Distribution rules and the Markets in Financial Instruments Directive

28 September 2012

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MiFID and implementation in the UK

MiFID I and implementation

The Markets in Financial Instruments Directive (MiFID) came into force on 1 November 2007, and introduced significant changes to the European regulatory framework, including:

- New client categories;
- New regulated activities (e.g., personalised investment advice);
- New conduct of business obligations.

Impact?

- Establish processes for categorising clients (including obtaining sufficient information);
- Establish processes for providing required information to clients (e.g., periodic reports);
- Review documentation to ensure compliance (e.g., requirements to obtain express prior consent from the client, obligation to notify clients of their classification, ensure appropriate risk warnings are included)

Client categorisation requirements under MiFID

Client: any natural or legal person to whom an investment firm provides investment and/or ancillary services

Eligible counterparty	Professional client	Retail client

• EEA regulated entities;
• National governments and their debt management offices;
• Central banks;
• Supranational organisations.
 	
Member States may also recognise additional entities (e.g., non-EEA entities)
	A client meeting the criteria set out in Annex II to MIFID, including:
	• Regulated entities;
	• National and regional governments / public bodies / central banks etc
	• Large undertakings which meet two of the following size requirements:
	  • balance sheet total: EUR 20 million
	  • Net turnover: EUR 40 million
	  • Own funds: EUR 2 million
	• Other institutional investors
		A client who is not a professional client

May request to be treated as professional or retail client	• May request to be treated as eligible counterparty or retail client	May request to be treated as a professional client
Status will be determined according to the law in the Member State where the client is established		

A client may be categorised as falling into more than one category depending on the type of business carried on with the client

Ability to opt-up or opt-down

Opt-up

Professional client to eligible counterparty:

- Member States may choose to allow this where client meets pre-determined thresholds: requires express confirmation from the client that they accept this status

Retail to professional client:

- Firm to assess expertise, experience and knowledge of client;
- Client to meet two of the following criteria:
  - Average of 10 significant transactions per quarter over previous 4 quarters;
  - Financial instrument portfolio (including cash and financial instruments) > EUR 500,000
  - Works / worked in financial services sector for at least one year and has relevant knowledge of the transactions / services
- Firm to provide written risk warning re loss of protections / investor compensation
- Client to confirm opt-up in writing, and confirm its awareness of losing protections

Opt-down

Eligible counterparty to professional / retail client:

- Firm may agree to a request to opt-down, but is not required to agree
- Default position is for former eligible counterparty to be treated as professional client unless it specifically requests treatment as a retail client

Professional to retail client:

- Firm may agree to a request to opt-down, but is not required to agree

MiFID – Appropriateness & Suitability

		Type of business		
		Investment advice and discretionary asset management	**Any other investment services**	**Execution-Only**
Category of investors	**Retail clients**	**Suitability** **(1) Knowledge and experience** **(2) Financial situation** • Source and extent of income, nature of assets, regular commitments **(3) Investment objectives** • Investment horizon, risk preference, risk profile, investment purpose If the firm does not obtain this information, it must not recommend investment services or financial instruments to the client.	**Appropriateness** **(1) Knowledge and experience** If the firm considers that the product or service is not appropriate, it must warn the client.	**No appropriateness test so long as relevant conditions are met:** • **Only <u>non-complex</u> financial instruments** • **Service is provided at the initiative of the client** • **Firm has informed the client clearly that it is not required to assess suitability**
	Professional clients	**Limited suitability test** **(1)** Firm can assume professional client has required knowledge and experience **(2) Financial situation** • [for investment advice - firm can assume client able to bear financial risk] **(3) Investment objectives**	• None (knowledge and experience are presumed)	• None
	Eligible counterparties	• N/A	• N/A	• N/A

MiFID - Inducements

An investment firm must act honestly, fairly and professionally in accordance with the best interests of its clients.

