The Markets in Financial Instruments Directive and the Single European Market in Investment Services (Third Edition)

SLAUGHTER AND MAY

August 2007

CONTENTS

THE MARKETS IN FINANCIAL INSTRUMENTS DIRECTIVE AND THE SINGLE EUROPEAN MARKET IN INVESTMENT SERVICES

> "MiFID as a whole is a ground-breaking package of measures. It will transform the landscape for the trading of securities and introduce much needed competition and efficiency throughout Europe's financial markets."[1]

The Markets in Financial Instruments Directive, or MiFID[2], is one of the centrepiece legislative measures in the European Union's Financial Services Action Plan (FSAP), which has also produced the Market Abuse Directive, the Prospectus Directive and the Transparency Directive.

MiFID will replace the existing Investment Services Directive (ISD)[3] which, together with the Banking Consolidation Directive (BCD)[4] and the Insurance Directives[5], constituted the foundations upon which the single European market in financial services has been developed.

This memorandum provides an introduction to MiFID and its impact for the European markets generally and for the UK in particular. The UK's implementation of MiFID is falling into place, with the bulk of the Financial Services Authority's (FSA) major consultation documents now published.

1 Key Consequences

The implementation of MiFID will have an impact on the securities markets and investment firms of all 28 EEA Member States[6]. The ISD was a minimum harmonisation directive and as a result was implemented in different ways across the then Member States of the EEA. Some, like the UK, implemented the ISD with super-equivalent effect (i.e. going beyond the minimum requirements of the ISD); others did not. As a result, the impact of MiFID in each Member State may vary, but there are certainly a number of headline consequences which will have a significant effect on the investment services market as a whole:

> the regulated investment services sector will expand, with the addition of important new regulated investment services and products;

[1] Charlie McCreevy, EU Commissioner for Internal Market and Services, Speech at the Institute for European Affairs given on 30 June 2006.

[2] Directive 2004/39/EC.

[3] Council Directive 93/22/EEC of 10 May 1993.

[4] Directive 2000/12/EC of 20 March 2000 which, along with the Capital Adequacy Directive (93/6/EEC), was recast by the Capital Requirements Directive, which was adopted on 7 June 2006.

[5] Directive 2002/83/EC of 5 November 2002 on life assurance; Directive 92/49/EEC of 18 June 1992 on non-life assurance and Directive 2002/92/EC of 9 December 2002 on insurance mediation. Directive 2005/68/EC of 16 November 2005 on reinsurance introduces a comparative supervisory regime for reinsurance activities – European Union (EU) Member States are required to implement this measure by 10 December 2007.

[6] The European Economic Area or EEA is constituted by all 25 EU Member States along with Norway, Iceland and Liechtenstein, which are members of the separate European Free Trade Association, or EFTA. By operation of the EEA Agreement formed between the EU and the EFTA States and in force since 1994, most legislative measures passed by the EU are now automatically adopted by these 3 EFTA States.

> as a result, the European investment services passport will enable firms to export a wider range of investment services;

> national-level barriers within the single market will be minimised;

> important core business standards will for the first time be prescribed in detail at European level; and

> the rules applying to different securities trading venues will be harmonised, laying the foundations for a wider range of regulated trading venues with more extensive trading transparency.

The European Commission's deadline for the transposition of MiFID into the national law of each Member State was 31 January 2007, but a further 9-month period expiring on 1 November 2007 has been allowed for implementation, at which time the rules of the national regulators giving effect to MiFID requirements must become effective.

2 Background

Since 1995, the ISD has provided a limited degree of harmonisation across the EEA investment services sector. The ISD sets a minimum level of regulation for investment firms across the EEA and at the same time establishes the passporting regime for those regulated firms, enabling an investment firm regulated in one EEA Member State to establish a branch in, or provide certain of its investment services cross-border into, any other Member State – this is known as the "ISD passport".

But the ISD has not been as effective as it might have been in establishing the framework for a single European market in investment services. There are two principal reasons for this lack of progress: first, the scope of investment activities to which the ISD applies is narrow; and second, while Member States are required to permit EEA-regulated investment firms to passport into their jurisdiction, they are not prohibited from imposing additional local rules which regulate the manner in which those services may be provided.

This lack of harmonisation, together with a growing awareness that the technology of the investment services sector, and the financial markets generally, had developed significantly since the ISD was enacted in 1993, led the European Union to revisit the regulation of the sector. When the FSAP was announced in May 1999, at the top of the list for action in the wholesale markets was to "prepare the ground for the effective cross-border provision of investment services" by "urgently updating" the ISD[7]. From this proposal came MiFID.

[7] European Commission communication of 11 May 1999.

3 Investment Firms, Investment Services and Investment Activities

Many of the main concepts used in MiFID are familiar from the ISD. However, there are important differences.

One potentially significant development is that the ISD applies only to firms providing "investment services for third parties on a professional basis"[8], whereas MiFID applies to firms whose regular occupation or business is "the provision of one or more investment services to third parties and/or the performance of one or more investment activities on a professional basis"[9]. This distinction was introduced principally because of the difficulty of characterising dealing on own account in all circumstances as the provision of an investment service.

This development may prove to have implications, for example for banks operating treasury functions, which arguably were not providing an investment service to third parties under the ISD but which will be performing an "investment activity" for the purposes of MiFID (and which, as credit institutions, will not be able to make use of the exemption for own account dealing in Article 2 of MiFID[10]). The FSA does not expect that this will bring a large number of firms currently outside the scope of UK regulation within the UK regulatory perimeter.

The distinction between "service" and "activity" may, however, be significant because the conduct of business protections provided by Articles 19, 21 and 22 of MiFID (respectively, conduct of business obligations, best execution and client order handling rules), the benefits of the conflicts provisions in Articles 13(3) and 18 and the client asset protections in Article 13(7) are afforded to a "client" of an investment firm, defined as a party to whom the firm provides an investment service and/or ancillary service, and excluding by implication a party with whom the firm engages solely in an investment activity. The FSA's approach, which makes much of this distinction, is discussed in more detail below.

What were known as "core" services and "non-core" services under the ISD are now respectively referred to as "investment services and activities" and "ancillary services" under MiFID. Investment advice (meaning personal recommendations as to particular transactions) – a "non-core" service under the ISD – is one of the investment services and activities under MiFID, as is the "operation of multilateral trading facilities", a concept not previously covered by the ISD. "Investment research and financial analysis or other forms of general recommendation relating to transactions in financial instruments" becomes a new ancillary service under MiFID. These developments, and their implications, are discussed further below.

8 Article 1(2), ISD.

9 Article 4(1), MiFID.

10 Article 2(1)(d), MiFID provides that a person whose sole activity is dealing on own account is not an investment firm unless it is a market maker or deals off-market on an "organised, frequent and systematic basis by providing a system accessible to third parties in order to engage in dealings with them".

The main additions to MiFID's list of financial instruments compared with those covered by the ISD are derivatives, particularly derivatives not referenced to an investment or currency, such as commodity derivatives. This development is also discussed further below.

