

Planning for MiFID

November 2005



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Executive summary

MiFID – the Markets in Financial Instruments Directive – is likely to apply from 1 November 2007. Its implementation will significantly alter financial services regulation in the UK, how firms operate their businesses and the way they interact with their customers.

Most FSA-regulated firms carrying on investment business are likely to be affected, whether or not that business falls within MiFID's scope. Implementation is therefore a major challenge, both for us and for industry. November 2007 may seem a long way off. But preparing to meet the challenge cannot begin too soon.

Significant aspects of the MiFID package have yet to be agreed at European level. So we cannot be certain at this stage about the final detail of the legislative requirements. During 2006, Treasury and the FSA will consult on the UK implementation – and publish cost-benefit analysis – of those final requirements (*see the overview below*). But it is already clear that implementation will mean significant sections of our Handbook will need to be reworked – for example, the conduct of business and systems and controls sourcebooks. This will affect, to a greater or lesser extent, **all** firms carrying on investment business, bringing changes to the nature of their regulatory obligations to their clients and to their supervisory relationship with us.

Potentially, there will also be new business opportunities. More services will be passportable. And implementation across the European Union may bring about significant changes in market structure. The precise impact will vary from sector to sector, firm to firm. Firms that are well-prepared will be positioned to make the most of these changes.

Firms are advised to start planning now to meet the implementation challenge. There is sufficient information and detail available for that process to begin. To help you get started, we have developed this document – Planning for MiFID – after dialogue with a number of trade associations and they have given us some useful input for it. Its purpose is to highlight the key impacts of MiFID and the types of compliance and business issues that are likely to arise, which you should consider in drawing up your plans. It is not a consultation document. It does not contain any FSA proposals on implementation or guidance on interpreting MiFID. That will be covered in our 2006 consultation programme.

Much of the preparation is likely to fall into the 2006-07 and 2007-08 financial years. Senior management are advised to earmark sufficient resource to assess the likely impacts of MiFID on their firm, and to consider how to respond to the business, operational and compliance issues that will arise.

Early planning will help identify implementation issues whose timely resolution will be important to delivering an orderly transition to the post-MiFID world. That is in the interests of consumers, industry and the FSA.

1 MiFID overview

What is MiFID?

The Investment Services Directive (ISD) has been the most significant European Union legislation for investment intermediaries and financial markets since it was implemented in 1995. It is now being completely replaced by MiFID¹ which extends the coverage of the current ISD regime and introduces new and more extensive requirements to which firms will have to adapt, in particular in relation to their conduct of business and internal organisation.

MiFID is a major part of the European Union's Financial Services Action Plan (FSAP), which is designed to create a single market in financial services. MiFID comprises two levels of European legislation. 'Level 1', the Directive itself, was adopted in April 2004. In several areas, however, it makes provision for its requirements to be supplemented by 'technical implementing measures', so-called 'Level 2' legislation. The Commission's proposed Level 2 measures, developed on the basis of advice provided by the Committee of European Securities Regulators (CESR) earlier this year, are the subject of continuing negotiation at European level in the European Securities Committee.

Formal Commission recommendations for the Level 2 measures are expected to be published in December 2005, or in January 2006. Their final adoption, following consideration by the European Parliament, is unlikely before the second quarter of 2006. Nevertheless, the broad shape and nature of the Level 2 measures is becoming clear. And while we cannot be definitive at this stage, we can identify the main areas of likely regulatory change, and some of the issues that will arise for firms (see section below on *'MiFID: meeting the challenges'*).

Which firms will be affected?

MiFID will directly affect those firms that fall within its scope. Scope is uncertain to some degree pending the finalisation of the Level 2 measures, as some important definitions, such as investment advice and commodity derivatives, depend on those measures. The position of any particular firm will also depend on the nature of that firm's business, and whether it falls within any of the exemptions in the Directive.

In general, MiFID will cover most if not all firms currently subject to the ISD, plus some that currently are not. It will include:

- investment banks;
- portfolio managers;
- stockbrokers and broker dealers;
- corporate finance firms;
- many futures and options firms; and
- some commodities firms.

In some other areas, the position for firms will be less clear-cut. Retail banks and building societies will be subject to MiFID for some parts of their business – for example, the sale of securities, or investment products which contain securities – but not for others. And there is the prospect – particularly in the retail market – of firms competing for the same type of business being subject to different regulatory standards, depending on whether the firm falls within the scope of MiFID. On the basis of the needs of consumers, business efficiency and competition considerations we shall be considering whether all firms should be subject to substantially the same requirements, whether relating to organisational matters or conduct of business matters.

