

MiFID implementation: a busy summer for the CSSF!

Now that the Law and the Grand Ducal Regulation of July 13, 2007 have been passed thereby completing transposition of Level 1 and 2 in Luxembourg, the CSSF is busy on Level 3. Between July 17 and July 31, 2007, it has issued 4 circulars dealing with MiFID (07/302, 07/305, 07/306 and 07/307)! This Flash News concentrates on the two most important ones (07/302 and 07/307) which clarify certain key aspects of MiFID.

The main areas covered are:

- Reporting to the CSSF of transactions on financial instruments admitted to trading on regulated markets;
- Conduct of business rules including client categorization, suitability, appropriateness and best execution;
- Organisational and governance requirements covering Compliance, risk management and internal audit functions, and identification and management of conflicts of interest.

The Circulars will enter into force on November 1, 2007.

I. Scope of application of the Circulars

1. CSSF Circular 07/302 on transaction reporting

CSSF Circular 07/302 applies to banks and investment firms established under Luxembourg Law and Luxembourg branches of banks and investment firms whose head office is located outside the European Union.

Investment firms concerned by this Circular are commission agents, private portfolio managers, professionals acting for their own account, market makers, underwriters of financial instruments and distributors of units / shares of UCIs.

However, UCITS 3 management companies performing discretionary portfolio management are not in scope.

2. CSSF Circular 07/307 on conduct of business rules

CSSF Circular 07/307 applies to banks and investment firms established under Luxembourg Law, including their branches established in an EU member state. These EU branches will have to apply the conduct of business rules of their host state, which hopefully should be close enough to those of Luxembourg. However, and unlike the now repealed CSSF Circular 00/15, the new Circular does not foresee its application to branches of Luxembourg banks and investment firms established outside the EU: branches in these states will have to comply with local conduct of business rules.

This Circular also applies to branches in Luxembourg of banks and investment firms whose head office is located outside the European Union.

In addition, this Circular encompasses UCITS 3 management companies whose authorisation covers, in addition to the activity of collective portfolio management, the services of discretionary portfolio management.

Finally, and again contrary to the former CSSF Circular 00/15, this Circular does not apply to subsidiaries of Luxembourg banks and investment firms included in the supervision on a consolidated basis by the CSSF.

II. Transaction reporting

All transactions in financial instruments which have been admitted to trading on a regulated market need to be reported to the CSSF no later than the close of the following business day. This applies to all relevant transactions whether carried out on a regulated market, on a MTF, by a systematic internaliser or over-the-counter. The list of relevant instruments is set out in point 3 of CSSF Circular 07/302 and includes transferable securities, money market instruments, shares / units of UCIs, and derivative instruments. Thus, the instruments covered are much wider than previously the case.

However, only credit institutions and investment firms which are “market facing” and / or act for their own account need to report to the CSSF.

The details of the new transaction reporting are published on the CSSF website.

CSSF Circular 07/302 repeals CSSF Circular 99/7 as from November 1, 2007.

III. Conduct of business rules

CSSF Circular 07/307 details several requirements in relation to the conduct of business rules of firms. The key requirements are:

1. Client classification

In line with MiFID requirements, the Circular distinguishes between three different types of clients, each with a different level of knowledge and sophistication: retail clients, professional clients and eligible counterparties which are professional clients in dealing services. The obligations on firms towards these different categories of clients will vary based on that categorization with retail clients naturally benefiting from the highest degree of protection.

Clients must be informed of their classification and of its consequences as well as of their right to change category in order to obtain more (or less) protection provided certain criteria are met. The Circular allows firms not to inform their existing non-professional clients of their classification as retail clients, thereby following the industry's wishes in that respect.

Firms may decide to classify their whole client base as retail clients, in order to simplify their own processes.

2. Suitability and appropriateness

Firms are required to assess the suitability of a service or transaction when providing discretionary portfolio management or investment advice. The “suitability test” requires firms to obtain information about the client's financial situation, his experience and investment objectives.

The “appropriateness test” applies to other services, where clients do not rely on the firm’s recommendations (execution of orders, reception and transmission of orders...). For the “appropriateness test”, firms are only required to 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. Appropriateness is not tested in circumstances where the client makes his own decision to deal in a non-complex financial instrument.

3. 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 client, taking into account a variety of factors, such as the price of the financial instrument, the speed of execution of the order and cost.

For orders on UCIs shares / units, the best execution principle is automatically met when the subscription, the redemption or the conversion of shares / units are done at the Net Asset Value.

The Circular indicates that the best execution obligation is based on best efforts and is not an obligation based on result.

4. Information and reporting to clients

Firms must provide appropriate information to clients so they can make informed investment decisions before the provision of service. The requirement to provide information to professional clients is less restrictive than for retail clients as the Circular indicates that firms shall provide information to professional clients on their request only.

In particular, CSSF considers that the prospectuses of any UCI(TS), SIF and SICAR are deemed to provide appropriate and sufficient information to investors. However, UCITS distributors must inform their clients of any other costs and charges associated with the investment service rendered in relation to UCITS shares / units.

The Circular clarifies some aspects of the reporting obligations to clients on executed transactions and portfolio management. Specifically, the Circular says that reporting must be to both the proxy acting on behalf of a client (“mandataire”) and to the client itself.

In addition, when a retail client account includes an uncovered open position in a contingent liability transaction, the Circular indicates that firms must inform retail clients of any losses exceeding a certain threshold but only if such a threshold was agreed and predetermined with the client.

Finally, the necessary comparison between the performance of a managed portfolio and the performance of a benchmark must be periodically reported to clients only if such a benchmark was agreed with the client.

IV. Organisational and governance requirements

1. Compliance, internal audit and risk management functions

The necessity to have a Compliance function and an internal audit function have been reemphasized with the law and the Grand Ducal Regulation of July 13, 2007. CSSF Circular 04/155 on the Compliance function and IML Circular 98/143 on internal control remain fully applicable.

In addition to these two functions, firms will be required to establish a risk management function according to the "proportionate principle" i.e. based on the nature, size and complexity of the business.

2. Conflicts of interest

Firms that provide investment services must draw up a comprehensive written policy identifying the steps that will be taken for identifying and managing conflicts of interest that present a risk of damage to client interests. Where 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.

More specifically, firms must inform the client about the nature and the amount (or the calculation method) of any inducement, including retrocession, paid to or received by a third party. This information must be given prior to the rendering of service and could be disclosed in a summary, providing that details are given on client's request.

V. Assessment by the external auditor

The external auditor of banks and investment firms will assess the compliance with CSSF Circular 07/307 in its long form report for the year-ends closing after September 30, 2008.



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