4 The Implementation Process

4.1 Lamfalussy Legislation

MiFID has been developed using the Lamfalussy legislative process. Named after Baron Lamfalussy, the chairman of the so-called "Committee of Wise Men" that devised it, the process was proposed in 2001 as a means of accelerating the development of European financial services legislation and enabling market experts to participate in the legislative process.

The Lamfalussy approach to law-making involves the preparation of a framework "Level 1" Directive which establishes guiding principles and requirements. Subordinate "Level 2" measures are subsequently prepared during the Level 1 implementation period. Level 2 measures build technical detail on to the Level 1 framework and are formulated by the European Commission with the assistance of advice provided by the European Securities Committee, itself a creation of the Lamfalussy process.

In support of these legislative measures are the Level 3 and Level 4 processes. At Level 3, the Committee of European Securities Regulators (CESR) works to develop recommendations, interpretative guidelines and common standards which aim to ensure the consistent implementation and application of the Level 1 and Level 2 legislative measures across the EU. Level 4 is concerned with supervision and enforcement: in essence, the Commission checks the compliance of Member States with Level 1 and Level 2 legislation and, where necessary and appropriate, takes action to ensure that it is observed and properly implemented.

The benefits of this approach are two-fold: first, the legislative timetable should be used more efficiently, allowing the European Parliament and Council to drive forward key policy objectives while leaving technical details to be finalised later; and secondly, experts with relevant financial markets knowledge and experience working outside the European legislative institutions can contribute substantively to the development of European law and regulation through the technical consultation process.

MiFID is a Level 1 framework Directive. In February 2006, the European Commission published draft Level 2 Implementing Measures – a draft Implementing Directive and a draft Implementing Regulation[11]. These draft Level 2 Implementing Measures were approved by the European Securities Committee in June 2006 and were adopted in August 2006.

[11] A Directive is a European instrument which requires implementation by each EU Member State before it can have direct effect as a matter of national law; a Regulation is a European instrument which has direct effect in each EU Member State without the need for national-level legislative implementation.

4.2 Timetable

MiFID was published in April 2004, initially providing for a 2-year period in which Member States must implement the Directive into national law. In December 2005, however, the European Parliament adopted a revised proposal to extend the deadline for implementation to 31 January 2007, with a further 9-month transitional period expiring on 1 November 2007 to enable firms affected by MiFID sufficient time to prepare; the proposed extension was approved by the European Council in March 2006.

4.3 Implementation in the UK

In the UK, responsibility for implementing MiFID is divided between HM Treasury, which must deal with necessary changes to UK primary and secondary legislation, and the FSA, which must make substantial changes to its Handbook of Rules and Guidance (the FSA Handbook).

In December 2005, HM Treasury published a consultation document on the UK's implementation of MiFID, and in particular on necessary changes to the UK's regulatory framework – principally the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001[12].

In order to have the necessary legislation in place before the 31 January 2007 deadline, HM Treasury had to deliver its final proposal to Parliament in early December 2006.

The FSA has produced several consultation, policy, discussion and informal papers in order to prepare for MiFID. The FSA's implementation process is generally governed by four principles:

> Implementing rules take the form of "intelligent copy-out" of MiFID text (using different terminology only where the directive text is particularly obscure or ambiguous).

> There is a presumption against "gold-plating" – adding to MiFID's requirements. In any event additional regulation has to be justified under Article 4 of the Level 2 Implementing Directive as necessary to meet UK-specific risks to investor protection. In Policy Statement 07/14, the FSA set out the agreement reached with the Commission on the measures to be notified by the UK under Article 4[13].

> Implementing rules may be extended to non-MiFID business and/or firms (such as the UK branches of non-EEA firms) to avoid unnecessary complexity and to ensure equal treatment in similar regulatory situations.

> In implementing MiFID, the FSA has cut the detail of the existing rulebooks pursuant to its move to more principles-based regulation.

[12] SI 2001/544, as amended.

[13] The FSA wish to retain measures relating to: the conditions advisers have to meet to call themselves independent; the provision of a simplified prospectus (SP) or key features document (KFD); the disclosure of actual commission and commission equivalent in relation to the sale of packaged products; and the use of dealing commission.

The discussion in this memorandum concentrates on the MiFID-related changes for MiFID investment firms rather than on the other aspects.

5 Implications for Firms and their Clients

Unlike the ISD, MiFID sets out detailed and specific requirements in relation to prudential and conduct of business matters for investment firms. The UK's pre-MiFID regulatory regime anticipated the progress which has now been made at European level by applying rules which were super-equivalent to the ISD requirements, and in some cases of a similar nature to those now prescribed by MiFID[14]. Unfortunately, there is not a clean match between the UK's existing super-equivalency and the requirements set out in MiFID and, as a result, the FSA must adapt its regime to fit the MiFID mould. The bulk of the FSA's proposals in this regard were set out in its consultation paper, CP06/19, published in October 2006, which included the proposed text for the FSA's New Conduct of Business Sourcebook. Feedback on these proposals was published in Policy Statement 07/2 (January 2007) and Policy Statement 07/6 (May 2007). The Conduct of Business Sourcebook Instrument 2007, which is annexed to Policy Statement 07/6, contains most of the rules and guidance that have now been made (known as "NEWCOB" or "COBS"). Some further amendments are set out in Annex 2 of Policy Statement 07/14 (which was published in July 2007).

The FSA also published in May 2007 a further consultation paper, CP07/9, setting out proposed conduct of business standards for non-MiFID firms and businesses that were not included in CP06/19. Once that consultation is complete, these non-MiFID amendments will, together with the current version of the New Conduct of Business Sourcebook, replace COB from 1 November 2007.

In particular, MiFID and its Level 2 Implementing Measures make specific provision in relation to, among other things, organisational requirements, outsourcing, customer categorisation, conflicts of interest, best execution and suitability. Set out below is a summary of these and other key requirements of MiFID.

As discussed earlier, MiFID will apply principally to investment firms and regulated markets, but it is important to appreciate that its implementation in the UK will also affect banks. Under the ISD an investment firm is defined as a firm which provides investment services to third parties on a professional basis whereas under MiFID the definition has been broadened to include any firm which performs investment activities on a professional basis. This has implications for certain banks which are not currently investment firms within the meaning of the ISD even though they trade in securities for their own account (because such trading is not an "investment service" provided for third parties).

[14] For instance, customer categorisation rules have been mandatory under the FSA's rules notwithstanding that the ISD contains no specific provision on that issue.

There is an exemption in MiFID for firms which do not provide any service or activity "other than dealing on own account unless they are market makers or deal on own account outside a regulated market or a multilateral trading facility (MTF) on an organised, frequent and systematic basis by providing a system accessible to third parties in order to engage in dealings with them"[15], but this exemption is not available to banks. As a result, much of the organisational and conduct of business requirements explained below will apply to banks with active treasury operations as much as to investment firms. These requirements, especially the organisational requirements, cut across or overlap with the requirements which will apply specifically to credit institutions under the Capital Requirements Directive (CRD)[16].