¹ Directive 2004/39/EC on markets in financial instruments is accessible at:
http://europa.eu.int/eur-lex/prl/en/oj/dat/2004/l_145/l_14520040430en00010044.pdf

In that context, some complicated judgements will be required. Such changes will be made only where consistent with our statutory objectives and principles of good regulation. The cost-benefit balance will be a major component of any decision. But in implementing MiFID requirements we expect to review, and potentially amend, much of the detail of our current regime, even for firms not directly within MiFID's scope. We will also use this opportunity to advance our approach to reviewing our Handbook, particularly our proposals for simplifying the retail conduct of business regime (as outlined in July in our Consultation Paper 05/10).

On this basis, the types of firm that are likely to fall outside MiFID scope but nevertheless likely to be affected to some extent by Handbook changes associated with MiFID include:

- operators of collective investment schemes when acting as such – for example, operators of hedge funds and private equity funds (a special regime applies to UCITS management companies);
- occupational pension scheme firms;
- life companies and friendly societies;
- financial advisers (FAs) that do not hold client assets; and
- authorised professional firms.

So, even if your firm's investment business is partly or wholly outside the scope of MiFID, this does not mean that you will be unaffected by our approach to its implementation.

What does MiFID do?

One of the main purposes of the ISD was to give a 'passport' to investment firms to enable them to provide investment services on a cross-border basis or to establish a branch in another Member State, in each case on the basis of Home State authorisation. It set out some basic high-level provisions governing the organisational and conduct of business requirements that should apply to firms. It also aimed to harmonise certain conditions governing the operation of regulated markets.

MiFID has the same basic purpose. But it makes significant changes to the regulatory framework to reflect developments in financial services and markets since the ISD was implemented.

Scope is wider ...

Firstly, MiFID widens the range of 'core' investment services and activities that can be passported. In addition to the services covered by the ISD, MiFID:

- upgrades advice that involves a personal recommendation to a core investment service that can be passported on a stand-alone basis;
- clarifies that operating a multilateral trading facility (MTF) is covered by the passport; and
- extends the scope of the passport to cover commodity derivatives, credit derivatives and financial contracts for differences for the first time.

A greater degree of harmonisation...

Secondly, MiFID sets more detailed requirements governing the organisation and conduct of business of investment firms, and how regulated markets and MTFs operate. It also includes new pre-and post-trade transparency requirements for equity markets; the creation of a new regime for 'systematic internalisers' of retail order flow in liquid equities; and more extensive transaction reporting requirements.

Doing business cross-border...

Thirdly, MiFID improves the operation of the 'passport' for investment firms by more clearly delineating the allocation of responsibility between home state and host state for passported branches and generally clarifying some of the jurisdictional uncertainties that arose under the ISD. For example, going forward, it is clear that a firm will be subject only to home state requirements under MiFID where it provides cross-border services from that state into another Member State. MiFID also more clearly recognises the concept of tied agents, who will be able to carry on some cross-border business under the passport of their principal.

Capital Requirements Directive

Fourthly, most firms that fall within the scope of MiFID will also have to comply with the new Capital Requirements Directive (CRD) which will set requirements for the regulatory capital which a firm must hold. Those firms brought into regulation by MiFID will be subject to directive-based capital requirements for the first time. The CRD will commence on 1 January 2007; that is, before MiFID. It amends the Banking Consolidation Directive and the Capital Adequacy Directive. We have commenced consultation on implementation of these directives and firms are referred to Consultation Paper 05/3 and Feedback Statement 05/1. We plan to give guidance to firms in our forthcoming consultations to assist them to determine the capital requirements relevant to them.

What is the FSA doing to prepare for implementation?

We have been consulting stakeholders informally since 2004 and, assuming Level 2 proposals are available late 2005 or early 2006, we will consult formally during 2006 on our proposed rules and guidance to implement MiFID. We will also be consulting on a range of non-scope issues, as indicated above, which are dependent to some extent on our approach to MiFID implementation. The programme is set out in the table below.

Our proposals for implementing MiFID will be carried in three Consultation Papers (CPs):

- the main MiFID CP: this will cover all necessary changes to FSA rules and guidance – except the organisational and financial promotions requirements of MiFID (we expect to follow it up later with a second CP covering any adjustments

to our proposals necessitated by any changes made to the Commission's recommended package before the Level 2 measures are finally adopted);

- the systems and controls CP: this will cover the organisational and systems and controls requirements arising both from MiFID and the CRD (which is to be implemented by 1 January 2007), setting out proposals for a single set of requirements (a common platform) for all firms subject to either or both these directives;
- the financial promotions CP: this will cover the MiFID provisions on marketing communications, within wider changes flowing from our financial promotions review and will be relevant to all firms.

Further CPs will cover proposed changes to existing requirements that are not squarely within the scope of MiFID, but which will be dependent to some extent on our approach to MiFID implementation.