A firm will not be considered to be acting honestly, fairly and professionally in accordance with the best interests of its client if, in relation to the provision of an investment or ancillary service to the client, the firm pays or is paid any fee or commission, or provides or is provided with any non-monetary benefit.

Exceptions:

- Where the fee, commission or non-monetary benefit is paid or provided to or by the client or a person on behalf of the client;
- Where the fee, commission or non-monetary benefit is clearly disclosed* to the client prior to provision of the relevant service, and is designed to enhance the quality of the service to the client; or
- Proper fees which enable or are necessary for the provision of services (e.g., custody fees).

* The disclosure must be made in a manner which is comprehensive, accurate and understandable. If the exact amount of the fee, commission or non-monetary benefit cannot be ascertained, the firm must disclose the method of calculating the amount

UK implementation / developments

FSA focus on suitability and provision of services to retail clients

UK Retail Distribution Review:

UK-specific rules on retail investment products and advice provided to retail clients in the UK

FSA guidance on suitability:

Following a review of the UK retail intermediaries sector in 2010, the FSA raised concerns regarding the large number of unsuitable investment selections it identified.

In March 2011 the FSA published guidance on best practice for suitability assessments, including the need for:

- Robust risk assessments, including a precise description of the possible risks and a balanced assessment of all the relevant factors;
- Process for ensuring that products / services are matched to the relevant risk profile in a consistent way;
- Thorough understanding of the relevant products

UK case-law on advisory duties and misselling:

When are advisory duties assumed?

- Highly fact-specific question;
- Contractual position is key
- As is customer sophistication / experience
- Regulatory factors are likely to feature heavily in future cases

UK misselling cases (1)

Wilson v Global (February 2011)

- Businessman trading futures, options etc
- Claim: broker gave advice
- Held: no advisory relationship
  - Contract stated no advice / execution only
  - Conversations: merely exchanging views

Cassa San Marino v Barclays (March 2011)

- Sale and Restructuring of CDO² Notes (which underperformed)
- Claims: Barclays misrepresented that Notes were very low risk and that it would not profit from the restructuring
- Held:
  - Claims failed on facts
  - AAA doesn't necessarily mean Barclays believed low risk
  - Purchase claim estopped in any event

Bank Leumi v Wachner (March 2011)

- Former CEO trading in currency options
- Claim: duty to advise as to suitability
- Held: no advisory duty
  - Terms of business made it clear that execution only service
  - Discussions were not sufficient to generate a general obligation to advise

Standard Chartered Bank v Ceylon Petroleum (July 2011)

- Claim: losses from oil derivatives
- Held: no advisory duty
  - Documents made it clear that SCB not advising
  - No request for advice by CP
  - Distinction between "advice" and assumption of duty of care
- Appeal judgment (July 2012): but on capacity not misselling

UK misselling cases (2)

Rubenstein v HSBC (September 2011)

- One-off investment in AIG bond by retail customer
- Claim: losses from negligent investment advice
- Held: advisory duty existed and was breached
  - Non-advisory documents / process not completed / followed
  - Advisory language used by "financial advisor"
  - Advice given, not mere supply of information
  - But negligence not causative of loss, which was too remote
- Appeal judgment (September 2012)
- Claimant won
- Loss was not caused by run on AIG, but by a collapse in value of funds, which was forseeable

Zaki v Credit Suisse (October 2011)

- Relatively experienced HNW Investor buys series of structured notes
- Claim: under s150 FSMA that notes were not suitable
- Held:
  - Court took into account knowledge / experience, financial situation and investment objectives
  - But market volatility meant line had been crossed and CS was in breach
  - However, claim also failed on causation
- Appeal judgment awaited

MiFID 2 / MiFIR – proposed changes

Why is it necessary to replace MiFID?