5.1 Organisational Requirements

Unlike other regulatory measures before it, as a product of the Lamfalussy legislative process, MiFID and its Level 2 Implementing Measures set out prescriptive specific requirements with regard to the manner in which investment firms should be organised and managed. MiFID itself sets out the high level principles in Article 13:

> "An investment firm shall establish adequate policies and procedures sufficient to ensure compliance of the firm … with its obligations under the provisions of this Directive …"

> "An investment firm shall maintain and operate effective organisational and administrative arrangements with a view to taking all reasonable steps designed to prevent conflicts of interest … from adversely affecting the interests of its clients."

> "An investment firm shall take reasonable steps to ensure continuity and regularity in the performance of investment services and activities. To this end the investment firm shall employ appropriate and proportionate systems, resources and procedures."

> "An investment firm shall have sound administrative and accounting procedures, internal control mechanisms, effective procedures for risk assessment, and effective control and safeguard arrangements for information processing systems."

The Level 2 Implementing Measures build on these guiding principles but in terms of the UK implementation of these requirements, there has not been a great deal of substantive change to the FSA's existing requirements.

Partly because of the extension of MiFID's scope to many banks, the FSA has unified the requirements which at present separately apply to investment firms and to banks. The CRD (which was required to be implemented by 1 January 2007) contains, in addition to a new capital adequacy regime, high-level requirements concerning management, systems and controls for

[15] Article 2(1)(d), MiFID.

[16] The CRD comprises two recast directives – Directive 2006/48/EC (covering credit institutions, including their capital requirements) and Directive 2006/49/EC (covering the capital adequacy of investment firms).

banks. These cover some of the same ground as the MiFID requirements. Accordingly, the FSA has developed the "common platform" approach which will apply to firms which are subject to the CRD and/or to MiFID[17]. This will result in some super-equivalence, depending on the Directive to which a firm is primarily subject.

The FSA's current rules are cast in the form of general requirements supplemented by guidance. The more prescriptive approach of MiFID and its implementing measures has required the FSA to produce rules in place of much of its guidance. The FSA's new rules can be seen in Appendix 1 of the FSA's Policy Statement 06/13.

In order to implement the CRD on time, the FSA incorporated the relevant CRD requirements into Chapter 3 of the FSA Handbook Senior Management Arrangements, Systems and Controls sourcebook (SYSC) with effect from 1 January 2007. These will remain in force for CRD firms until 1 November 2007. MiFID firms remain subject to SYSC Chapter 3 (apart from the new CRD provisions) until 1 November 2007. From that date, SYSC Chapter 3 will be disapplied for common platform firms and those firms will instead have to comply with the new "common platform" rules in SYSC Chapters 4 to 10. CRD or MiFID firms may adopt these "common platform" rules before 1 November 2007 if they wish, in which case SYSC 3 will cease to apply to them.

One material change under the common platform rules is that an independent compliance function is now required. Among other things, this means that compliance officers must not be involved in the performance of the services or activities they monitor and their remuneration must not be determined in any way which might, or might be likely to, compromise their objectivity.

A firm is not required to comply with these latter requirements if the nature, scale and complexity of its business, and the nature and range of services and activities which it undertakes, are such that those requirements are not proportionate, provided that the compliance function nonetheless "continues to be effective"[18].

5.2 Outsourcing

In the UK at least, the concept of regulated firms being required to manage and monitor their use of outside service providers is nothing new, but MiFID (alongside the CRD) is significant because for the first time European legislation has spelt out the requirement for an investment firm to ensure that outsourcing undermines neither the integrity nor the performance of the services which it provides, nor the ability of the regulator to oversee its activities.

17 For which refer to CP06/9 and PS06/13.

18 SYSC 6.1.5R.

The FSA's rules which will implement Article 13(5) of MiFID require an investment firm to "ensure, when relying on a third party for the performance of operational functions which are critical for the performance of continuous and satisfactory service to clients and the performance of investment activities on a continuous and satisfactory basis, that it takes reasonable steps to avoid undue additional operational risk"[19]; and further that "outsourcing of important operational functions may not be undertaken in such a way as to impair materially the quality of its internal control and the ability of the [regulator] to monitor the firm's compliance with all obligations".

The FSA has adopted verbatim in its new rules the definition in the Level 2 Implementing Directive of those activities which constitute an outsourcing for the purposes of MiFID: "an arrangement of any form between an investment firm and a service provider by which that service provider performs a process, a service or an activity which would otherwise be undertaken by the investment firm itself"[20]. The new rules provide a more specific explanation of those functions which are considered to be critical or important operational functions: "an operational function is regarded as critical or important if a defect or failure in its performance would materially impair the continuing compliance of a common platform firm with the conditions and obligations of its authorisation or its other obligations under the regulatory system, or its financial performance, or the soundness or the continuity of its investment services and activities"[21]. The FSA has stated that it does not intend to give any more specific guidance on the meaning of "critical" or "important" for these purposes when implementing MiFID in the UK[22] as it is likely to vary from firm to firm.

Any firm seeking to outsource critical or important operational functions or investment services or activities will be required by the FSA's rules to exercise due skill, care and diligence in entering into, managing or terminating an outsourcing[23] and, in particular, take all necessary steps to ensure that, among other things[24]:

> the service provider is able and properly authorised to provide the outsourced services reliably and professionally;

> the firm has in place systems to monitor and assess the standard of performance of the service provider and retains the necessary expertise to supervise the outsourced functions and manage the risks associated with it;

> the service provider will protect any confidential information relating to the firm or to the firm's clients;

> the service provider will co-operate with the relevant regulator and provide effective access for the regulator, the firm and its auditors to relevant data and premises; and

19 SYSC 8.1.1R.

20 Article 2(6), Level 2 Implementing Directive.

21 SYSC 8.1.4R (Article 13(1), Level 2 Implementing Directive).

22 Paragraph 7.12, CP06/9 and paragraph 6.13, PS06/13.

23 SYSC 8.1.7R (Article 14(2), Level 2 Implementing Directive).

24 SYSC 8.1.8R (Article 14(2), Level 2 Implementing Directive).

> a contingency plan for disaster recovery and periodic testing of back-up facilities in relation to the outsourced activities is established, implemented and maintained, where necessary.

It is clear that a firm will not engage in outsourcing by obtaining advice or other services which are merely ancillary to the firm's investment business – e.g. obtaining legal advice or subscribing to an electronic market information service.

The MiFID approach to outsourcing and the new FSA rules are, therefore, similar to the pre-January 2007 FSA regime[25], and, as such, implementation is not generally likely to give rise to any significant surprises for UK regulated institutions. However, MiFID does make it clear that the sub-contracting out of investment services can amount to outsourcing. In particular, there are special rules where an investment manager uses the services of a sub-manager in a non-EEA country in respect of retail client portfolios. Two conditions must be satisfied before an investment firm can proceed with such an arrangement (without the prior consent of its competent authority). The overseas manager must be authorised or registered in its home country to provide the service in question and must be subject to prudential supervision; and there must be an appropriate co-operation agreement between the investment firm's competent authority and the supervisory authority in the third country.