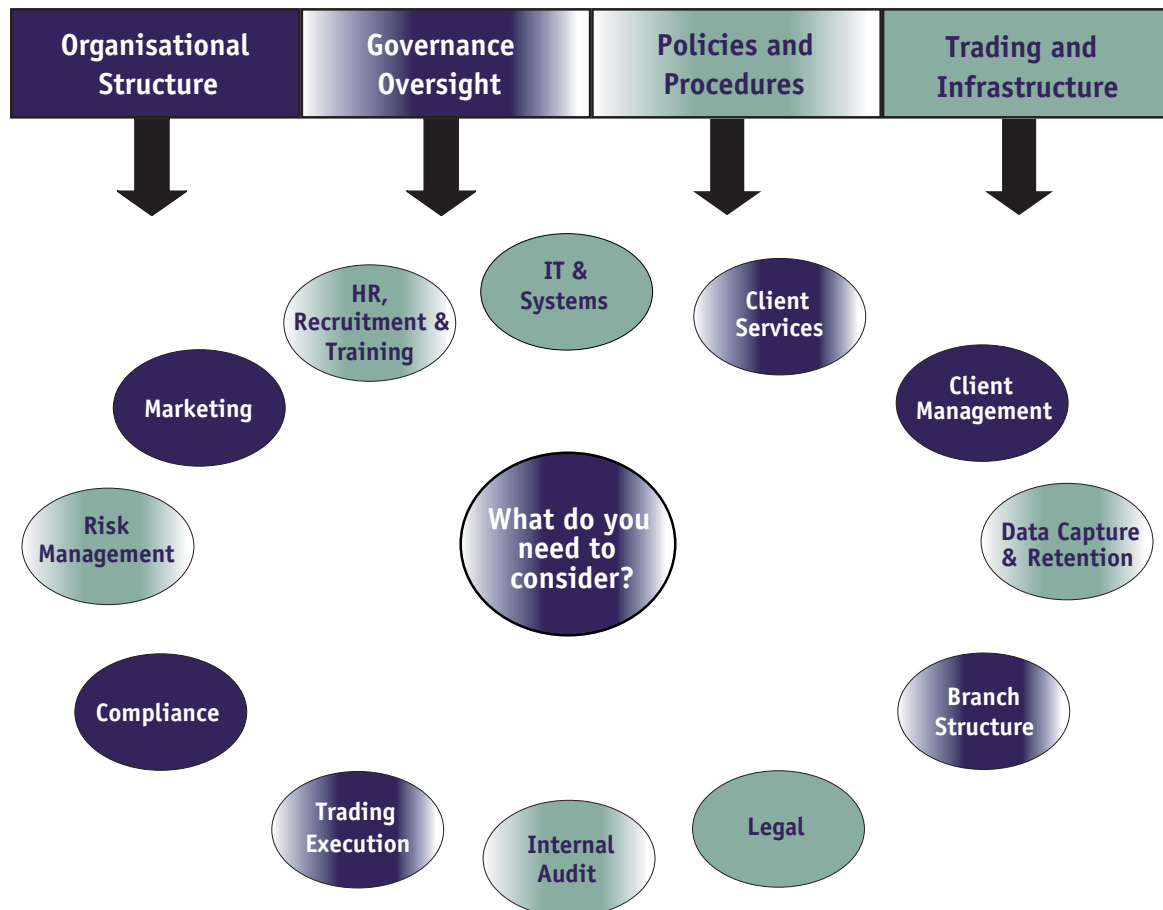
MiFID-related CPs and their planned publication dates	
Consultation Papers on MiFID implementation	
Main MiFID CP	March 2006
Systems and controls CP	March 2006
Financial promotions CP	April 2006
MiFID Follow-up CP	H2 2006
Non-scope MiFID-dependent CPs	
Disclosure	Q1 2006
Simplifying the retail COB regime	Q2 2006
Standards for non-MiFID scope wholesale firms	H2 2006
Systems and controls for non-MiFID, non-CRD firms	H2 2006
Expected deadlines	
MiFID implementing rules and guidance made	31 Jan. 2007
Firms to be complying with MiFID requirements	1 Nov. 2007

What do you need to consider?

If you have not done so already, you should start preparing for MiFID so that you are ready before the likely implementation deadline of 1 November 2007. Responsibility lies with firms' senior management to understand the issues and organisational challenges your firm may face and take the requisite action. The

diagram below highlights the typical functional impacts that MiFID is likely to have.

Organisational structure, governance oversight, policies and procedures and trading and infrastructure are of critical importance, but MiFID will have an impact on many other functions in firms. Reviewing these in a thorough way will help identify the business issues that your firm will need to address.



This diagram is for indicative purposes only; it does not provide a comprehensive list of the business functions that may be affected by MiFID.

This document is not guidance and should not be relied on as such; nor is it intended to be comprehensive in terms of MiFID's impact in the UK. The MiFID technical implementing measures (Level 2) are set to be finalised in the coming months. We will be consulting in full on the implementation of MiFID in the UK next year.