Scheduled review

- Under MiFID, the Commission was required to report to the European Parliament and Council **within 3 years** following entry into force of MIFID regarding the appropriateness and effectiveness of certain provisions under MiFID
- On the basis of these reports, the Commission would submit a proposal for any necessary amendments to MiFID

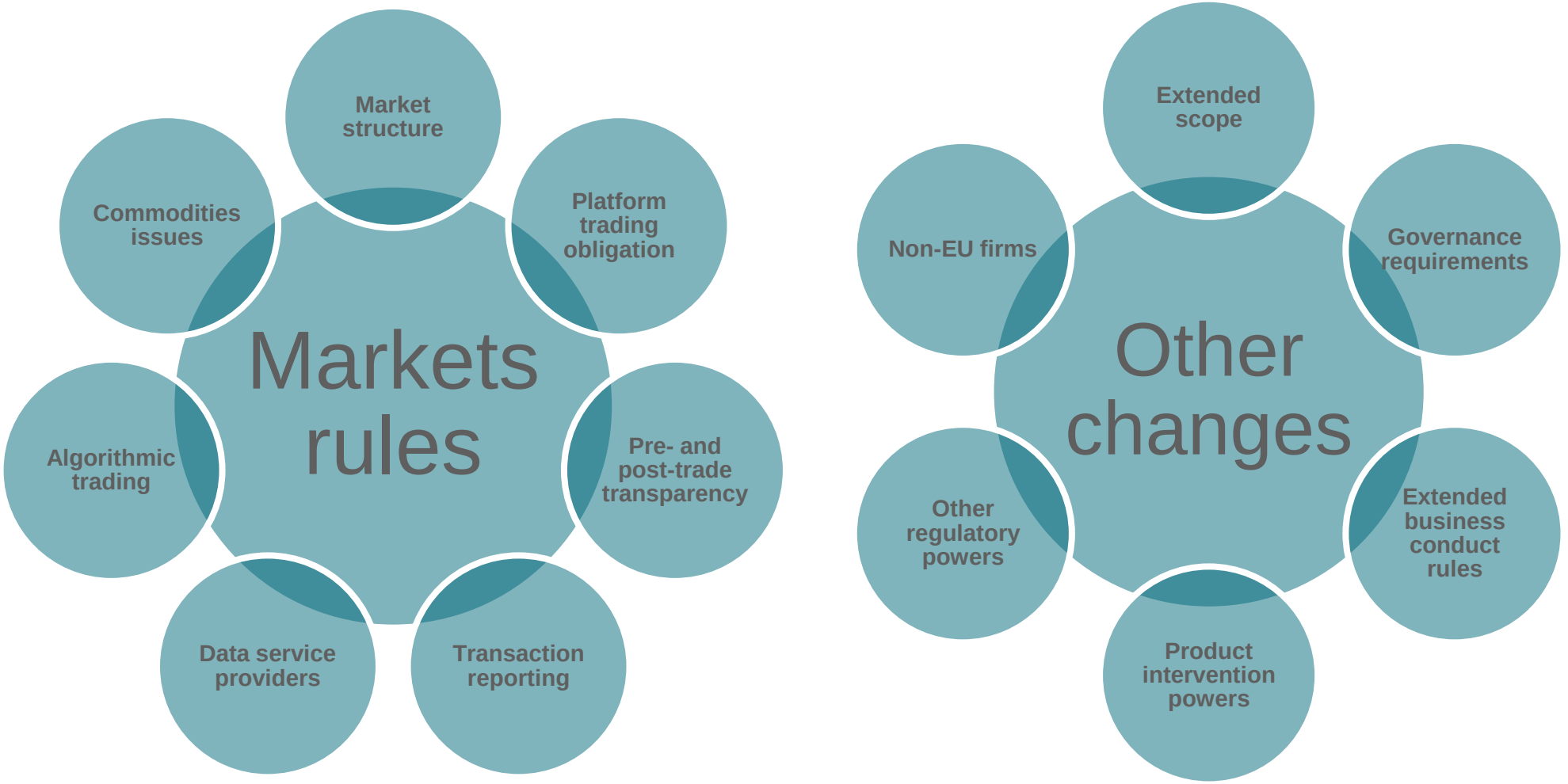
Perceived problems

- Need to update MiFID to reflect new services and products
- Need to clarify aspects of MiFID which are unclear
- Increased focus on transparency
- Increased focus on customer protection and conduct of business