The FSA indicated during the consultation process that supervision of outsourcing arrangements falls within a firm's obligations to maintain robust governance arrangements and adequate control mechanisms: "Failure by a firm to have adequate arrangements regarding its outsourcing would be a failure to have robust governance arrangements or internal control mechanisms …"[26]. Notwithstanding that MiFID speaks only of outsourcing in relation to the core MiFID investment activities, the FSA's implementing rules will apply a consistent MiFID-compliant standard to outsourcing in relation to all existing UK regulated activities, all activities specified in the BCD (including lending) and all MiFID ancillary services (including the provision of investment research)[27].

5.3 Client Status and Categorisation

The FSA has interpreted MiFID to mean that a firm only has "clients" to the extent that it is providing a "service" to third parties. Where a firm is performing an "activity", in MiFID terms, without providing a service, then any counterparty to that activity is not a client. This approach represents a significant departure from the current regime where the basic presumption (subject to important exceptions) is that anyone with whom a firm deals is its client.

25 Refer in particular to what were, under the pre-January 2007 regime, SYSC 3A.9 and Integrated Prudential sourcebook (PRU) 6 in the FSA Handbook. Note that SYSC 3A.9 has now been moved to SYSC 13.9. Most of PRU 6 has now been moved to the Prudential sourcebook for Insurers (INSPRU) Chapter 5 (with the exception of PRU 6.1.9G which has been moved to SYSC 14.1.65G).

26 Paragraph 7.6, CP06/9.

27 SYSC 8.1.1R.

There are two main implications:

- a firm dealing on own account may in some circumstances be able to claim that it has no clients, even when dealing with retail investors[28]. The FSA expects firms to be able to give robust justification for such a claim, especially where retail investors are concerned. However, where investors are not clients, then client-related rulebook obligations and protections (for example, best execution, suitability and appropriateness) will fall away; and

- the FSA will preserve the non-client status of corporate finance and venture capital "contacts", which is the term used for persons with whom a firm deals in the course of corporate finance or venture capital business, such persons being counterparties to transactions entered into or arranged by the firm (for example, target company shareholders or investors in an initial public offering).

Where there is a client relationship, MiFID requires investment firms to categorise their customers before dealing with them and to apply differing regulatory protections depending on the categorisation. But whereas the UK's pre-MiFID regime provides for three categories of customer – private customer, intermediate customer and market counterparty – MiFID provides for firms to categorise their clients into one of two main categories: retail clients and professional clients. Within the professional clients category is a sub-category of institutions, eligible counterparties, which, in certain circumstances, may be eligible for treatment as, in effect, super-professional clients. The FSA's rules implementing MiFID's client categorisation rules (using the "copy-out" approach discussed above) can be found in Annex 3 of Policy Statement 07/6.

A retail client is any client which is not a professional client; a professional client is defined in Annex II of MiFID and includes, broadly, authorised financial institutions, high net worth companies, regional and local government bodies and certain other institutional investors. Any firm which is currently treated in the UK as a market counterparty, and most of those firms currently classified as intermediate customers, will be treated as professional clients for the purposes of MiFID.

Retail clients are afforded the highest degree of regulatory protection, whereas professional clients are presumed to have sufficient financial awareness to be able to deal without the full armoury of regulatory protections under MiFID. Thus, when investment firms deal with professional clients, certain regulatory obligations are either modified or disapplied: the obligations to supply information to professional clients are less extensive[29], experience and competency can be assumed when applying the suitability and appropriateness test[30], the professional nature of the client is taken into account when providing best execution[31] and certain client reporting obligations do not apply[32].

[28] FSA's informal paper of August 2006 on MiFID's Client Categorisation Requirements.

[29] See Chapter 6 of COBS and Article 29, Level 2 Implementing Directive.

[30] See Chapters 9 and 10 of COBS and Articles 35 and 36, Level 2 Implementing Directive.

[31] COBS 11.2.6R and Article 44, Level 2 Implementing Directive.

[32] COBS 16.2.1R and Section 4, Chapter III, Level 2 Implementing Directive.

Any customer classified as a professional client (including an "eligible counterparty") can request non-professional treatment. The investment firm may then agree to "provide a higher level of protection"[33] – in other words, a professional client may opt to be treated as a retail client.

Investment firms are permitted to provide certain services to some professional clients pursuant to a light-touch conduct of business regime under MiFID[34]. When providing execution and/or reception and transmission services to such "eligible counterparties", an investment firm is not required to comply with MiFID's detailed conduct of business requirements[35], the requirement to provide best execution[36] or the "prompt, fair and expeditious execution" requirement[37]. Accordingly, under MiFID, eligible counterparties can deal in the wholesale markets with other participants in a regulatory environment similar to that applicable to market counterparties under the UK's pre-MiFID regime.

Some professional clients are automatically considered to be eligible counterparties – governments, central banks, commercial banks, other investment firms, insurers, investment managers, pension funds and any other EEA authorised financial institution.

Member States can also include in the category of eligible counterparty undertakings which meet "predetermined proportionate requirements"; importantly, though, the law of the Member State in which the relevant undertaking is established will determine the counterparty status, rather than the law of the home state of the investment firm[38].

Before dealing with its customer as an eligible counterparty, an investment firm is required to obtain positive confirmation from that customer that it understands that it will be treated in that way[39]. A customer so treated may request at any time that it instead be treated as an ordinary professional client (or a retail client), either on a general basis or on a trade-by-trade basis[40].

5.4 Conflicts of Interest

Conflicts of interest have in recent years been a topical subject in the investment services market, with regulators both in Europe and elsewhere raising the matter as a cause for serious concern. By way of examples, European and US regulators (and the FSA in particular) have focused recently on potential conflicts of interest in the investment banking sector, especially between investment research and corporate finance advisory interests, and in the asset management sector, where commission-in-kind, or soft commission, had become a relatively standard practice. Both areas of concern have now been addressed by rule changes in the UK, but it undoubtedly remains a sensitive area for investment firms and their clients.

33 COBS 3.7 and Annex II, MiFID.

34 Article 24, MiFID.

35 Article 19, MiFID.

36 Article 21, MiFID.

37 Article 22(1), MiFID.

38 `Article 24(3), MiFID.

39 COBS 3.6.4R.

40 COBS 3.7 and Article 24(2), MiFID.

As a result, although conflicts of interest were addressed in general terms in the ISD, it is no surprise to find that MiFID will impose specific and detailed requirements for firms to identify and manage conflicts of interest[41]. Establishing and maintaining systems to manage conflicts of interest is a key organisational principle for investment firms under MiFID, as noted in paragraph 5.1 above. The FSA's implementing rules spell out in more detail both the types of situations which may give rise to conflicts and the types of conflict management policy required of firms.

Currently, FSA rules and industry practice rely on two principal tools to manage conflicts. The first is the use of Chinese walls – the complete separation of business functions whose operations may give rise to conflicts. The second is "informed consent" – whereby firms seek the contractual agreement of their clients to the existence of actual or potential conflicts (for example, where the investment banking side may be advising a corporate client and the trading side may be taking positions in its securities). Special rules apply to conflicts arising in the area of investment research; MiFID also prescribes special rules in this area.