General information on MiFID is available from the European Commission and the FSA FSAP websites:

http://europa.eu.int/comm/internal_market/securities/isd/index_en.htm

<http://www.fsa.gov.uk/Pages/About/What/International/EU/fsap/>

The FSA will hold a conference entitled FSA Implementation of the Markets in Financial Instruments Directive in the UK on 15 May 2006. Further details are available at:

<http://www.fsa.gov.uk/pages/Doing/Events/events/markets.shtml>

If you have any queries arising from this document please contact the MiFID Implementation Office at the FSA: planningmifid@fsa.gov.uk.

2 MiFID: meeting the challenges

Introduction

In this section we highlight some of the main changes likely to arise from the organisational, conduct of business, transparency and transaction reporting requirements of MiFID. We also comment on some of the implications for cross-border business. We focus on the Level 1 requirements and outline in broad terms some significant changes that are likely to arise through Level 2.

2.1: Organisational requirements

What is changing?

The FSA Handbook currently contains some organisational requirements for firms. The MiFID requirements are more extensive and our Handbook will be amended to reflect this. Firms will need to meet these new requirements when they are authorised and then continue to meet them. The organisational requirements apply on a home state basis. This means that they will apply to a UK-authorized firm's business, including any business into another jurisdiction, whether the firm is providing services on a cross-border basis from its UK base or using a branch to provide services.

The requirements are likely to cover:

- compliance arrangements, including measures governing personal transactions;
- internal systems and controls, particularly in relation to:
 - business continuity;
 - staff;
 - risk assessment, management and mitigation;
 - internal audit;
 - administrative and accounting procedures; and
 - IT systems and processing.

- outsourcing of 'critical and important' functions and investment services;
- record-keeping, particularly in relation to transactions undertaken for clients;
- management of conflicts of interest to prevent the interests of clients being adversely affected; and
- safeguarding of client financial instruments or money held by the firm.

What will you need to consider?

Much of the detail in these requirements is, of course, subject to the final Level 2 measures. However, it is already clear that firms will need to consider, in particular:

- the efficiency and effectiveness of their arrangements for compliance and risk management;
- the general integrity of their systems and controls (including internal audit and business continuity management); and
- their arrangements for identifying conflicts of interest and the resilience of the organisational arrangements used to manage them (likely to be a significant area of change for many firms).

There is likely to be an increased focus on the 'functional independence' of compliance and risk management controls. As a consequence, firms will need to review the adequacy of their:

- internal organisation;
- reporting lines; and
- allocation of senior management responsibility.

MiFID is likely to introduce new requirements to be satisfied in the outsourcing of 'critical and important' functions (and, possibly, investment services). Firms will need to ensure that all existing outsourced arrangements meet the relevant requirements as finally agreed in Level 2.

Who will the requirements affect?

The organisational requirements will apply to:

- all investment firms within MiFID scope;
- all credit institutions doing MiFID business;
- UCITS management firms (insofar as they engage in discretionary portfolio management, investment advice or safekeeping of units in collective investment schemes); and
- firms or market operators running MTFs.

Our Consultation Paper on systems and controls, planned for March 2006, will set out our proposals. The CRD also has (high-level) requirements for systems and controls. Given the substantial overlap between firms subject to MiFID and the CRD, we are developing a 'common platform' of systems and controls requirements – that is, one set of requirements which implement both directives, so far as practicable. We recognise that this common platform must be capable of application in a proportionate way, because of the wide variety of firms to which it will apply. In the second half of 2006, we will consider how far this approach should apply to firms outside the scope of these directives.

2.2: Conduct of Business

Client classification

What is changing?

The client classification regime is the starting point for many of the conduct of business changes that will affect firms. It defines firms' specific regulatory obligations for the business they conduct with each category of client. The MiFID client classification regime has similarities with the current FSA regime, but it differs in three key respects:

- Firstly, although MiFID distinguishes between three types of client: retail client, professional client and eligible counterparty (ECP), these are not exactly the same as our current categories of private customer, intermediate customer and market counterparty (for example, not all intermediate customers under our current rules will be professional clients under MiFID);
- Secondly, whilst there is some flexibility for clients to move between categories to obtain more, or less, regulatory protection, the criteria for doing so are not identical to those applying under our current rules.

- Thirdly, the regulatory protection afforded to each category of client under MiFID will not be the same as that provided for under the current FSA classification regime. For example, MiFID will impose more obligations on firms when doing business with professional clients (and some of these are highlighted in the following sections). The approach under MiFID to regulating business with ECPs will also not be as 'light touch' as the FSA market counterparty regime; for example, a firm will not be able to provide investment advice to an ECP without complying with the relevant conduct of business requirements.

What will you need to consider?

Many firms will need to examine their existing classifications and possibly change the classification of some of their clients. To the extent that their business processes and systems need to take account of classification decisions, firms may need to amend these processes and systems as well as their client documentation.