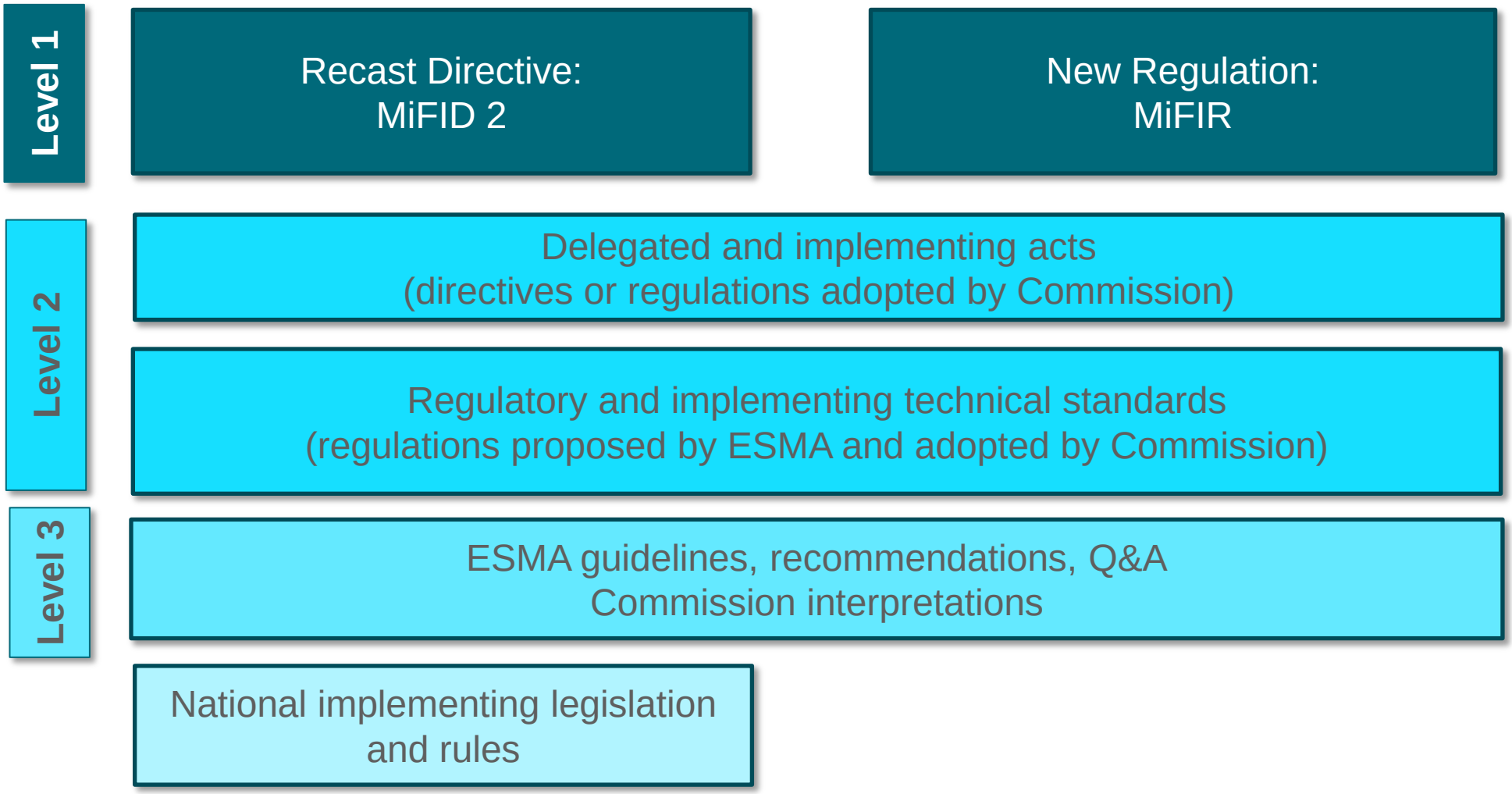
G20 agenda

- "All standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest."
- [G20 leaders, Pittsburgh, September 2009]

