PRICEWATERHOUSECOOPERS

The impact of MiFID in the FSA's new rules

MiFID has now arrived

The foundations for the implementation of the Markets in Financial Instruments Directive (MiFID) in the UK are now almost in place, pending the finalisation of the draft consultation papers. For those playing the waiting game, the waiting is now surely over.

On October 31 2006 the FSA released its final two Consultation Papers incorporating changes required by MiFID: CP 06/19 'Reforming Conduct of Business Regulation' which included the draft text for the New Conduct of Business Handbook (NEWCOB) and other miscellaneous provisions; and CP 06/20 on 'Financial promotion and other communications, including draft Handbook text for NEWCOB 4 and 5'.

Progress required

Subject to what are likely to be only minor adjustments to the regulations, firms which have not yet done so must now start making significant progress in the interpretation and implementation of MiFID for 1 November 2007.

With less than 12 months until MiFID 'goes live' it is imperative for all firms to determine how they will be impacted and to start implementing the required changes. Those firms which have not started finalising their MiFID gap analyses and implementation plans are now likely to be well behind many of their peers.

In this bulletin we set out some of the changes within CP06/19 and CP06/20, and the impact that these changes will have.

Business changes

For those larger firms which have been steadily working to interpret business changes and plan for MiFID implementation, it is now time to decide upon the detail, finalise plans, and start and/or continue with the implementation work. The whole business: front, middle and back office needs to be involved in the project to ensure MiFID is embedded in the firm's policies, processes, systems and controls.

We believe that MiFID offers opportunities to review and rationalise systems and support the implementation of a robust control environment across the business.

Main observations on the Consultation Papers

The extent of the detail and insight in terms of the guidance offered is a pleasant surprise, compared with initial expectations of pure 'copy out' of the Level 2 Directive and Regulation.

Best Execution

Since its Discussion Paper earlier this year the FSA has come under unusually heavy fire for its interpretation of a number of elements within MiFID that appeared to potentially undermine the efficiency of UK capital markets. The principal areas which attracted controversy concerned the use of external benchmarks and the definitions concerning client order acceptance. The FSA has now listened to the feedback and alleviated most of the concerns by:

- Making revisions (or clarifications) as to the definitions of a 'client' and 'client order'.
- Providing commentary on the different effects of whether a 'service' or 'activity' is being conducted and the impacts this has on the Best Execution requirement.

The FSA counsels firms wishing to rely on only providing 'investment activities', and thus avoiding Best Execution obligations, to obtain suitable legal opinions to support their interpretation: FSA remains doubtful that this means of avoiding the Best Execution obligation will be available to many firms.

Proposals for the application of the Best Execution requirements have now effectively reverted to a high-level copy out of MiFID providing greater clarity within NEWCOB on *when* Best Execution should be given and when it is *not* required. NEWCOB is now broadly equivalent to the MiFID Level 2 material although further analysis on implementation may uncover some subtle differences. MiFID obligations such as the requirement to provide Best Execution to Professional clients (unless specific instructions are received to the contrary), and the application of a broader remit of what constitutes Best Execution under the current regime still means a number of systems and process changes will have to be made by firms.

Firms are continuing to analyse current business models in order to try to limit the provision of Best Execution, such as by creative use of client documentation, but in our view the FSA has now ceded all the ground it intends to over what constitutes a client order and how those should be processed. The regulator is, in our view, unlikely to allow lawyers to circumvent a cornerstone of the legislation.

Client classification

Most of the FSA's work in this area remains unchanged from the relatively well received informal paper issued in August 2006. However, there are a few areas which we consider are worthy of further mention:

Grandfathering: A year ago the industry faced the potentially massive exercise of re-classifying, notifying and obtaining consent from clients in a two-way process.

In NEWCOB the FSA has tried to provide as much sensible wriggle room as possible for firms with guidance on 'automatic', 'transitional' and 'reviewed' grandfathering. However, significant time and effort will still be needed to undertake the re-classification exercise for new clients. The fact that clients have to also be notified of, for example, Execution and Conflicts policies will in itself present a challenge. This will prove more difficult for firms which have issues with their CRM systems, particularly those concerned with the quality of static data.

Transferability of client status: the FSA has confirmed it does not believe that MiFID allows one firm (Firm A) to classify clients based on the grandfathered classification status those clients have with another firm (Firm B) based on pre-MiFID classification processes.

Requirements for Professional clients

Although widely anticipated, the new rules (e.g. Best Execution, certain client asset requirements, advice and Appropriateness) applying to Professional clients, will have a greater impact on commodity firms, inter-dealer brokers and private banks than firms which already have a retail client base. These firms in particular may need to be implement new process, or current processes may need to be radically altered.

Appropriateness test

This is a new requirement and is a test that sits between suitability (for investment advice and portfolio management scenarios) and traditional execution-only.

The Appropriateness test will apply to all non-advised investment services involving complex products, AND to services involving non-complex products where the investment service is provided at the initiative of the firm, i.e. it does not satisfy the MiFID requirement to constitute execution-only (MiFID Level 1, Article 19(6)). This could affect the services a firm provides that are the result of personalised communications, e.g. 'direct offer' type marketing, because if these communications are personalised it could be seen to be inferring that the products are Appropriate to the recipients' circumstances (see below for further information).

