

**Notification and justification for retention of the FSA's requirements on the content of confirmation and periodic statements ("the Provisions") under Article 4 of Directive 2006/73/EC ("Level 2 Directive") implementing Directive 2004/39/EC ("Level 1 Directive").**

1. The FSA proposes to retain a number of its existing requirements on the content of client confirmations and periodic statements in addition to those content requirements that are imposed by the Level 2 Directive. This notification explains how the Provisions satisfy the requirements of the Article 4 test. It is structured as follows:
  - An explanation of how the Provisions go beyond the requirements of the Level 2 Directive;
  - A description of the specific risks to investor protection and to market integrity addressed by the Provisions and explanation why they are not adequately addressed by the Level 2 Directive;
  - An explanation of why the Provisions are proportionate; and,
  - An explanation of why the Provisions do not restrict or otherwise affect the rights of investment firms under Articles 31 and 32 of the Level 1 Directive.
2. Unless indicated otherwise, references in this notification to the rules of the FSA are references to rules in the proposed new conduct of business sourcebook (COBS) contained in Part 3 of Annex 6 to FSA consultation paper 06/19: Reforming Conduct of Business Regulation, published on 31 October 2006.<sup>1</sup>

*In what way are the Provisions additional to those in the Level 2 Directive?*

3. Article 19(8) of the Level 1 Directive requires that clients receive adequate reports on the services provided by an investment firm. Article 40 of the Level 2 Directive requires a firm to provide retail clients with a notice ("trade confirmation") confirming the execution of an order that contains specified information. Article 41 requires a firm to provide retail clients with a periodic statement of portfolio management activities carried out on their behalf that contains certain specified information.
4. The FSA is proposing to retain the following specific Provisions in support of the general principle in Article 19(8) of MiFID, as well as transposing the express requirements of Articles 40 and 41 of the Level 2 Directive<sup>2</sup>:
  - a. A requirement<sup>3</sup> for a trade confirmation to disclose any mark-up or mark-down imposed where the firm acted as principal and owed a duty of best

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<sup>1</sup> [http://www.fsa.gov.uk/pubs/cp/cp06\\_19\\_annex6.pdf](http://www.fsa.gov.uk/pubs/cp/cp06_19_annex6.pdf). Defined terms are shown in italics in that consultation paper. Where amendments to defined terms are proposed, these changes are shown in Part 1 of that Annex. Where no changes are proposed to those defined terms, they should be read in accordance with the existing FSA glossary, which can be accessed at <http://fsahandbook.info/FSA/html/handbook/Glossary>.

<sup>2</sup> The FSA proposes to implement Article 40 of the Level 2 Directive through COBS 17.2 and Article 41 of the Level 2 Directive through COBS 17.3. Each of these is supported by the table in COBS 17 Ann 1R, which sets out the detailed contents requirements for trade confirmations and periodic statements.

<sup>3</sup> COBS 17 Ann 1 R (1) (14)

execution. The concept of a mark-up or a mark-down applies where the firm is a principal to the trade and modifies the price offered to the client from the market price. This mark-up or mark-down constitutes a different mechanism for the firm to obtain remuneration for the trade. The FSA proposes to include this as a separate item in trade confirmation reports to ensure it is properly disclosed.

- b. A requirement<sup>4</sup> for a confirmation for a transaction involving the conversion of currency to state the rate of exchange obtained by the firm.
- c. A requirement<sup>5</sup> that a confirmation for a transaction in an instrument where a dividend or other right has been declared but not paid to state if the purchaser is not to receive the benefit of that right or dividend.
- d. Requirements<sup>6</sup> for confirmations or periodic statements to include the essential details in respect of transactions in derivatives and options. These cover:
  - i. maturity, delivery or expiry date;
  - ii. last exercise date and strike price for an option;
  - iii. if the transaction closes out an open futures positions, all essential details required in respect of each contract comprised in the open position and each contract by which it was closed out and the profit or loss arising out of closing out that position (ie a difference account);
  - iv. for a transaction in an option, the date of exercise and either the time of exercise or that the client will be notified of that time on request;
  - v. whether the exercise creates a sale or purchase in the underlying asset; and
  - vi. the strike price of the option and if applicable, the total consideration to or from the client.
- e. A requirement<sup>7</sup> for periodic statements for discretionary managed portfolios to include the details of assets loaned or charged.
- f. A requirement<sup>8</sup> for periodic statements for discretionary managed portfolios involving transactions with actual or potential liability for the client above the acquisition cost (contingent liability transactions) to include details of unrealised and realised profits on uncovered open positions in such transactions during the relevant period and profit or loss to the client from transactions to close out contingent liability transactions during that period.