MiFID 2/MiFIR propose wide-ranging changes to EU regulation



Proposed legislative structure



Expected timetable

- Q4: Legislative proposal

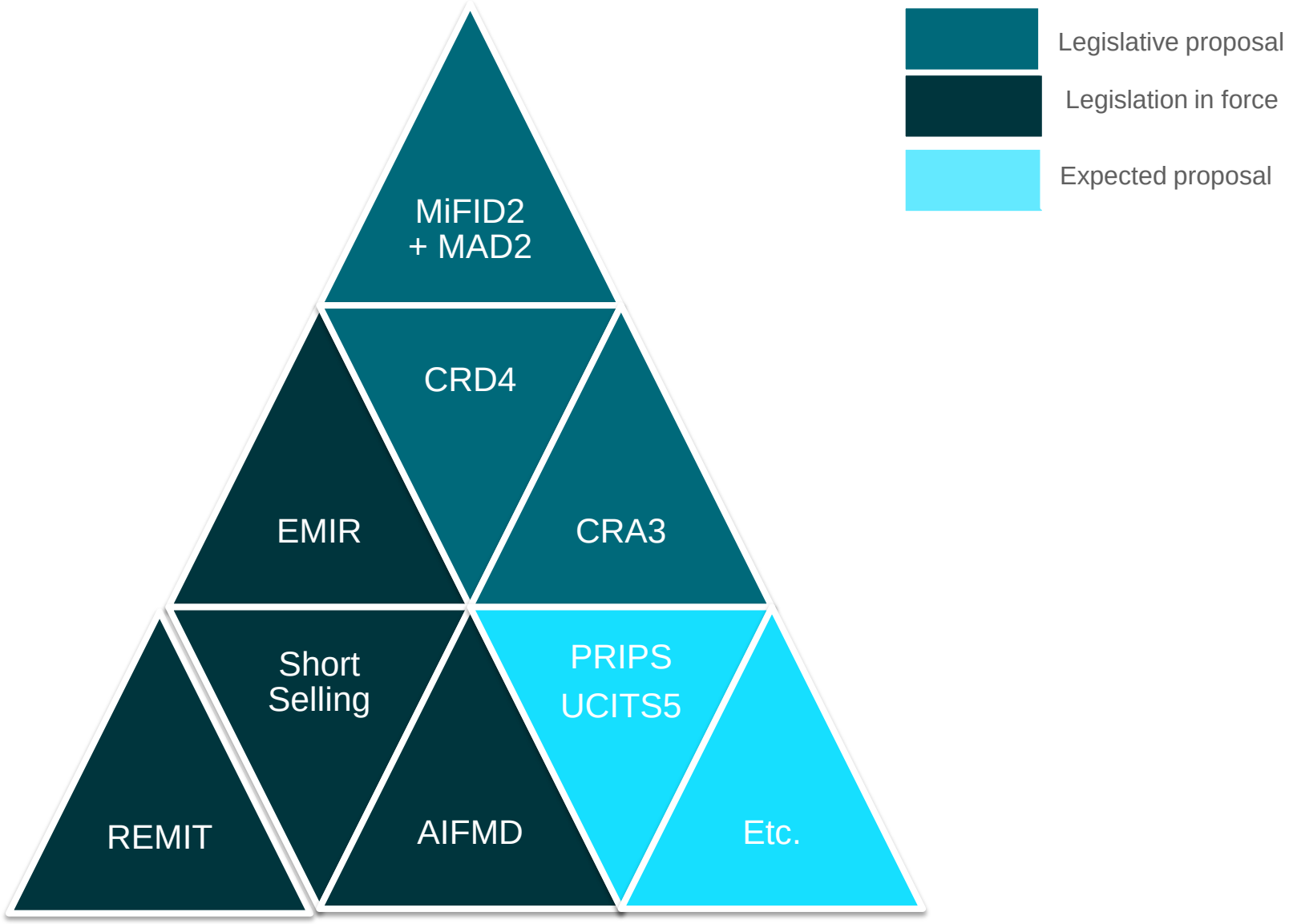
- Negotiations in Council/ European Parliament

