

MiFID – the Markets in Financial Instruments Directive

This bulletin directs firms' attention to the key business issues which they should be considering.

What does MiFID do?

MiFID is a complete rewrite and updating of the Investment Services Directive (ISD). In areas already covered by the ISD it introduces greater detail, clarity and prescription. It also covers new areas of business, so commodities and derivatives of all forms are legislated for, and investment advice is now a core activity, previously it was ancillary. The Directive is intended to have a substantial pro-competition effect in equity markets. The new Directive thus has a substantial and pervasive effect on all financial businesses not regulated as credit institutions or insurance companies, but may well impact parts of their business too. In the UK the greatest impacts will probably be in equity market structures and the financial advice market.

Who does it impact?

The table below shows the main impacted areas.

Business	Highest impact areas
Investment banks/broker dealers	Equities trading
Portfolio managers	Client classification, best execution, outsourcing
Stock brokers	Best execution
Private banks	Client information, suitability
Future & Options firms	Best execution, investment advice
Commodities firms	Systems and controls, best execution

Key Impacts

Exchanges and markets: MiFID abolishes the concentration rule, that is national authorities can no longer require firms to route equity orders only to stock exchanges, and in particular home exchanges.

The theoretical arguments for concentration were that it aided price formation and discovery, and helped build pools of liquidity. Both are vital to achieving best execution for clients.

To meet those objectives in the absence of a concentration rule the Directive establishes new, detailed rules for pre-trade transparency, post-trade transparency and trade reporting. The Directive is agnostic as to how its requirements should be met. Thus firms will need to note the market changes in deciding how to meet their own obligations. Will liquidity move? Will new trade reporting media become available?

Regulatory reporting will be, in future, to the home state of the investment firm executing the transaction.

The simple addition of market venue codes to post trade and regulatory reports may be difficult for legacy systems.

Systematic Internalisers

A number of large firms regularly execute client orders in shares on own account rather than on an exchange. If firms do this on a regular and systematic basis in liquid shares they are defined as systematic internalisers and will, in the future, be subject to the same pre and post trade transparency requirements for orders of standard market size or below as other investment firms. They are only required to accept orders from their clients but must achieve best execution for these clients. They may not unreasonably restrict the clients they accept.

Thus current internal crosses will be disclosed to the market in the future, aiding price formation.

Systematic internalisers will have to decide whether to incur the expense of retaining this new status, or refuse to deal at or below market size, or put all orders through the market, or establish themselves as a Multilateral Trading Facility. A key consideration, apart from the costs associated with each option, will be the scale of benefits in attracting order flow and liquidity.

Best execution

MiFID both extends the scope of best execution to all assets covered by the Directive, but also extends the scope of clients and market participants who are entitled to best execution. There are carve-outs for particular types of firms, and clients can forego best execution.

Best execution will prove problematic for the following reasons:

- A best execution policy will have to be agreed for each asset class for each client;
- Data will have to be captured to demonstrate that any transaction met the agreed policy (each transaction does not have to be 'best execution' on its own); and
- New market venues/pools of liquidity will have to be monitored. And this landscape may shift over time. There will be increasing use of performance metrics.

In addition, although best execution is a well-known concept in liquid equities it is unfamiliar, and difficult to define, in other asset classes. For many, bonds, OTCs etc. achievement of best execution can range from difficult to meaningless. But best execution is required by the Directive.

Client agreements

The Directive is prescriptive in this area. Agreements will have to include details of best execution policy. It is likely all agreements will have to be reviewed; it may be possible to amend current agreements via side letters.

Client classification

The Directive defines classes of client – retail, professional and eligible counterparty. There is no intermediate category as in the UK currently. It will be more difficult to migrate retail customers to professional status, and some current intermediary clients may be reclassified as retail.

The classification clearly offers different levels of investor protection, and hence cost. Firms with intermediate customers, such as private banks and private client stockbrokers, may wish to re-segment their client base and map clients to their services differently.

This part of the Directive has a grandfathering clause, but its effect is not clear and may appear less helpful than at first appears.

Governance

MiFID sets out requirements for internal audit, compliance functions and the management of risk and conflicts. They are not substantially different from current FSA requirements apart from management of conflicts where the emphasis is more on avoidance than disclosure.

Record-keeping

There are detailed record-keeping requirements for a number of areas, transaction data, client data, client agreements, client reports etc. The content and practice is not markedly different from FSA requirements but in some cases the retention period is longer. The requirement to be able to reconstruct the key events in a transaction on request could prove problematical. And some areas of business, such as corporate finance, have not had prescriptive record keeping rules before.

Client information/suitability

The Directive sets out the information to be taken into account when judging the suitability of an asset or product for a client. It also sets out the way judgements should be made.

The requirements appear to exceed current FSA requirements on both counts, in particular, suitability must take into account the overall financial wherewithal of a client, including cash and debt, and must pay attention to the current asset allocation i.e. a product which is suitable on one occasion may not be so on the one hundredth purchase as the portfolio has become too concentrated.

In addition, the Directive introduces the arcane concept of 'appropriateness'. If providing non-advisory services i.e. reception and transmission of orders, firms have to satisfy themselves that the client has the knowledge and experience necessary to understand the risks of the product or service involved.