The FSA rules, set out in Policy Statement 06/13[42], follow closely the text of the Level 2 Implementing Measures and require firms to:

> identify conflicts between the firm and any client and also between any one client and another client;

> maintain and operate effective organisational and administrative arrangements with a view to preventing conflicts adversely affecting the interests of clients; and

> establish, implement and maintain an effective conflicts of interest policy set out in writing.

The implementing rules are clear that if a firm's organisational and administrative arrangements "are not sufficient to ensure, with reasonable confidence, that risks of damage to interests of a client will be prevented, the firm must clearly disclose the general nature and/or sources of conflicts of interest to the client before undertaking business for the client"[43]. Although the text of the Directive is not explicit on the point, it is understood that disclosure and client consent, whilst acting to mitigate conflicts once arisen, are not in themselves "organisational and administrative arrangements" which can be used to *prevent* the risk of damage to clients' interests posed by conflicts from arising; as such, a firm will not be able to comply with its obligations under MiFID simply by disclosing potential conflicts to its clients. However, disclosure and consent continue to be of importance in the management of a firm's fiduciary obligations, which are often stricter than those imposed by regulation – firms should, therefore, continue to ensure that suitable provisions are incorporated in their engagement letters, terms of business and similar documents.

41 SYSC Chapter 10 and Article 18, MiFID.

42 See Appendix 1 to PS06/13.

43 SYSC 10.1.8R and Article 18(2), MiFID.

Statements from the FSA help to clarify the position: "Our proposals under MiFID … require disclosure of an actual or potential conflict of interest as a method of managing a conflict, but only where the firm is not reasonably confident that its other procedures and measures for managing the conflict or potential conflict will prevent the risk of damage to the client's interests. This does not imply that disclosure cannot be the appropriate method of managing a conflict, but it does change the emphasis – a firm must consider whether other measures will be effective before resorting to disclosure"[44].

Guidance included in the FSA Handbook states: "an over-reliance on disclosure without adequate consideration as to how conflicts may appropriately be managed is not permitted"[45].

Clearly the intention is to put a firm's clients into the driving seat with regard to decisions concerning the acceptability of potential conflicts.

5.5 Best Execution and Client Order Handling

Investment firms are certainly familiar with the duty of best execution under existing FSA rules. Article 21 of MiFID applies the duty of best execution to a firm when executing orders for a client, and takes a broader frame of reference to obtaining the best possible result for the client than simply achieving the best price: the obligation is to take all reasonable steps to achieve the best possible result, taking into account price, costs, speed, likelihood of successful execution and settlement, size, nature and "any other consideration" which is relevant to the execution of the order.

In response to queries by CESR on the scope of the MiFID best execution requirements, the European Commission made it clear that the key concept to focus on is the execution of orders *on behalf of clients*[46]. The Commission clarified that the scope of best execution requirements in relation to dealing on own account is limited to circumstances where the firm is acting on behalf of the client. Whether the execution of the client's order can be seen as done on behalf of the client is a question of fact in each case, which depends on whether the client legitimately relies on the firm to protect his or her interests in relation to pricing and other elements of the transaction – such as speed or likelihood of execution and settlement – that may be affected by choices made by the firm when executing the order. In Policy Statement 07/15, published in August 2007, the FSA confirmed that it would be proceeding on the basis of the Commission's response, and suggested that firms apply the analysis and tests presented in the Commission's response to determine whether best execution applies in particular circumstances.

44 Speech by Hector Sants, Managing Director, Wholesale & Institutional Markets, FSA: Market abuse and conflicts of interest: The FSA approach (5 June 2006).

45 SYSC 10.1.9G.

46 Working Document ESC-07-2007: Commission answers to CESR scope issues under MiFID and the implementing directive (March 2007).

Where best execution does apply, the Level 2 Implementing Directive provides that in determining the relevant importance of the factors listed above, a firm should take account of the categorisation of the client, the nature of the order and the type of, and venue of execution for, the relevant instrument being traded[47]. Nevertheless, if a client issues specific instructions in respect of an order, a firm will be required to execute orders in accordance with those instructions.

For retail clients, the COBS rules provide that the "best possible result" will be determined in terms of the total consideration, representing the price of the relevant financial instrument and the costs related to execution[48].

Investment firms are required to establish and implement arrangements for complying with their best execution obligations, including the production and periodic review of a best execution policy. The policy, to which the client must give prior consent, must specify (among other things) the execution venues on which the firm will execute client orders[49].

The FSA's interpretation of Article 21 of MiFID is that it should not be necessary for a firm to be able to demonstrate that it achieves the best possible result for every customer order, but rather that the firm should have in place execution arrangements which lead it to take all reasonable steps to obtain the best possible result for its client orders[50].

Whereas under the FSA's existing regime investment firms have been able to agree when dealing with intermediate customers that they will not provide best execution, MiFID will not permit disapplication for all professional clients, but only those which qualify as eligible counterparties.

A modified form of the best execution requirement will apply for discretionary investment managers and order passing firms[51]. Furthermore, the best execution obligations of Article 21 will not apply to transactions concluded between participants in an MTF or between the MTF and its participants[52], or to transactions concluded on a regulated market[53]. Firms executing client orders through the systems of an MTF or on a regulated market will, however, be subject to the requirements of Article 21 in relation to those clients.

In addition to the obligation to provide best execution, Article 22 of MiFID requires investment firms to implement "procedures and arrangements which provide for the prompt, fair and expeditious execution of client orders, relative to other client orders or the trading interests of

47 Article 44(1), Level 2 Implementing Directive.

48 COBS 11.2.7R (Article 44(3), Level 2 Implementing Directive).

49 See COBS 11.2.14R; 11.2.16R; and 11.2.22R-11.2.29R.

50 See paragraph 2.16 of Discussion Paper 06/3.

51 COBS 11.2.30R – 11.2.34R (Article 45, Level 2 Implementing Directive).

52 Article 14(3), MiFID.

53 Article 42(4), MiFID.

the investment firm"[54]. In other words, a firm must provide timely execution and fair allocation of order priority. Investment firms in the UK are currently required to provide timely execution under existing FSA conduct of business rules.

5.6 Suitability and Appropriateness

Article 19 of MiFID requires investment firms to make an assessment of the "suitability" and "appropriateness" of transactions and services when dealing with clients other than on an execution-only basis.

The suitability test is to be applied when a firm provides investment advice or portfolio management: the investment firm shall "obtain the necessary information regarding the client's … knowledge and experience in the investment field relevant to the specific type of product or service, his financial situation and his investment objectives so as to enable the firm to recommend to the client … the investment services and financial instruments that are suitable for him"[55]. In CP06/19 the FSA states that, so far as investment advice and portfolio management for retail clients is concerned, it does not expect its use of the MiFID suitability formulation in its new rules to require firms in general to change their approach to assessing suitability, although it points out that there may be a greater impact on firms dealing with professional clients since MiFID applies suitability requirements to these clients for the first time[56].

The appropriateness test is to be applied when a firm provides MiFID investment services which do not involve advice or discretionary portfolio management[57], including execution services which do not fall within the conditions for execution-only business: the investment firm must ask the client to provide "information regarding his knowledge and experience in the investment field relevant to the specific type of product or service offered … so as to enable the investment firm to assess whether the service or product envisaged is appropriate for the client"[58].