- Q1:Agreement on text
- Q2: Publication in Official Journal
- Consultation on Level 2 and 3 measures begins

- Adoption of Level 2 and 3 measures

- Q1: Adoption of national implementing measures
- Further transition period (to be determined) for:
  - consolidated tape for non-equities data
  - non-EU firms

Context


MiFID2
+ MAD2
CRD4
EMIR
CRA3
Short
Selling
PRIPS
UCITS5
REMIT
AIFMD
Etc.
Legislative proposal
Legislation in force
Expected proposal

Extended business conduct rules (1)

Change	Examples of impacts
Removal of grandfathering for pre-MiFID professional clients	Firms may need to re-classify (repaper) existing clients
Municipalities and local authorities requesting professional client status: member states can impose additional criteria	Firms may need to re-classify (repaper) existing clients Less likely to treat as professional clients in future
Additional conduct rules for business with eligible counterparties, including duties to: a) act honestly, professionally, etc. and to ensure information fair, clear, not misleading b) provide appropriate information on firm and services (incl. instruments, strategies, risk warnings) c) report transactions to clients	Firms may need to repaper clients if additional information needed
Record telephone calls and e-communications regarding execution services (keep for 3 years and make available for clients)	Systems build and costs
Requirement to provide greater detail on execution policies and seek consent to execute outside MTF/OTF	Possible need to repaper clients (no transitional provisions)

Extended business conduct rules (2)

Change	Examples of impacts
Duty to publish summary report on top 5 execution venues	Systems build and costs
No title transfer collateral arrangements with retail clients	May affect retail repo/securities lending in the UK
Independent advice: duty to provide information on nature of service and details of how advice meets clients needs, ban on receiving inducements*	Ban on inducements more limited scope that UK RDR Duty to provide explanation of advice applies more broadly than current FSA rules
Ban on portfolio managers receiving inducements*	Applies more broadly than UK RDR
If investment service offered as package with other service/product, duty to inform client of whether can be purchased separately and costs*	Unbundling of research and execution already established practice But burdensome to provide separate pricing/costs on other products/services
Restrictions on execution only business for structured UCITS, non-UCITS funds, derivative linked bonds, etc.*	Extends duty to assess appropriateness

