

# The Markets in Financial Instruments Directive

## Overview

The Markets in Financial Instruments Directive (MiFID) was issued by the European Commission in April 2004 as part of its Financial Services Action Plan. It is expected to come into force by 1 November 2007 and replace the current Investment Services Directive (ISD).

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## MiFID

The main purpose of MiFID is to improve the 'passporting' regime previously provided by the ISD, which allows firms to provide investment services on a cross border basis under Home State authorisation.

The basic structure of MiFID will be similar to the ISD in that there will be 'core' and 'non-core' investment services, although under MiFID these will be known as 'investment services and activities' and 'ancillary services'.

Under the directive, a firm which carries out ancillary services only will not be a MiFID firm and will therefore not be able to benefit from passporting its services into other member states. However, if a firm carries on both investment services and activities and ancillary services it will be subject to MiFID and will be able to provide both the investment services and activities and ancillary services in other member states.

### Services covered by MiFID

Investment services and activities include:

- reception and transmission of orders in relation to one or more financial instruments;
- execution of orders on behalf of clients;
- dealing on own account;
- portfolio management;
- investment advice;
- underwriting of financial instruments and/or placing of financial instruments on a firm commitment basis;
- placing of financial instruments without a firm commitment basis;
- operation of multilateral trading facilities.

Ancillary services include:

- safekeeping and administration of financial instruments, including custody and related services;
- granting credits or loans to an investor to allow him to carry out a transaction in one or more financial instruments, where the firm doing so is involved in the transaction;
- advice to undertakings on capital structure, industrial strategy and related matters and advice and services relating to mergers and the purchase of undertakings;

- foreign exchange services connected with the provision of investment services;
- investment research and financial analysis;
- underwriting services;
- investment services and activities related to the underlying of derivatives, where these are connected to the provision of investment or ancillary services.

Although the above categories look similar to the current core and non-core services with the ISD, there are a few notable differences. In particular, investment advice is now classified within investment services and activities. Pure advisory firms will therefore now be able to operate across all member states, but it also means that the full MiFID conduct of business rules will apply to them.

### Instruments covered by MiFID

The instruments covered by MiFID will also be wider than the list of instruments currently covered by the ISD. MiFID instrument include:

- transferable securities;
- money-market instruments;
- units in collective investment undertakings;
- derivatives relating to securities, currencies, interest rates or yields, or other derivatives which may be settled physically or in cash;
- commodity derivatives that are traded on a regulated market and/or a multilateral trading facility even if they are physically settled;
- OTC commodity derivatives with a cash settled option other than on default or other termination event;
- other OTC commodity derivatives which are physically settled, which are not for commercial purposes, and which have the characteristics of other derivatives, having regard to certain factors such as the existence of clearing and margining;

- credit derivatives;
- financial contracts for differences;
- derivatives relating to climate variables, freight rates emission allowances or inflation rates or other statistics and certain other derivatives

### Key areas of change under MiFID

MiFID will have a significant impact on many sections of the FSA handbook. The impact of each of these sections, on individual firms, will vary, depending on the activities undertaken by each firm.

The key areas of change include:

#### Organisational requirements

Under MiFID, firms will need to consider, inter alia:

- the efficiency and effectiveness of their arrangements for compliance and risk management;
- the general integrity of their systems and internal controls (including internal audit and business continuity management);
- their arrangements for identifying conflicts of interest and their organisational arrangements used to manage them.

The rules will focus on the 'functional independence' of compliance and risk management controls. At a minimum, therefore, all firms should review the adequacy of their:

- internal organisation;
- reporting lines; and
- allocation of senior management responsibilities.

The Capital Requirements Directive (CRD) also contains high level requirements in relation to a firm's systems and controls. As a result, the FSA have developed a 'common platform' of systems and controls requirements to cover both these directives.

(We have prepared a separate factsheet on the organisational requirements of MiFID, which can be found on the Moore Stephens website at [www.moorestephens.co.uk/mifid](http://www.moorestephens.co.uk/mifid).)

