policies and the level of compliance by the firm and its relevant persons with the processes. The firm must also monitor the effectiveness of measures taken to address any deficiencies in risk management, including failures by the relevant persons to comply with such processes or follow such policies. See Article 7 of the Implementing Directive.

Investment firms must also, when appropriate and proportionate in view of the nature, scale and complexity of their business and the nature and range of the investment services and activities undertaken in the course of that business, maintain a risk management function that operates independently and implements effective risk management policies.

Internal Audit

When appropriate and proportionate in view of the nature, scale and complexity of their business and the nature and range of investment services and activities, investment firms must maintain an internal audit function that is separate and independent from the other functions and activities of the investment firm. Internal audit must implement an audit plan to examine and evaluate the effectiveness of the investment firm's systems, internal control mechanisms and arrangements and verify compliance with any recommendations or issues, as well as report internal audit matters to senior management. See Article 8 of the Implementing Directive.

Compliance Officer

Investment firms must establish an effective and independent compliance function to monitor and regularly assess the effectiveness of compliance measures and the actions taken to address any deficiencies in the firm's compliance with its obligations. The compliance function must be given the resources and authority to discharge its duties properly and independently. See Article 6 of the Implementing Directive. Further, a compliance officer must be appointed and must be responsible for the firm's compliance function and for any required reporting as to compliance to senior management. The relevant persons involved in the compliance function must not be involved in the performance of the services or activities they monitor and the method of determining the remuneration of the relevant persons involved in the compliance function must not compromise their objectivity.

However, an investment firm need not comply with the remuneration or performance of duties requirements if it can demonstrate that, in view of the nature, scale and complexity of its business, and the nature and range of investment services and activities, the requirement is not proportionate and that its compliance function remains effective.

Regulatory Cooperation and Transaction Reporting

The main purpose of transaction reporting and cooperation among regulators is to enable the regulators to properly monitor the activities of their firms in order to uphold the integrity of the markets. This should be done in a way that is effective but that makes it as easy as possible for firms to buy and sell financial instruments across borders. Under MiFID, firms will only have to report transactions once, to their home regulator. There is no obligation to report transactions to the regulator of the market where the trades have

been executed. The regulators in the different Member States will have to exchange information concerning transactions in order to ensure that the activities of investment firms are properly monitored.

Regulators must automatically receive information concerning transactions in financial instruments for which they are the competent authority of the most relevant market in terms of liquidity. See Article 25(3). For example, a German investment firm will report trading in Vodafone shares to its regulator and that regulator will then pass on this information to its UK counterpart as it is the competent authority of the most relevance to Vodafone. Competent authorities may also request additional information. For example, the UK authorities could ask the German authorities to provide them with information concerning transactions in Vodafone derivatives or other financial instruments that involve Vodafone shares.

MiFID aims at harmonizing the content of the reports. However, Member States are given a possibility, in restricted circumstances, to add extra reporting obligations.

MiFID sets out what information concerning the transactions carried out by an investment firm must be reported. See Article 12 of the Implementing Directive. The regulation specifies and describes particular data fields that need to be reported, but does not prescribe the particular technical standards that should be used.

In principle, regulated markets should not be subject to regulation by more than one authority. Normally, a regulated market will be regulated by its home competent authority, which is the regulator that authorized its operations. Exceptionally, however, MiFID provides for a reinforced cooperation of competent authorities when a regulated market becomes of substantial importance in another Member State. This possibility to establish appropriate cooperation arrangements is triggered when, for example, a regulated market merges with another regulated market or when there is another change of ownership of regulated markets. The legal texts do not specify what this reinforced cooperation entails. This is left up to the competent authorities to determine.

Transparency

Transparency is another core principle of MiFID. Transparency is allowing investors and market participants to know at what prices they can buy or sell a share, pre-trade transparency, and at what prices shares have been sold and bought, post-trade transparency. Large trades are subject to limited transparency. In the case of pre-trade transparency, orders bigger than certain thresholds need not be displayed to the public. . In the case of post-trade transparency, large trades are made public but only after a certain period of time has elapsed.

These exceptions to the transparency rules have been introduced in order to take into account the trade-off between transparency and liquidity provision, for example, sometimes too much transparency may reduce the willingness of actors to place their own capital at risk and thus facilitate trading because exposing their positions to the whole market could make them vulnerable to those who would wish to trade against them.

MiFID establishes a comprehensive pre- and post-trade transparency regime for equities only. This means that regulated markets are not bound by such transparency requirements in relation to their bond trading by virtue of MiFID. However, Member States may decide to apply transparency requirements to financial instruments other than shares.