* Not limited to retail clients

MiFID 2 / MiFIR – Impact on non-EU firms

Growing EU debate on third country issues

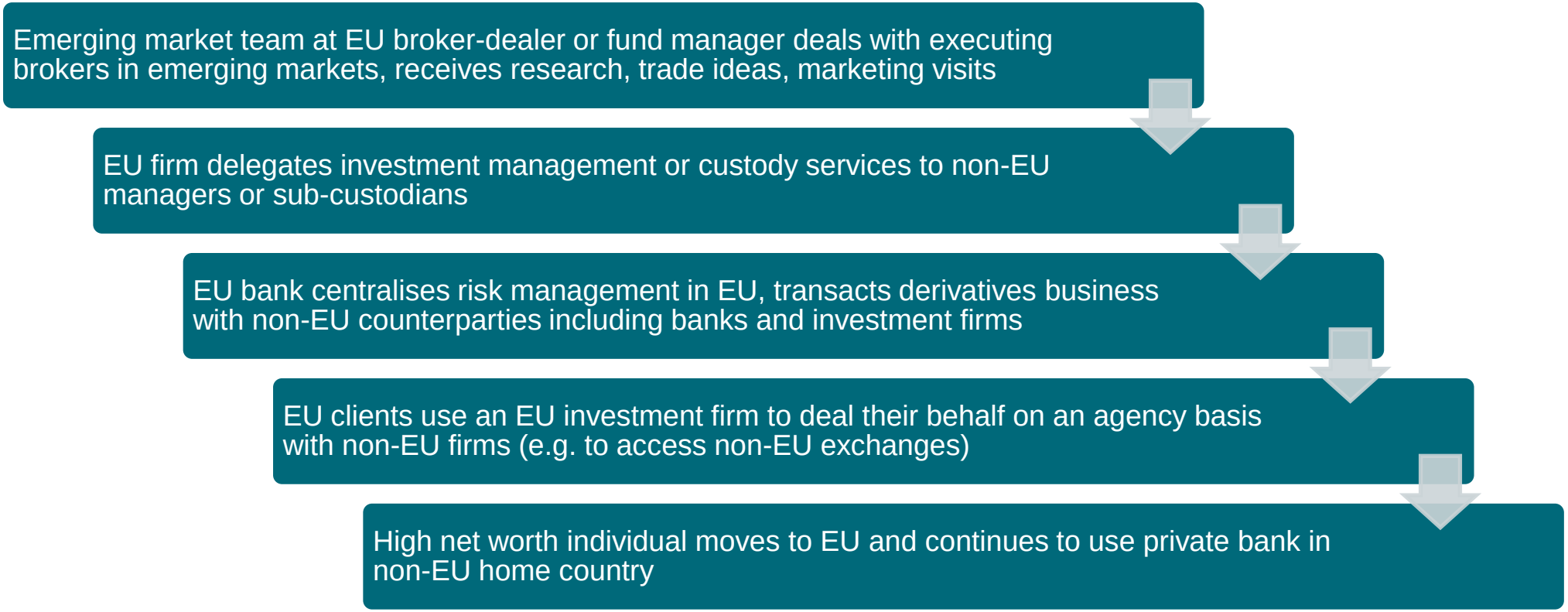
- **Financial conglomerates directive, audit directive prospectus/transparency directive, MiFID 1**
- **Mutual recognition initiative**
- **AIFMD, EMIR**
- **Extraterritoriality under Dodd-Frank Act**

Favoured EU solutions

- **The move from equivalence to equivalence + reciprocity**
- **GATS issues on reciprocity/mutual recognition agreements**
- **Passive provision of services (unsolicited business)**

A possible omnibus approach?

Cross-border business



Not realistic that the non-EU firm entirely passive (never calls, never emails, never visits)
So, does the non-EU firm need a licence in the EU if it wishes to interact with EU clients/counterparties in these ways?

Today, a patchwork of differing rules for non-EU firms...

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Branches

Mainly non-EU banks (some national incorporation rules for investment firms)

BCD/MiFID permit national authorisation of branches

But "no more favourable treatment" than EU firms

Prudential recognition (but some dotation/branch capital requirements)

Business conduct rules apply

Do not benefit from passport

Cross-border business

No directive constraint

Exemption approach e.g.