Perhaps unsurprisingly, the obligations in each case are less onerous when an investment firm deals with professional clients because it is permitted to make certain assumptions about the objectives, resources, knowledge and experience of professional clients which it cannot make in respect of retail clients. In the case of the appropriateness test, an investment firm may assume the necessary experience and knowledge on the part of its professional clients, thus practically confining the test to retail clients only[59].

[54] COBS 11.3.1R.

[55] Article 19(4), MiFID, COBS 9.2.1R.

[56] Paragraphs 14.12 and 14.14, CP06/19.

[57] Article 19(5), MiFID.

[58] COBS 10.2.1R(1).

[59] COBS 10.2.1R(2).

If the firm reaches the conclusion that the service or product in question is not appropriate to its client, it must give the client a warning to this effect[60]. The warning can be in a standardised format. If the client nonetheless wishes to purchase the service or product, the firm should then consider whether to go ahead with the transaction, having regard to the circumstances. If a client refuses to provide the relevant information (or provides insufficient information) for an assessment of appropriateness, the firm must warn the client that it has not been able properly to assess the appropriateness of the product or service; if the client nonetheless wishes to proceed, the firm may then consider whether to do so, having regard to the circumstances[61].

5.7 Investment Research, Financial Analysis and General Recommendations

MiFID introduces a new ancillary service – investment research and financial analysis or other forms of general recommendation relating to transactions in financial instruments.

MiFID provides that a firm solely carrying on these activities (and/or providing other ancillary services) cannot be authorised as an investment firm. Whether any of the activities are regulated in a Member State will be a matter for domestic legislation (for example, investment research or other advice which recommends particular financial instruments is regulated under the Financial Services and Markets Act 2000).

Where an investment firm, authorised to carry on one or more investment service or activity, is also authorised by the home Member State to provide investment research or other general advice, then those ancillary services may be carried on throughout the EEA pursuant to the MiFID passport. This should make it easier for a firm to distribute investment research.

"Investment research" is defined in the Level 2 Implementing Measures as material which, while falling short of constituting investment advice, amounts to a recommendation or suggestion of an investment strategy concerning financial instruments or issuers and is intended for "distribution channels" or for public dissemination[62].

Where a firm produces investment research, the COBS rules require firms to take measures to secure the independence of the financial analysts concerned, and include provisions in relation to personal account trading, inducements, relationships with issuers covered by the research and the partiality of others involved in internal review of the research. The FSA's current conduct of business rules in this area are detailed and of broadly similar effect to the provisions in MiFID (albeit that MiFID necessitates certain changes in terminology)[63].

60 COBS 10.3.1R and Article 19(5), MiFID.

61 COBS 10.3.3R and Article 19(5), MiFID.

62 Article 24(1), Level 2 Implementing Directive and see the FSA Glossary's definition of "investment research" in Part 1 of Annex 3 to PS07/2.

63 See Chapter 17 of CP06/19 for a discussion of the FSA's proposals to implement the relevant provisions of MiFID and COBS 12.1 and 12.2 (Investment research) and 11.7 (Personal account dealing) for the rules in this area.

5.8 Execution-only Business

There is a presumption against execution-only business for retail and professional clients in MiFID. Execution-only services may be provided, however, in the following circumstances[64]:

> the services consist only of the execution and/or the reception and transmission of client orders;

> the services relate to shares admitted to trading on a regulated market or an equivalent third country market[65], money market instruments, bonds or other forms of securitised debt (excluding bonds or securitised debt that embed a derivative), undertakings for collective investment in transferable securities (UCITS) and other "non-complex financial instruments";

> the services are provided "at the initiative of the client";

> the client has been clearly informed that the firm is not obliged to assess suitability in providing the service; and

> the firm complies with its obligations under Article 18 of MiFID to control or manage conflicts of interest (see paragraph 5.4 above).

The term "non-complex financial instruments" is not defined in MiFID, but instead in the Level 2 Implementing Directive[66]. The criteria which determine whether an instrument is non-complex are that:

> the instrument is not one which gives a right to buy or sell another transferable security and is not any other type of derivative instrument;

> there are "frequent opportunities" to trade, redeem or otherwise realise the instrument at publicly available prices;

> the instrument does not involve any contingent liability other than the initial cost of acquiring the instrument; and

> adequate information on the instrument's characteristics is publicly available and likely to be understood by a retail client.

64 COBS 10.4.1R, and Article 19(6), MiFID.

65 The Commission will maintain and publish a list of equivalent third country markets which the FSA intends to refer to in COBS 10.5.4G, once this list is available.

66 Article 38, Level 2 Implementing Directive; see COBS 10.4.1(3)R.

Recital 30 to MiFID[67] provides that a service should be considered to be provided at the initiative of the client "unless the client demands it in response to a personalised communication from or on behalf of the firm to that particular client, which contains an invitation or is intended to influence the client in respect of a specific financial instrument or specific transaction. The service can be considered to be provided at the initiative of the client notwithstanding that the client demands it on the basis of any communication containing a promotion or offer of financial instruments made by any means that by its very nature is general and addressed to the public or a larger group or category of clients or potential clients". The FSA has included guidance to this effect in COBS[68].

The implication, therefore, is that an execution-only firm may advertise its services generally, but may not target specific clients or potential clients. Persons seeking to place execution-only business with a firm in response to a generally distributed advertisement will be considered to be acting on their own initiative[69].

5.9 Information for Clients and Marketing Communications

MiFID and the Level 2 Implementing Directive prescribe the information which firms must give clients with additional requirements for "marketing communications"[70]. Although these requirements are not of themselves onerous or unfamiliar in a UK context, the rewriting of the FSA's financial promotion rules has been proving particularly difficult as a technical matter and may lead to increased complexity[71].

6 Implications for the EEA Investment Services Market

From the starting point of the ISD, MiFID expands both the list of regulated investment services and the list of regulated financial instruments. The schedule to this memorandum sets out the information contained in Annex I to MiFID, which describes the services and financial instruments to which MiFID applies. Together, these lists determine both the minimum core activities that Member States are required to regulate and the scope of the European passport for investment services[72]. The large majority of investment firms subject to MiFID will also be subject to the EU capital adequacy directives.

67 Although recitals are not part of the operative legislative text of a European Directive, they are indicative of the legislative intent and are therefore expected to influence the implementation process at national level.

68 COBS 10.5.1 - 2G.

69 See discussion at paragraphs 15.25 - 27 CP06/19.

70 Article 19(2) and (3), MiFID and Articles 27 - 34, Level 2 Implementing Directive.

71 CP06/20, PS07/2 and PS07/6.

72 Section A of Annex I to MiFID sets out the core "investment services and activities" to which MiFID applies. Section B sets out the "ancillary services" to which the passport element of the Directive applies. Whilst the provision of ancillary services does not trigger the requirement to become regulated under MiFID, firms passporting Section A core services and/or activities are entitled to passport ancillary services at the same time; ancillary services cannot be passported independently of Section A core services and activities.