## Conduct of business

### Client classification

Currently, the FSA identifies three types of clients: private client, intermediate customer and market counterparty. MiFID also creates three categories of clients: retail, professional and eligible counterparties. However, the definitions in MiFID are significantly different from the current definitions. MiFID also provides rules that allow clients to change their initial classification on request.

MiFID defines clients which will be considered as professional clients or eligible market counterparties. Retail clients are defined as those clients who do not fall into the other categories.

We have prepared another factsheet covering the new client classification, which can be found on the Moore Stephens website at [www.moorestephens.co.uk/mifid](http://www.moorestephens.co.uk/mifid).)

MiFID imposes a range of investor protection measures, especially to retail clients. However, there is a general requirement that all firms act honestly, fairly and professionally, and in accordance with the best interests of the client.

### Suitability

Firms which provide discretionary portfolio management and investment advice will, under MiFID, be required to obtain 'know your client' information and sufficient information to be able to demonstrate that the recommended products and services are suitable for the client. This is broadly similar to the current requirements but, under MiFID, these requirements apply to both retail and professional clients.

In order to be able to assess suitability, a firm will have to consider:

- the client's investment objectives;
- the client's knowledge and experience to understand the risks; and
- the client's ability to bear the risk associated with the particular transaction.

The firm is then required to assess this information and to conclude whether or not the proposed transaction or service is suitable for that particular client.

MiFID does recognise that there should be a 'lighter touch' for professional clients, where a firm can assume that the client has the knowledge and experience to understand the risks involved. Also, firms dealing with per se professional clients (i.e. not opted-up retail clients) can also assume that the client is able to bear the risk associated with the particular transaction.

Therefore, firms must have records which will enable them to differentiate not only between retail and professional clients, but also between per se professional and normal professional clients.

### **Appropriateness**

This is a new requirement under MiFID. The suitability requirements apply to discretionary portfolio management and investment advice. For other retail investment services (other than some execution-only business, which is covered below) the firm must be able to demonstrate that the recommended products and services are appropriate for the client.

There is little guidance to what procedures a firm is required to follow to determine whether a product or service is appropriate, but firms will need to demonstrate that they have assessed that the client has the necessary experience and knowledge to understand the risks involved. In doing this, firms should consider;

- the educational and professional background of a client;
- the types of products and services the client is familiar with; and
- the nature and frequency of the transactions they have undertaken

If a firm considers that a service or product is not appropriate for a client, the firm may still act for them and provide the service, provided that the client has been advised that the firm is of the opinion that the product or service is inappropriate.

The key difference between the 'suitability' and 'appropriateness' tests is that the appropriateness test only requires a firm to assess whether the client has the knowledge and experience necessary to understand the risks involved, whereas the suitability test requires the firm to assess the client's financial position as well.

As with the suitability requirement, firms will have to maintain records which can clearly support the assessment of appropriateness and suitability.

### **Execution only business**

There is provision under MiFID which allows the appropriateness rules to be relaxed for certain types of execution only business, i.e. those executing transactions in non-complex instruments without providing advice. Non-complex instruments include shares traded on a regulated market, money market instruments, bonds and other securitised debt.

In order to rely on these provisions, certain strict criteria must be met, including the requirement that the service must be provided at the initiative of the client, and the client must be warned that the firm has not assessed suitability or appropriateness.

### **Best execution**

This is one of the most controversial areas of MiFID. Under the existing COB rules, the 'best execution' rules require a firm to take reasonable care to ascertain the best available price in the relevant market at the time, for transactions of the size and type concerned. The proposed rules under MiFID require the firm to take reasonable steps to obtain the best possible result, taking into account price, cost, speed, likelihood of execution and settlement, size, nature and any other consideration relevant to the transaction.

Therefore, the new requirements place a much greater emphasis on the best overall result rather than just the best price.

Another key change proposed under MiFID is that there will be no 'carve out' from the duty to provide best execution, in relation to intermediate customers.