Under MiFID, both ECPs and professional clients will be able to request regulatory protection either generally, on a trade-by-trade basis, or in relation to a 'particular investment service or transaction, or types of transaction or product'. Firms will need to consider how they would administer such a system. Clients may fall into different categories in respect of different products or services.

MiFID also contains transitional provisions which allow firms to continue treating professional clients as such, provided certain conditions are satisfied. In our MiFID Consultation Paper we will set out how we think these provisions can operate to help firms manage their transition to the MiFID regime.

Who will the requirements affect?

The client classification requirements will affect all MiFID-scope firms. However, the impact is likely to vary, depending on the nature of the firm's business and the size and breadth of its existing client base. For example, it is likely to be less severe for a firm that deals only with private individuals. We will also consider the case for, and against, using the MiFID client categorisation regime as the basis for classifying clients doing non-MiFID business.

Marketing

What is changing?

Implementation of the MiFID requirements on 'marketing communications' relating to MiFID instruments or services is likely to have an impact on the existing UK financial promotions regime. The Level 1 provisions require a firm to ensure that all information – including marketing communications provided to clients or potential clients – is fair, clear and not misleading and to ensure that marketing communications are clearly identifiable as such. This will be supplemented by further requirements at Level 2.

What will you need to consider?

Firms will need to review their financial promotions and marketing functions, particularly to consider whether their procedures for approving financial promotions will satisfy the expectations of the new regime. These procedures are likely to be fairly similar to key elements of the existing FSA financial promotions regime. We will consult on the necessary changes for MiFID implementation alongside wider proposals for change resulting from a substantial review of the financial promotions regime for investment business. This is likely to involve a move towards a regime based on high-level rules that will place more responsibility on senior management.

Who will the requirements affect?

The Consultation Paper reflecting the outcome of our financial promotions review is planned for April of 2006. The proposals will be relevant to all firms – both MiFID and non-MiFID scope firms – that promote their investment products and services to retail investors. This will include, for example, life insurance companies and other current 'non-ISD' investment firms.

Information about the firm and its services

What is changing?

MiFID will establish requirements governing information about the firm and its services that must be provided to a client, whether retail or professional, including:

- the nature and detail of the information that must be provided;
- when it must be given;
- the form in which it must be provided; and

- when it must be updated.

These requirements are likely to differ from those in the current FSA rules.

What will you need to consider?

Firms will need to consider the adequacy of:

- procedures for capturing and generating required information and for getting it into the relevant form in relation to the services offered by the firm to its clients;
- existing mechanisms for delivering information to the range of clients with whom they do business, and the circumstances in which it will be required; and
- procedures for updating information to clients.

Firms will also have to consider whether, in the period running up to MiFID implementation, they should start to give existing clients additional information on the basis of the above requirements.

Who will the requirements affect?

The MiFID requirements will apply to all MiFID-scope business carried on by MiFID firms, with more extensive requirements for business with retail clients. We shall be considering, and consulting upon, the extent to which the information requirements in our current rules for non-scope retail investment business should be adapted to take account of MiFID.

Client agreements

What is changing?

The Directive requires firms to keep a record of the document or documents agreed with their clients effectively covering the terms on which they provide investment services. It is not clear at this stage whether there will be specific requirements on the content and conclusion of client agreements at Level 2.

What will you need to consider?

There are likely to be a number of specific information provision, notification and consent requirements deriving from both the Level 1 and the Level 2 provisions. Where firms usually incorporate such provisions in client agreements, it would be advisable to plan for a review of the agreement content and consider amendments for existing clients. Additionally, in the light of the finalised Level 2 text, firms may need to revise their agreements or terms of business for all clients acquired after November 2007.

Who will the requirements affect?

The MiFID requirements will apply to MiFID-scope business carried on by MiFID firms, with (possibly) more extensive requirements for business with retail clients. We shall be considering to what extent it may be appropriate to adopt any MiFID standards for similar business carried on by non-scope firms with retail clients.

Suitability and know your customer

What is changing?

Like the current FSA rules, MiFID contains 'know your customer' and suitability requirements which apply when a firm provides investment advice and discretionary portfolio management. These are broadly similar to current requirements, but the MiFID requirements will apply to both retail and (in more limited form) professional clients.

What will you need to consider?

In order to be able to meet these requirements firms will need to review:

- the comprehensiveness and adequacy of procedures for capturing and recording 'know your client' information and providing it as appropriate to the individuals who provide advice or make discretionary management decisions;
- the adequacy of arrangements for ensuring suitable recommendations are given and investment management decisions taken;
- whether current standardised fact-finding processes (for example, for retail clients) capture all the information required by MiFID; and
- their arrangements for business with professional clients.

Who will the requirements affect?

The MiFID requirements will apply to all MiFID-scope firms providing investment advice and portfolio management to retail or professional clients. We shall be considering whether – and if so how – the fact-finding and suitability requirements for retail clients of non-MiFID firms should be aligned with the MiFID standards.