In addition to expanding the scope of the regulated investment services sector in Europe, MiFID seeks also to improve efficiency and competition in investment services by removing obstacles at national level to the development of a single market.

Finally, in anticipation of a single liquid pan-European capital market, MiFID provides a new framework for the regulation of securities market infrastructure, in particular acknowledging that mainstream securities dealing activity is no longer confined to the principal recognised investment exchanges.

6.1 Investment Advice

MiFID expands the scope of regulated investment services by making investment advice one of the core investment services and activities. The significance of this change is that a firm whose sole business is to provide investment advice will need to be authorised as an investment firm. Under the ISD, investment advice is not a core service and it is therefore a matter for each Member State to decide whether to regulate it (as does, for example, the UK). As a result of the changes brought about by MiFID, investment advisers will be better placed to take advantage of the EEA passport[73].

There was debate, and a degree of concern for some time, about the Level 2 Implementing Measures which would define more precisely the nature of regulated investment advice. In particular, there was much discussion about whether generic recommendations should be included in the definition (for example, a recommendation to invest in shares rather than bonds). This widening of the definition would have had far-reaching consequences for the UK, where generic advice is currently unregulated. Fortunately, however, in its Level 2 Implementing Measures the Commission has adopted the advice of CESR, framing the definition of investment advice in terms of a personal recommendation to deal in a particular financial instrument.

This is narrower in scope than the existing UK definition, which is not limited to personal recommendations. The current proposal, however, is that the UK should retain its wider definition (therefore regulating a wider group of advisers than anticipated by MiFID), although only the narrower MiFID definition will be used to establish whether a firm is a MiFID investment firm and to determine the availability of the MiFID European passport.

6.2 Regulated Financial Instruments

Under MiFID, most forms of commodity and other non-financial[74] derivatives will become specified financial instruments and, as a consequence, a firm which deals in such derivatives will be required to be authorised by a national regulator (and as a result may also be able to rely on the passport to carry on that business in other EEA Member States). MiFID provides, however,

[73] Under the ISD, investment advice is a non-core service which can be passported only by an investment firm authorised for one of the core ISD investment services.

[74] Including credit, weather and emissions.

that the authorisation requirement, and therefore also the passport, is not available to a firm whose main business consists only of dealing on own account in commodities and/or commodity derivatives, unless that firm is part of a group the main business of which is the provision of investment services or banking services[75].

In the UK certain types of commodity and other non-financial derivatives – contracts for differences referenced to the price or value of commodities and some precious metal options – are specified financial instruments under existing legislation. But MiFID necessitates changes to the UK's approach, in particular in relation to commodity futures. Under UK legislation, a future is currently only a specified investment for regulatory purposes if it is entered into for investment rather than commercial purposes. MiFID brings into the regulated markets all cash-settled commodity futures contracts and all exchange- or MTF-traded, and standardised over-the-counter, physically-settled futures[76].

6.3 Home State Regulation of Cross-border Services

In contrast to the ISD, MiFID provides that Member States may not impose additional local requirements on an investment firm which relies on the passport to provide cross-border services into that Member State[77]. In other words, if an investment firm provides MiFID investment services and activities from its home state into other EEA Member States, only the home state regulator's conduct of business rules will apply to that activity. This policy initiative clearly addresses one of the key practical deficiencies of the ISD; the anticipated consequence is that bringing down national-level barriers will encourage cross-border business and thereby improve efficiency and competition in a single investment services market.

MiFID does not prohibit a Member State, however, from imposing local requirements in circumstances where an investment firm seeks to establish a branch in that jurisdiction; in particular in relation to: general conduct of business, best execution, client order handling, transaction reporting, off-market quotations and post-trade disclosure[78].

Unfortunately, there is some lack of clarity within MiFID over the allocation of responsibility for the supervision of cross-border services provided by a branch.

MiFID provides that the host state can apply these rules to a passporting branch only in respect of "services provided by the branch within its territory"[79]. One interpretation of this phrase is that a passporting branch providing services on a cross-border basis into other EEA Member States will be subject to host state rules for the activities carried on *in* that host state, but home

75 Article 2(1)(k), MiFID.

76 Paragraphs 5-7 of Section C, Annex I, MiFID.

77 Article 31(1), MiFID.

78 Articles 32(1) and 32(7), MiFID.

79 Article 32(7), MiFID.

state rules for the activities provided *from* the host state into other states. This may in particular have implications for the provision by non-UK investment banks of investment services from a London branch.

To illustrate with a practical example: a UK investment firm providing investment services into Belgium would be subject to UK conduct of business rules in respect of both its UK and Belgian activities. If the firm establishes a branch in France under the MiFID passport, notwithstanding any prudential supervision of the branch activities by the FSA, the French regulator would apply local conduct of business rules to the activities of that branch within France. If the branch then provides cross-border services into Germany under the passport, UK conduct of business rules would apply to those cross-border activities.

An alternative (and arguably more logical) interpretation would be to read the phrase "services provided by the branch within its territory" as conferring responsibility on the host state regulator for the supervision of the provision of all services provided by a branch which is established in the territory of the host state regulator.

This interpretation would have the practical effect that the UK investment firm providing investment services into Belgium would be subject to UK conduct of business rules in respect of both its UK and Belgian activities; the French branch, however, would be subject to French conduct of business rules in respect of all its activities in and from France, including if it were to provide cross-border services into Germany (or the UK, for that matter).

The FSA discusses these issues in paragraphs 5.16 - 19 of CP06/14 and Chapter 4 of Section A of Policy Statement 07/2. Passporting issues also form part of CESR's 2006/2007 Level 3 Expert Group Work Programme. CESR produced a consultation paper on passporting under MiFID which closed on 9 February 2007. This paper included consideration of the practical application of requirements for the supervision of branches, and consideration of the interpretation of "within its territory". CESR commented that no further legislation would result from the outcome of this consultation; instead CESR hopes to develop a voluntary framework between regulators. In May 2007, CESR published its recommendations[80], which included a commitment to carry out further work to develop a common model of practical co-operation for the supervision of branches. In June 2007, CESR published the European Commission's response to certain questions about the allocation of responsibilities among home and host state regulators in relation to the supervision of branches. The Commission's response, which provided some clarity but also accepted that there were some "grey areas", envisaged the following situations:

> Where both the branch through which the service is provided and the client are in the host Member State, responsibility for supervising should be allocated to the host state regulator;

> When the client is in the Member State of the head office (i.e. the home Member State), the regulator responsible for supervising should be that of the home Member State; and

80 The Passport under MiFID: Recommendations for the Implementation of the Directive 2004/39/EC, May 2007.

> Where, however, the client is not either in the Member State of the branch or in the Member State of the head office, the allocation of responsibility has to be decided on a case by case basis. The Commission's suggested approach in these circumstances involves the following principles:

  - There should be effective shared and common supervision of the branches between the home and host state regulators;
  - Home and host state regulators have a legal obligation to co-operate under various MiFID articles;
  - Regulators should establish Memoranda of Understanding ("MoU") to determine the practical arrangements for their co-operation in the supervision of branches; and
  - CESR should begin working on a multilateral MoU for the supervision of branches under MiFID or establish a common template for bilateral MoUs which regulators could use for reference purposes.