UK, Ireland, Lux, Sweden

Remote licence, registration

Belg., Germany, NL

Solicitation based

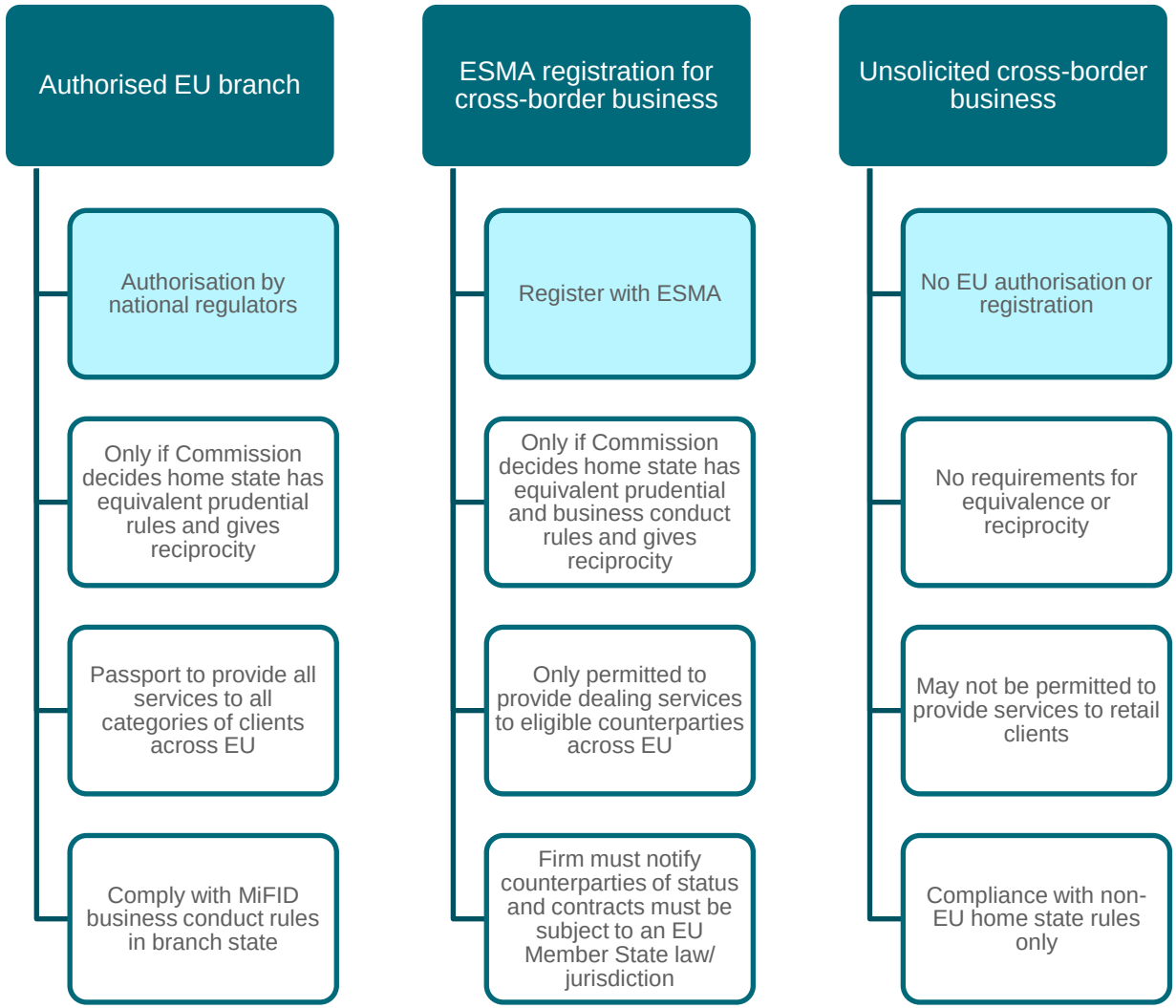
France, Germany, Italy, Spain

Relationship vs transaction-by-transaction solicitation tests

Differing approaches to "intermediation"

Mostly no equivalence requirement and home state conduct rules

New harmonised regime offers only three choices to non-EU firms*



Plus additional 2 year transitional period for "existing firms" (can be extended)

* The description of the proposed regime in this slide is based on the original Commission legislative proposal.

Key issues for non-EU firms

Existing branches of non-EU firms may be required to stop performing investment services and activities

Unless Commission can make equivalence/reciprocity determination

Non-EU firms carrying on cross-border business with EU clients may be unable to register with ESMA

Unless Commission can make equivalence/reciprocity determination

Unregistered firms restricted to unsolicited cross-border business

Restriction on solicitation even within an existing business relationship

Uncertainty about business intermediated by EU affiliates

Ability of EU firms to deal with non-EU firms may be impaired if non-EU firms fear need to register/create branch in the EU

Definition of “third country firm”: unclear how rules apply to non-EU banks and application of exemptions for non-EU firms

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2012 88595-1-13