Execution-only services can be provided for non-complex products if the client has specifically requested it. There is no appropriateness judgement and the client has to be told that. 'Non-complex' means, broadly, listed shares, UCITS, money market instruments etc. Complexity relates to the ease with which the risks of the product may be understood. It appears to rule as complex low volatility products which have embedded derivatives.

Inducements

The Directive says that inducements are allowed only if they are not detrimental to the interests of the clients. It clarifies that, in the area of advice, commission may be paid if it results in unbiased advice. Proving lack of bias may introduce a difficult concept to the already difficult areas of commission unbundling in the wholesale markets, and personal advice in the retail.

Outsourcing

The outsourcing requirements will not be unfamiliar but outsourcing to a non-EEA entity will require special steps to be taken.

The European dimension

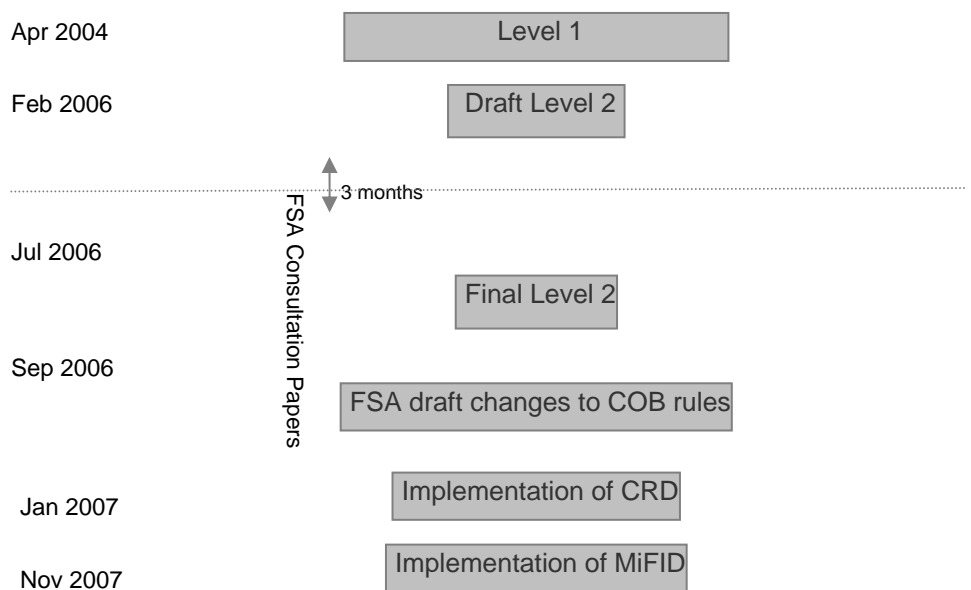
There is a shift in many areas of MiFID from host state to home state rules. Cross-border outsourcing, even intra-group, needs to be considered. The activities of the whole group should be mapped to MiFID. This will often not follow the legal entity structure, but the business processes.

Where are we now?

The Directive became European Law two years ago and is due to be implemented on 1 November 2007. It is a new style of financial Directive where detail is added to the framework by further legislation at Level 2. The proposed Level 2 text was published in January and should become law by the summer. Further changes may appear before then.

The FSA will consult on its own regulations to implement the full Directive in the third and fourth quarters of 2006. Its rules must be made by January 2007. The timetable is extremely tight.

Figure 1: High level indicative MiFID timeline



The FSA's transposition will be difficult. Most market-related rules are set in the form of an EU Regulation. Once agreed this is European Law, the FSA cannot alter a word. They will wish to offer guidance.

Other parts of Level 2 are set out as a Directive which requires transposition into national law. The ability of regulators to retain or add additional requirements is tightly curtailed by Article 4 of the Directive so the FSA may have little flexibility in transition. This could have a significant impact on the FSA's existing rulebook: there will be less scope for amplification, in the way to which firms have become accustomed over recent years, and elements of the FSA's existing regime such as the menu and the bundled and softened commission regime, may be removed, unless the FSA is able to plead retention with Brussels on the grounds of specific risks to investor protection or to market integrity in the United Kingdom that are not fully addressed by the directive.

Action points to consider

- The available texts are in sufficient detail and stable enough to allow project plans to be drawn up even though the final text is not yet available.
- The main aim at this stage should be to assess the impact on policies, processes, organisation and systems so that the work required to undertake the changes can be planned well in advance to ensure appropriate resources will be available when necessary. Although the end date is November 2007 any systems changes will need to allow for testing and parallel running.
- MiFID is a business issue. A senior executive should 'own' the project and should ensure that all relevant business units, as well as support functions, are involved.
- For some firms, investment banks and private banks in particular, substantial strategic change to their business models may be possible or necessary to gain strategic advantage.
- Expert project management is vital given the pervasiveness of MiFID across businesses.
- The actions of related third parties will have to be constantly monitored. Changes in practice outside the firm may force reconsideration of current plans.
- Mapping the total business to MiFID is crucial, particularly if there is a European or global element.

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This bulletin is produced periodically to address important issues, affecting the financial services industry. If you wish to receive it by e-mail or if any of your colleagues would like to be added to the mailing list or if you do not wish to receive further editions, please write to:

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