Appropriateness and execution-only services

What is changing?

MiFID will require changes to the current position under FSA rules where most investment products can be provided on an execution-only basis. Under MiFID, an execution-only service can be provided only where:

- it relates to 'non-complex' instruments – including shares admitted to trading on a regulated market (or equivalent third country market), money market instruments, bonds and other securitised debt (but excluding bonds that embed a derivative) and UCITS (and possibly others, depending on the final Level 2 measures);
- it consists only of execution of orders and/or the reception and transmission of orders;
- it is provided at the initiative of the client; and
- the client is warned by the firm that the firm has not assessed suitability.

For other investment products, MiFID introduces a new requirement for firms to obtain information from clients about their relevant knowledge and experience, and assess whether the service is appropriate for that client. If the firm assesses the product or service to be inappropriate it must warn the client of that; if the client does not provide sufficient information then the firm must warn the client it has not been able to carry out the assessment. This is not a test of suitability (which applies only to the provision of investment advice and portfolio management). Appropriateness therefore does not relate to the making of a personal recommendation.

The application of this requirement to business done with professional clients is still subject to discussion at Level 2. An important distinction between suitability and appropriateness is that suitability requires a consideration of a client's financial situation and investment objectives (as well as knowledge and experience), whereas appropriateness focuses just on a client's knowledge and experience.

What will you need to consider?

Firms providing relevant services will need to assess and decide the basis on which to provide them post-MiFID, and whether this entails any organisational or other business change.

Firms offering services under the appropriateness test will need to:

- consider the adequacy of systems for obtaining information from clients and for setting and operating controls over client activity; and

- develop systems and procedures for assessing appropriateness and carrying forward the outcomes in the ways required by MiFID.

Firms offering services on an execution-only basis will need to:

- assess the adequacy of procedures for making the assessments implied by MiFID (or, ensuring the conditions are met) and providing the required warnings.

Who will the requirements affect?

The appropriateness requirements will primarily affect firms that provide ‘execution-only’ dealing services in more ‘complex’ financial instruments for retail clients. Covered warrants, options and contracts for differences are among the investments traded by retail customers that may need to be considered. Certain disclosure requirements and restrictions on certain forms of solicitation will apply for firms that wish to provide business on an execution-only basis. We will be considering to what extent it may be appropriate to adopt the MiFID standard for similar business carried on by non-scope firms with retail clients.

Best execution

What is changing?

The MiFID requirements on best execution will mean some important changes to the current FSA regime. An investment firm will be required to take all reasonable steps to obtain the best possible result for its clients including taking into account relevant considerations such as price, cost, speed and the likelihood of execution and settlement when executing orders.

In doing so, the firm must:

- establish and implement effective arrangements and an ‘order execution’ policy designed to obtain the best possible results in executing client orders;
- disclose ‘appropriate information’ to clients about its ‘order execution’ arrangements and policy, including the execution venues it uses;
- obtain prior client consent to its policy;
- monitor the effectiveness of its execution arrangements and policy, and update them as necessary; and
- at their clients’ request, demonstrate that their orders have been executed according to the firm’s policy.

What will you need to consider?

Firms will need to develop an execution policy, or review any existing policy, and obtain client consent to the policy before undertaking any transactions.

The policy will need to cover selection of execution venues that will enable the firm to secure the best results for clients on a consistent basis and firms will need to keep that selection under review.

Firms will need to consider how they will monitor execution performance by the venues included in their policy, and their processes for determining which execution venues to use. They will need to consider the extent to which their existing trading strategies enable them to deliver on these obligations. This could have systems impacts for some firms and generate wider demand for data relating to executions.

Who will the requirements affect?

These requirements apply to an investment firm (all brokers and broker-dealers) executing client orders in both wholesale and retail markets and to all MiFID financial instruments. They are also likely to apply to portfolio managers and order receivers and transmitters.

Client order handling

What is changing?

MiFID requires investment firms to execute client orders promptly, fairly and expeditiously and follows the general thrust of existing FSA rules.

Among other things, the Level 2 measures are likely to require investment firms to:

- ensure that orders executed on behalf of clients are promptly and accurately recorded and allocated;
- allocate aggregated orders promptly, accurately and fairly;
- refrain from front running;
- ensure that any client assets received in settlement of an executed order are promptly and correctly delivered to the account of each relevant client; and
- make public client limit orders that are not immediately executed under prevailing market conditions.

What will you need to consider?

Most of these requirements are broadly similar to existing conduct of business rules. Some review of existing systems and processes is advisable, though we do not expect that their overall impact will be substantial for most firms. The requirement to make public client limit orders that are not immediately executed is a new requirement. Firms will need to consider the details of their contracts with clients and the venues they would use to make limit orders public.

Who will the requirements affect?

These requirements apply to all brokers and dealers when executing client orders in any MiFID financial instrument. They are also likely to apply to portfolio managers and order receivers and transmitters, such as introducing brokers.