Firms will need to develop an execution policy or review any existing policies, and obtain client consent to the policy before undertaking any transactions. This means that the policy needs to be documented and available for review. The policy must cover the selection of execution venues to enable the firm to secure the best results for clients on a consistent basis, which also needs to be kept under review.

### Financial promotions

Although the rules on financial promotion are to be updated, the requirement that financial promotions continue to be clear, fair and not misleading will remain. MiFID will include specific objective standards which specify how information provided to clients should satisfy this requirement. However, the majority of these standards should not change from the existing rules.

Under MiFID, firms are required to provide retail clients with information concerning the terms of the agreement for investment services, and the firm itself, in good time, before the earlier of those services being provided and the retail client being bound by the agreement. Information is also to be provided by the firm to a professional client, in good time, before the provision of services.

### Terms of business

The number of changes that are going to be introduced under MiFID means that a firm's terms of business will need to be re-written. The revised terms of business will need to reflect the new client classifications and should be given to everyone. There will be no opt out for issuing terms of business for execution only transactions.

It is likely that the new terms of business will need to include greater details on areas such as client assets, charges and cost disclosures. It is also going to be considered best practice to obtain approval from clients to the new terms of business.

### Record keeping

MiFID contains detailed provisions on record keeping. Some of these are very similar to the existing requirements, however, there are some very important changes, such as:

- records must be kept for five years of relevant data relating to all financial instrument transactions undertaken by the firm on their own account or on behalf of a client;
- the records which need to be kept must cover all services and transactions undertaken by the firm.

For client orders and decisions to deal, the following details must be kept:

- name of client;
- name of relevant person acting on behalf of the client;
- details of the instrument, price and quantity;
- the nature of the order;
- other details and particular instructions relevant to the transaction;
- the date and time of receipt of the order and the decision by the firm to deal.

For details of a transaction, the following details need to be kept:

- name of client;
- trading day on which transaction was executed;
- the time the transaction was executed;
- details of the instrument, price and quantity;
- the nature of the order, whether it was buy or sell;
- counterparty;
- identification of the venue where the transaction was executed;
- total consideration;
- the natural person who executed the trade.

### Pre-trade transparency

MiFID introduces a comprehensive pre- and post-trade transparency regime for trading in shares on the following three main types of execution venues:

- regulated markets (RM) including stock exchanges such as the LSE and virt-x.
- multilateral trading facilities (MTF) covering alternative execution venues currently referred to as alternative trading systems in the UK
- over the counter (OTC) trades undertaken by firms outside of a RM or MTF, including those acting as systematic internalisers.

## **RM and MTF**

While the LSE and virt-x already have trading systems and rules that provide transparency levels, these will be expanded to require market operators running continuous order matching systems to make aggregated information public on orders at each of the best five price levels on either side of the book. In the case of quote-driven markets, the operator must publish the best bids and offers of all designated markets. For MTF the MiFID requirements will be the same as RM.

## **Systematic internaliser**

A systematic internaliser is an investment firm which, on an organised, frequent and systematic basis, deals on its own account by executing client's orders outside an RM or MTF. Systematic internalisers will need to provide firm bid or offer quotes in 'liquid' shares on a continuous basis, which may require firms to change their current systems. They will be allowed to execute orders from professional clients in certain circumstances.

MiFID sets out the criteria for 'organised, frequent and systematic', which in general fall into three headings: organisational, commercial and qualitative.

Each regulator is required to maintain and publish a list of systematic internalisers.

## **Post-trade transparency**

All trading venues will have to make public specified information about completed transactions in shares as close to real time as possible, with a three minute maximum. For portfolio transactions, there is a requirement that the information must be disclosed as close to 'real time' as possible so that process can be allocated to particular shares.

It may be that this information will be available from the exchanges themselves but, if not, firms will need to make sure that they have an alternative way of making transaction reports.

The rules on transaction reporting will also apply to UK firms which are a remote member of an overseas exchange, which were previously exempt from reporting.

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