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<sup>4</sup> COBS 17 Ann 1 R (1) (15)

<sup>5</sup> COBS 17 Ann 1 R (1) (16)

<sup>6</sup> COBS 17 Ann 1 R (1) (19)-(24)

<sup>7</sup> COBS 17 Ann 1 R (2) (8)

<sup>8</sup> COBS 17.3.7R, which is supported by guidance at COBS 17.3.8

Alternatively, the firm can provide the net profit or loss in respect of the client's overall position in each contract.

5. These Provisions could, on one reading, be seen as additional to those in Articles 41 and 42 of the Level 2 Directive in that each contains specific regulatory disclosures in areas where that Directive has no detailed requirements. However, there is also a strong argument that these Provisions should be seen as the more specific application of the general reporting requirement in Article 19(8) of the Level 1 Directive (and, in the case of trade confirmations, Article 40(1)(a) of the Level 2 Directive) and therefore not imposing any additional requirements on firms.

*What are the specific risks to (i) investor protection or to (ii) market integrity that the requirements address that are not adequately addressed by the Level 2 Directive?*

6. The detailed requirements in Articles 41 and 42 of the Level 2 Directive do not explicitly cover more complex transactions with retail clients, such as derivative trading. Whilst the general requirement to provide clients with the essential details of their transactions applies to dealings in all investment types, the particular Level 2 MiFID requirements are equity focussed and do not address the particular characteristics of options or other derivative products.
7. Also, the detailed requirements in Articles 41 and 42 of the Level 2 Directive do not include five other matters that we would consider important to enable the client to have adequate information about the transaction carried out on his behalf (e.g. exchange rate used, mark-up of price) and to review the integrity of services provided by the agent (i.e. to avoid opportunities to make hidden profits).
8. The Provisions address investor protection risks arising from asymmetry of information and principal-agent conflicts. These risks arise because the MiFID requirements either provide no standards in a particular area or do not provide for the disclosure of adequate detail. The requirements to provide further information in respect of derivatives ensure that a client receives a better factual understanding of his financial position. In the absence of the additional requirements it would be possible for firms to generate 'secret' profits from the activities undertaken on behalf of their clients that would not be required to be disclosed. By providing the additional information proposed clients can more easily tell whether the dealer or portfolio manager was acting in their best interests.

*In what way are the risks of particular importance in the circumstances of the market structure of the United Kingdom?*

9. The UK market has a long history of retail investment in derivative and contingent liability instruments and use of these instruments is becoming increasingly mainstream<sup>9</sup>. In recent years financial spreadbetting services have been heavily promoted to retail clients by both specialist firms and highstreet names. The additional risk presented by these instruments means that additional information is required to ensure clients understand their positions.

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<sup>9</sup> Recital 10 to the Level 2 Directive clarifies that the market structure of the Member State in question includes the behaviour of firms and consumers in that market.

10. Other additional information disclosures proposed, such as exchange rate and mark up disclosure, seek to address specific abusive practices by firms that have been observed in the UK markets in the past.

*Why are the requirements proportionate?*

11. Our view is that if there is a market failure which the high level reporting requirements under MiFID do not address, it is small. This is because these are protections which clients will want and firms are therefore likely to provide them, in the main. We expect that, were the requirements to be lifted, a significant proportion of firms would continue to meet the standard of behaviour set by the rules. These requirements are long standing and in many cases have become accepted market practice. The requirements are, therefore, low cost. A proportion of firms would however be expected to use the relaxation of the requirements to profit gouge from their customers. Quantifying the number of firms who would change their behaviour and exploit the relaxation and hence the exact size of the benefits of retention is difficult to assess. As firms currently provide these protections, the cost of retaining them must be small.
12. These additional provisions take the approach of requiring the firm to provide information to the clients (to correct information asymmetries) – enabling the client to hold the firm to account – rather than using stronger regulatory tools such as prohibition. Furthermore these provisions do not necessitate new communications with clients but rather specify certain information elements to be included in a communication already required under MiFID. As such they are low cost and proportionate to the market failure.

*Do the requirements restrict or otherwise affect the rights of investment firms under Articles 31 and 32 of Directive 2004/39/EC.*

13. The Provisions relate to matters within the scope of Article 19(1) of the Level 1 Directive. They will not restrict or otherwise affect the rights of investment firms under Articles 31 and 32 of Directive 2004/39/EC. This is because the FSA will not apply them to firms exercising rights under Article 31 and will only apply them to firms exercising rights under Article 32 in the circumstances contemplated by Article 32(7).