Reporting information to clients

What is changing?

MiFID requires a firm to provide to its clients adequate information on the service provided. In particular it sets out requirements to ensure that clients are promptly advised of the essential details of a transaction and receive a regular statement with essential information on their investment portfolio.

What will you need to consider?

The main difference is that the flexibility under existing FSA rules for private customers to vary the content or frequency of contract notes for reporting on transactions and periodic information for portfolio management is not replicated in MiFID. Those firms that use this flexibility to provide bespoke reports to their clients are advised to review their practices, and may need to make changes to reporting systems.

Who will the requirements affect?

These requirements apply to all firms when they carry on MiFID business, although detailed requirements are likely to apply only to retail clients. They are generally similar to existing conduct of business rules. For firms outside MiFID scope undertaking retail investment business, we will be looking to retain some of the flexibility no longer available to MiFID firms.

2.3 Markets and transparency

Pre- and post-trade transparency

MiFID introduces comprehensive pre- and post-trade transparency regimes for trading in shares on the three main types of execution venues:

- Regulated Markets (RMs) – these include stock exchanges such as the London Stock Exchange (LSE) and virt-X;
- Multilateral Trading Facilities (MTFs) – these cover alternative execution venues (currently referred to as alternative trading systems in the UK); and
- Over the Counter (OTC) – OTC trading refers to trades undertaken by firms outside a RM or MTF, including those acting as systematic internalisers.

Pre-trade transparency

What is changing?

Regulated Markets and MTFs

While there are currently no UK requirements about pre-trade transparency as specific as the MiFID requirements, both the LSE and virt-X have trading systems and rules that provide transparency levels tailored to the type of share being traded and the method of trading. MiFID will introduce more extensive pre-trade transparency requirements, particularly for trades below specified size thresholds and for trades that take place outside the order book. MiFID requirements for MTFs (which are identical to those for RMs) are very similar to what currently applies to ATs.

Systematic internalisation

MiFID introduces a completely new transparency regime for investment firms that are systematic internalisers in shares. MiFID defines a systematic internaliser as an investment firm which – on an organised, frequent and systematic basis – deals on own account by executing client orders outside an RM or MTF. Implementing measures regarding the definition of systematic internalisers are currently being developed at Level 2. Systematic internalisers must provide firm bid or offer quotes in ‘liquid’ shares on a continuous basis. Subject to certain waivers (see below) their quotes must represent a binding price for trades up to certain thresholds (defined as ‘standard market size’).

Systematic internalisers have no obligation to quote in all liquid shares; they can quote for a subset of liquid shares and this subset can change over time. The list of liquid shares will be defined on the basis of criteria to be set out in the Level 2 measures.

Systematic internalisers will be permitted to execute orders from professional clients at prices other than the quoted prices in certain circumstances (e.g. if the order is larger than a threshold determined in the Level 2 measures).

The following activities will not be subject to the quoting obligations:

- dealing above ‘standard market size’;
- dealing in non-liquid shares; and
- dealing in other asset classes (e.g. bonds).

What will you need to consider?

RMs and MTFs will have to consider what modifications they need to make to their rules and trading systems to comply with the MiFID requirements. They will need to consider in particular the requirements relating to trading below the pre-trade block thresholds (which will apply across the EU) and changes they need to make to ensure that the use of request for quote systems fall within the new regulations.

Exchange and MTF members/participants will have to assess whether – and how – the new obligations impact on their business models; they may also have to change their system to meet the new MiFID requirements.

Firms executing trades outside RMs or MTFs will have to decide whether any part of what they currently do fits the definition of ‘systematic internalisers’ under MiFID and, if so, whether the quoting obligations apply to them. Compliance with the pre-trade obligations may involve the development of a new business model as well as significant system changes.

Who will the requirements affect?

The new requirements directly affect RMs, MTFs and those firms that are deemed to be systematic internalisers in liquid shares. Indirectly, the way in which these bodies respond to the new requirements will impact on all other firms in meeting their best execution obligations.

Post-trade transparency

What is changing?

MiFID extends the scope of post-trade transparency requirements from RMs to MTFs and investment firms trading outside RMs or MTFs. All trading venues will have to make public specified information about completed transactions in shares as close to real time as possible (with delays for large risk trades) and on a reasonable and non-discriminatory commercial basis. Investment firms can choose the disclosure channel – RM, MTF, third-party or proprietary arrangements – through which they make the details of each transaction public. The information will have to be checked for accuracy and meet the other criteria described above.

What will you need to consider?

RMs, MTFs and investment firms will need to consider their internal controls for applying the new block trading provisions. Investment firms that trade outside a RM or MTF will need to consider the method by which they publish details of their trades and the steps they will need to take to ensure the accuracy and timeliness of publication.

Who will the requirements affect?