The biggest impact from the introduction of the Appropriateness test will be on those firms dealing with retail clients. Professional clients can be assumed to have the necessary experience and knowledge to understand the risks in the areas they have been deemed professional. The FSA has given guidance that where clients have been properly categorised as Professionals they do not envisage it likely that obtaining any further client data will be necessary.

It should be noted that, if the product is not considered Appropriate by the Front Office (for example, because the client cannot provide adequate evidence to confirm his or her knowledge/experience) the client *can still continue to proceed and effect the transaction after provision of a warning*. In these cases, however, the FSA states that the firm should still consider the best interests of the client, taking account of the facts and circumstances. This may mean refusing to do business, which is a highly unattractive commercial prospect, but one which carries the lowest regulatory risk.

Financial Promotions and product disclosure

MiFID provisions are, in many areas, much more high level and principles-based than that of existing COB requirements although the 'clear, fair and not misleading' test remains. This has clearly posed the FSA a number of difficulties in achieving a balance in an area that is, particularly in the retail space, a core element of the Treating Customers Fairly agenda. There are, however, areas where existing rules and guidance have had to be removed from the draft COB rules, meaning that there will be challenges ahead for firms when interpreting what is required of them.

One particular area where firms will need to consider the impact of changes is in relation to the potential application of the Appropriateness test in responses to certain marketing campaigns. When the Appropriateness test applies, firms will not be required to apply it before sending out marketing material, but will be required to do so before a transaction is effected - this is similar to the current 'may be suitable' assessment required for the marketing of derivatives and warrants under current rules.

The difficulties will however arise for firms in determining:

- Which products the Appropriateness test might need to apply to automatically (i.e. complex products).
- Which clients are Retail where no classification has taken place (for whom no assumption of expertise can be applied and information must therefore be obtained).
- Whether a client is responding to a communication that has been personalised in relation to marketing of non-complex products as this may trigger the need for the Appropriateness test.

Other Impacts - Complaints (DISP)

Although relatively high level, the Complaints section of MiFID has been one of the more complicated areas to transpose into the existing UK regime: The FSA's paper and draft regulations require some careful reading to untangle when and how:

- The DISP changes will apply to MiFID and non-MiFID businesses – and the corresponding relevance of the 'retail client' versus 'eligible complainant' definitions.
- It affects branches which do incoming and outgoing business.
- The Financial Ombudsman Service (FOS) scheme applies.

Although the specific rules on the timing of letters has been removed, once the changes are fully understood, the onus will still be on firms to ensure they treat customers fairly (including undertaking root cause analysis of complaints), and to deal with complaints in a reasonable timeframe. The FSA has indicated that it expects the majority of complaints to be completed within eight weeks.

Super equivalency (or gold-plating)

The FSA's decision to retain a number of its other current requirements (resulting in super-equivalence) such as the requirement for a Suitability Letter and the Initial Disclosure Document are likely to require it to make Article 4 notifications to the European Commission, which could be rejected: FSA is taking a clear stance in this area against Brussels' wishes, and will need to hone its arguments in defence of existing regulations carefully. If it loses, firms will need to consider whether to press for such requirements to be replaced by industry guidance or determine for themselves whether existing practices are worth retaining.

The FSA has also decided to retain the 'agent as client' provision. This is a welcome move, as this gives a firm some flexibility where it has permission to deal with only a certain set of clients and to rationalise to a degree the need to go through the customer due diligence process required to on-board clients.

Expectations of Senior Management

Senior Management need to take note that the FSA will expect firms, wholesale or retail, to take more ownership of how they apply the rules; measure their risk; and mitigate their exposure to risk. The thrust of current FSA speeches is on increasing expectations of board and senior management engagement in this process.

This approach goes hand in glove with the ARROW 2 methodology which raises the focus by supervisors on Senior Management in terms of taking greater responsibility and regard for compliance and risk in their businesses. As a result, firms will need to apply more rigour in their approach to better integrate compliance risks within operational and strategic goals.

Some of the MiFID changes (e.g. understanding the nature of a 'client' and determining when Best Execution applies) will require close scrutiny and analysis and may pose some difficulties in determining definitive solutions - but as long as firms can demonstrate they have thought through the complexities and show effective consideration and coverage of risks they should be able justify their decisions.

From interpretation… to implementation

Although some firms have taken a proactive approach to understanding the business impacts of MiFID, in order to try to leverage any potential strategic advantages for early adopters, other firms are at different stages of analysis and implementation.

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For those who have yet to analyse the impact that MiFID will have on their business, the FSA has with these Consultation Papers alone now provided over 1600 pages from which firms can interpret, analyse, design and implement the changes necessary to meet MiFID's requirements.

Firms of all sizes should now be beyond the phase of analysing the impacts of MiFID, and should be designing and implementing changes with the ownership and support of Senior Management and the Front Office. Firms with business which is not covered by MiFID should be navigating carefully around the rule book as a result of the application and disapplication of MiFID provisions to non-scope business and/or firms: non-MiFID businesses may also find that some provisions are applied to them in due course by the FSA in the interests of consistency and need to prepare for this.

In our view, key actions for Senior Management now are to:

- Review the assessment of the impact of MiFID on the firm's or group's businesses in the light of recent developments.
- Consider what opportunities are created for their businesses by MiFID and whether full advantage is being taken of them.
- Monitor progress with implementation of systems, process and documentation changes required.
- Consider the need for an independent health-check or comparison with peers' progress to assess the risk that important issues for the firm or group.

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