6.4 De-concentration and MTFs

MiFID provides a new framework for the regulation of securities market infrastructure, which recognises that trading activity in the European securities markets is no longer concentrated on the main exchanges. In particular, MiFID incorporates in European legislation for the first time the concept of an MTF – a multilateral trading facility – which functions as a market but not in accordance with the requirements which apply to regulated markets.

An MTF is defined as a "multilateral system, operated by an investment firm or a market operator, which brings together multiple third-party buying and selling interests in financial instruments – in the system and in accordance with non-discretionary rules – in a way that results in a contract"[81].

MiFID anticipates that an MTF can be operated either by a "market operator" (a person which is, or which operates, a regulated market) or by an investment firm. The operation of an MTF becomes a core investment activity under MiFID[82], so that an MTF operator must be specifically regulated as such and can rely on the passport to provide MTF dealing services in or into other EEA jurisdictions on the basis of a home-state authorisation. The Alternative Investment Market (AIM) becomes an MTF under MiFID; the operation of the AIM by the London Stock Exchange is an example of a market operator carrying on the MTF investment activity[83].

81 Article 4(1)(15), MiFID.

82 Paragraph 8, Section A of Annex I, MiFID.

83 It was also announced in November 2006 that a group of investment banks are planning to establish an MTF to rival the major European exchanges.

A regulated MTF operator will be subject to additional requirements under MiFID, which would not apply to an investment firm operating an MTF under the ISD, namely:

> the operation of transparent and non-discretionary rules for fair and orderly trading; and

> the publication of trading price information both pre- and post-trade.

MTFs are not subject to the Market Abuse, Prospectus or Transparency Directive requirements, whether operated by a market operator or an investment firm. As such, there is no requirement for a prospectus to be published when securities are admitted to trading by an MTF (unless an offer to the public is involved); nor are the issuers of securities so traded subject to the continuing obligations requirements of those three Directives.

6.5 Systematic Internalisers

Article 27 of MiFID introduces the concept of a “systematic internaliser”, which it defines as an investment firm “which, on an organised, frequent and systematic basis, deals on own account by executing client orders outside a regulated market or an MTF”[84].

Systematic internalisers which deal in shares which are admitted to trading on a regulated market and for which there is a liquid market are required to publish firm quotes, which reflect prevailing market conditions, on a regular and continuous basis during normal trading hours for those shares[85].

Although they may update these quotes at any time, and, under exceptional market conditions, withdraw them, systematic internalisers are generally, under the terms of Article 27, obliged to execute orders at their quoted prices. However, the obligations of Article 27, including the pre-trade transparency requirements, do not apply to deals in excess of standard market size.

Article 28 additionally requires investment firms to provide post-trade information to the market “as close to real-time as possible” and “on a reasonable commercial basis”[86].

Equivalent requirements apply to firms (and market operators) which operate an MTF, pursuant to Articles 29 and 30 of MiFID.

84 Article 4(1)(7), MiFID.

85 The European Commission is investigating whether and to what extent requirements on pre- and post-trade transparency should be introduced for trading in non-equity financial instruments such as bonds and derivatives.

86 Article 28(1), MiFID.

IMPORTANT NOTE: This memorandum is intended as a general guide to MiFID and its implementation in the UK. It should not be relied upon as a substitute for legal advice.

If you have specific questions relating to MiFID or its implementation in the UK, please contact your usual adviser at Slaughter and May or speak directly to Ruth Fox, Jan Putnis, John Crosthwait or Ben Kingsley in Slaughter and May's Financial Regulation Group on +44 (0)20 7600 1200.

SCHEDULE

MiFID, Annex I:
List of Services and Activities and Financial Instruments

Section A
Investment services and activities

(1) Reception and transmission of orders in relation to one or more financial instruments.

(2) Execution of orders on behalf of clients.

(3) Dealing on own account.

(4) Portfolio management.

(5) Investment advice.

(6) Underwriting of financial instruments and/or placing of financial instruments on a firm commitment basis.

(7) Placing of financial instruments without a firm commitment basis.

(8) Operation of Multilateral Trading Facilities.

Section B
Ancillary services

(1) Safekeeping and administration of financial instruments for the account of clients, including custodianship and related services such as cash/collateral management.

(2) Granting credits or loans to an investor to allow him to carry out a transaction in one or more financial instruments, where the firm granting the credit or loan is involved in the transaction.

(3) Advice to undertakings on capital structure, industrial strategy and related matters and advice and services relating to mergers and the purchase of undertakings.

(4) Foreign exchange services where these are connected to the provision of investment services.

(5) Investment research and financial analysis or other forms of general recommendation relating to transactions in financial instruments.

(6) Services related to underwriting.

(7) Investment services and activities as well as ancillary services of the type included under Section A or B of Annex I related to the underlying of the derivatives included under Section C – 5, 6, 7 and 10 - where these are connected to the provision of investment or ancillary services.

Section C
Financial instruments

(1) Transferable securities.

(2) Money-market instruments.

(3) Units in collective investment undertakings.

(4) Options, futures, swaps, forward rate agreements and any other derivative contracts relating to securities, currencies, interest rates or yields, or other derivatives instruments, financial indices or financial measures which may be settled physically or in cash.

(5) Options, futures, swaps, forward rate agreements and any other derivative contracts relating to commodities that must be settled in cash or may be settled in cash at the option of one of the parties (otherwise than by reason of a default or other termination event).

(6) Options, futures, swaps, and any other derivative contract relating to commodities that can be physically settled provided that they are traded on a regulated market and/or an MTF.

(7) Options, futures, swaps, forwards and any other derivative contracts relating to commodities, that can be physically settled not otherwise mentioned in C.6 and not being for commercial purposes, which have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are cleared and settled through recognised clearing houses or are subject to regular margin calls.

(8) Derivative instruments for the transfer of credit risk.

(9) Financial contracts for differences.

(10) Options, futures, swaps, forward rate agreements and any other derivative contracts relating to climatic variables, freight rates, emission allowances or inflation rates or other official economic statistics that must be settled in cash or may be settled in cash at the option of one of the parties (otherwise than by reason of a default or other termination event), as well as any other derivative contracts relating to assets, rights, obligations, indices and measures not otherwise mentioned in this Section, which have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are traded on a regulated market or an MTF, are cleared and settled through recognised clearing houses or are subject to regular margin calls.

CONTACT ADDRESSES

London
One Bunhill Row
London EC1Y 8YY
United Kingdom
T +44 (0)20 7600 1200
F +44 (0)20 7090 5000

Paris
130 rue du Faubourg Saint-Honoré
75008 Paris
France
T +33 (0)1 44 05 60 00
F +33 (0)1 44 05 60 60

Brussels
Square de Meeûs 40
1000 Brussels
Belgium
T +32 (0)2 737 94 00
F +32 (0)2 737 94 01

Hong Kong
47th Floor
Jardine House
One Connaught Place
Central
Hong Kong
T +852 2521 0551
F +852 2845 2125

www.slaughterandmay.com