Shares traded on exchanges and trading platforms are subject to the pre- transparency requirements set out in MiFID. However, fulfilling the pre-trade transparency obligations will depend on the type of trading system that a stock exchange operates. For example, if an exchange operates an order-book system that matches the incoming buy and sell orders, it will have to disclose the five best buy and sell orders in the order book. There is a different requirement for trading systems that are quote-driven, for example, systems where different market makers display bid and offer prices at which they are ready to trade a particular share. In such a quote-driven market, each registered market maker has to make public and continuously update their quotes.

Recordkeeping

MiFID contains a general record keeping requirement that obliges investment firms to keep the records necessary to enable regulators to monitor compliance. See Article 13(6). This general provision is sometimes supplemented with explicit record keeping requirements, such as record keeping with regard to client order handling or transactions.

To provide investment firms with greater legal certainty, the European Commission suggests that regulators should draw up an indicative list of records in order to help firms assess what records they need to keep. Generally, firms must retain the records required for a period of five years. See Article 51(1). However, regulators can require firms to keep their records for a longer period of time if such is necessary to enable effective supervision and if the longer period is justified by the type of instrument or transaction. In addition, records related to the client agreement and the documents that set the rights and obligations of the firm and the client have to be retained for at least the duration of the relationship with the client.

The records must be retained in a medium that allows the storage of information in a way accessible for future reference by the regulator, and in such a form and manner that the following conditions are met:

- the regulator must be able to access them readily and reconstitute each key stage of the processing of each transaction;
- it must be possible for any corrections or other amendments, and the contents of the records prior to such corrections or amendments, to be easily ascertained;
- it must not be possible for the records otherwise to be manipulated or altered.

Firms must record all orders, irrespective of whether they have received an order on the phone or through other means. However, voice recording of telephone orders is not required. But Member States can still impose obligations relating to the recording of telephone conversations or electronic communications involving client orders.

Reporting to Clients

Every time a firm receives a client order, it has to record this order. After executing the order, the firm has to report to the client that it has done so. See Article 19(8). The notification has to be prompt and, in case of a retail client, the firm must send the notification on the following business day at the latest. See Article 40(1) of the Implementing Directive. In this way, clients have the opportunity to verify whether the firm has executed the order in accordance with their instructions and/or (in cases where the client has not given any specific instructions) with the obligation to act in their best interest.

Customers also have to be informed on a regular basis and in sufficient detail of the type of services that have been provided to them. See Article 19 (8). In this respect, MiFID sets out three groups of reporting requirements: reporting in the case of portfolio management (Articles 41 and 42), reporting obligations in respect of the carrying out of orders other than for portfolio management (Article 40), and reporting related to the safeguarding of client instruments and funds, Article 43.

Investment Advice

Investment advice means the provision of personal recommendations to a client, either on its request or at the firm's initiative, regarding financial instrument transactions. See Article 4(1)(4). Further, a personal recommendation is one that is made to a person in his capacity as an investor or potential investor, or in his capacity as an agent for an investor or potential investor.

That recommendation must be presented as suitable for that person, or must be based on a consideration of the circumstances of that person, and must constitute a recommendation to take one of the following two sets of steps: (1) to buy, sell, exchange, redeem, hold or

underwrite a particular financial instrument; and (2) to exercise or not to exercise any right conferred by a particular financial instrument to buy, sell, exchange, or redeem a financial instrument. See Article 52 of the Implementing Directive. A recommendation is not a personal recommendation if it is issued exclusively through distribution channels or to the public.

Firms that provide only generic advice, such as advice on types of financial instruments only that is not specific to particular investments, do not have to be licensed under MiFID. The definition of investment advice, as detailed in Article 52 of the Implementing Directive, does not cover this type of advice. However, investment firms providing this type of service may be subject to national legislative requirements, including the need to have a license, and the rules governing these kinds of firms are not standardized.

A customer can still rely on generic advice it receives from an investment firm. Under MiFID, an investment firm is under an obligation to act in the best interests of its clients, and any communication it provides to clients must also be fair, clear and not misleading. This means that the provision of generic advice by investment firms will be subject to compliance with these provisions of MiFID, even though it is not an investment or ancillary service within the terms of the Directive. In particular, this means that the provision of generic advice that is not in fact suitable for the client will be contrary to the firm's duty to act in the best interests of the client.

Moreover, where generic advice is not based on a consideration of the client's circumstances, presenting it as suited to such circumstances will be misleading, and thus, a breach of the requirement of Article 19(2) that information provided to customers not be misleading.