The new post-trade transparency requirements will affect providers and users of equity trade data – RMs, MTFs, their members and firms trading OTC (buy-side and sell-side firms), as well as equity trade data disseminators.

Transaction reporting

What is changing?

MiFID transaction reporting requirements will shift the reporting emphasis to the competent authority of the home/host state of the firm and not to the competent authority of the regulated markets on which the instrument is traded. Transaction reporting refers to post-trade reporting to regulators and does not refer to the publication of trades. Following MiFID implementation the transaction reporting obligations of some UK firms will be affected as follows.

Increase in the types of instruments covered

While current reporting requirements extend to debt and equity related products, MiFID requires transaction reports for any instrument admitted to trading on a regulated market – including commodity instruments admitted to trading on exchange.

Continuation of UK standards above the minimum requirements of MiFID

We are likely to continue to require the following transactions to be reported, even though MiFID does not require this:

- transactions in instruments that are only admitted to trading on prescribed markets that are not regulated markets (currently this means transactions on AIM and Ofex must be reported); and
- transactions in OTC instruments that are referenced to instruments traded on prescribed markets.

In addition, currently the vast majority of firms must report transactions in the designated investments covered by our rules irrespective of where they are traded. It is unlikely that we will require reporting of transactions in instruments that are only quoted on exchanges outside the EU.

What will you need to consider?

MiFID may have a significant impact on commodities firms which will now have to report transactions in any instruments traded on those commodities exchanges that are regulated markets. We are exploring the possibility of collecting MiFID compliant transaction reports from those exchanges that have commodity derivatives admitted to trading. If these exchanges cannot provide us with reports that satisfy MiFID requirements, then commodities firms will need to find alternative means for ensuring that their transaction reports are received by us.

UK firms that are remote members of overseas exchanges will have to report transactions to us as the qualifying exchange exemption no longer applies. FSA-authorized firms which currently submit transaction reports to non-UK EU exchanges will have to decide how they will report transactions to us once MiFID is implemented. Under MiFID, trades on non-EU exchanges will still need to be transaction reported by firms if the subject instrument is also traded on a regulated market in the EU. For example, a transaction in IBM common stock on the NYSE will still need to be reported to us as the instrument also has a London quote.

It is unlikely that UK firms will have to report transactions in instruments that are not admitted to trading on any exchange within the EU.

Finally, we believe that, similar to the current rules, firms that conduct discretionary investment management business can satisfy their MiFID reporting requirements if they can guarantee that their sell-side brokers report the trades to us. These investment firms will be required to transaction report electronically if they trade instruments caught under MiFID with counterparties that are not FSA-authorized brokers – e.g. other investment firms or overseas brokers.

Who will the requirements affect?

Potentially all firms, depending on the nature of their business. UK-based firms that undertake business only in UK-traded instruments that are not commodity linked will be least affected. All UK based firms will have to ensure, post-MiFID, that existing transaction reporting arrangements cover all the relevant instruments and are received by the relevant authority, which in the case of all UK-based activities will be the FSA.

2.4 Cross-border business, branching and passporting

What is passporting?

Currently, firms that are authorised in one Member State can provide ISD services in other Member States either cross-border or through a branch without having to be authorised separately in each Member State in which they wish to do business – this is known as the ‘passport’. MiFID extends the range of activities and instruments covered by the passport and clarifies the home/host supervision of passported firms. In particular, MiFID:

- upgrades advice that involves a personal recommendation to a core investment service that can be passported on a stand-alone basis;
- clarifies that operating an MTF is covered by the passport; and
- extends the scope of the passport to cover commodity derivatives, credit derivatives and financial contracts for differences for the first time.

Who has responsibility for supervising passported firms under MiFID?

Under MiFID, a passported firm's home state regulator has supervisory responsibility for both conduct of business requirements and organisational requirements, except in some circumstances where the relevant host state regulator takes responsibility for conduct of business requirements. So, where a firm provides services on a purely cross-border basis only home state requirements will apply. Where a firm establishes a branch in another Member State, under MiFID the branch must comply with home state requirements relating to organisational requirements. And it must comply with host state requirements on conduct of business insofar as its activities are within host state territory. Where a passported branch provides services outside the territory of its host state, only home state requirements should apply.

Use of tied agents

MiFID introduces a discretionary tied agent regime and sets out obligations for investment firms if they decide to use tied agents. This regime is largely similar to the current UK appointed representative regime. Tied agents will be able to provide certain activities cross-border and to establish branches in other Member States under the passport of their principal. MiFID provides a way for firms to provide some services through the use of tied agents (by allowing them to use tied agents to provide cross-border services and establish branches).

What will you need to consider?

Firms may want to review how they currently conduct business throughout the EU, how this business is structured, and whether any change to their arrangements is desirable.

Who will the requirements affect?

The requirements will affect UK-regulated firms that fall within MiFID's scope and that decide to make use of the passport to conduct business across Europe, including through the use of tied agents.