

Draft

COMMISSION DIRECTIVE

implementing Directive 2004/39/EC of the European Parliament and of the Council as regards record-keeping obligations for investment firms, transaction reporting, market transparency, admission of financial instruments to trading, and defined terms for the purposes of that Directive

BACKGROUND NOTE

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BACKGROUND NOTE

Draft Commission Directive implementing the Markets in Financial Instruments Directive 2004/39/EC ('MiFID')

1. INTRODUCTION

Directive 2004/39/EC on Markets in Financial Instruments ('the MiFID' or 'the level 1 Directive') is the principal piece of legislation recently adopted in the field of securities markets, and will replace Directive 93/22/EEC on investment services in the securities field. This Directive was agreed unanimously by Member States and gathered a strong Parliamentary majority. It came into force in April 2004. The transposition period, by which Member States are bound to adopt national legislation in order to enact the level 1 Directive into national law elapses on 31 January 2007; a deferred application date, 1 November 2007, has been agreed upon to allow firms to put in place practical arrangements to comply with the obligations set in the Directive once the transposition period has elapsed.

The MiFID is a Lamfalussy-type Directive: that is, as a 'level 1' directive, it contains framework principles, agreed by the Council and the European Parliament through co-decision, which need to be developed and elaborated with detailed technical implementing measures ('level 2 measures'). The scope of the level 2 measures is defined and circumscribed by the level 1 text. These technical measures are adopted by the Commission through the 'comitology' procedure established by decision 1999/468/EC, after consultation with the European Securities Committee (ESC), which is the competent regulatory committee in the field of securities, and taking into account the views of the European Parliament. The Commission has presented 2 draft measures to implement the level 1 Directive; in both measures, the Commission has taken particular care to ensure that the political agreement represented by the level 1 Directive and the limits of the delegated powers are respected.

The draft implementing measures have been drawn up after a very long, open and iterative consultation process embracing and building on the views of all stakeholders concerned (Member States, industry, exchanges, consumers, regulators). They are largely based on technical advice produced by the Committee of European Securities Regulators (CESR), an independent advisory body in the field of securities which assists the Commission in the preparation of technical implementing legislation on the basis of a Commission mandate. Since 2000 – when the preparatory work began for the level 1 Directive – there have been more than 15 formal, public consultations on MIFID and the implementing measures, including consultations undertaken by CESR in the course of producing its advice. As part of this process, consultation on DG Internal Market and Services draft working documents has taken place within the ESC since March 2005; these working documents were sent to the European Parliament and also published on the Commission's website, and comments from stakeholders on those working documents have been taken into account.

Studies carried out by the Commission and by leading economists have unambiguously shown that the integration of European capital markets has significant and positive overall effects on EU economic growth. These implementing measures form an integral part of the European project to promote those economic benefits.

The draft implementing measures have been structured into one Regulation and one Directive. For the majority of the envisaged measures uniform solutions are desirable to avoid ‘gold-plating’ by Member States; to this end, the Commission has adopted a twofold approach:

- Wherever legally possible (i.e. where the texts are sufficiently exhaustive to allow direct application in national legal regimes) – and in order to conform with the Stockholm European Council Declaration on the Lamfalussy process (April 2002) – the Commission has presented the draft implementing measures in the form of a Regulation.
- Nevertheless, in those cases where the use of a Regulation was not legally or technically feasible, a principles-based though tightly worded Directive, allowing Member States to only make the necessary adaptations for the rules to fit into their national legal systems has been proposed.

The MiFID provisions that will be implemented by the present Directive (‘the level 2 Directive’ or ‘the Implementing Directive’) are the following:

- **Article 13**, setting out the organisational requirements with which investment firms have to comply in order to be authorised to provide investment services or carry out investment activities;
- **Article 18**, containing measures related to the identification, management and disclosure of conflicts of interests, including those related to the provision of the ancillary service of investment research.
- **Article 19**, setting out the conduct of business rules with which an investment firm has to comply when providing services to its clients;
- **Article 21**, establishing the best execution obligation in respect of the execution of client orders;
- **Article 22**, fixing the principles and requirements relating to client order handling;
- **Article 24**, setting out the criteria for treatment as an eligible counterparty;
- **Article 4**, specifying the circumstances under which a recommendation will constitute investment advice.

2. GENERAL ISSUES

2.1. Principles-based approach

The Level 1 Directive and its implementing Directive introduce a modern and comprehensive regime governing organisational and operating requirements for investment firms. The implementing Directive covers all facets of an investment firm’s organisation and introduces a high level of investor protection in the areas concerned with the relationship between investment firms and their clients. It has relied mainly on a principles-based approach establishing clear standards and objectives that investment firms need to attain rather than prescribing specific and detailed rules. The advantage of this approach is that it provides the flexibility needed when regulating a diverse universe of entities and activities while also imposing a significant degree of responsibility on all the actors concerned.

Principles-based regulation avoids a ‘one-size-fits-all’ approach by introducing obligations at a level of generality that allows for calibration of the requirements according to the nature, scale and complexity of the particular investment firm and its business and allowing Member States to adapt EU rules to national situations. Both firms and competent authorities should monitor investment firm activities and judge whether they comply with the principles set out in the law. Investment firms, knowing the nature of their business as well as their regulatory obligations, will be in the best position to assess, with adequate guidance from the regulator, what is the most appropriate way to structure their organisation. The proposed implementing Directive is therefore conceived and structured in such a way that it creates strong incentives for the firm to monitor its own activities and determine whether its activities comply with the principles set out in the Directive. There is also a greater onus on competent authorities who will need to acquire the operational expertise to guide the industry properly and to enforce the provisions adopted under this implementing Directive. The relevant competent authority may assess the adequacy of any additional actions, steps, measures or procedures, and also, given the context, issue guidance as to the applicability of those measures to more general circumstances thus mitigating any legal uncertainty associated with the principles-based approach. Such guidance might, for example, reflect international standards, such as those produced by International Organization of Securities Commissions, provided that they are not inconsistent with the MiFID and its implementing measures. Guidance ought to facilitate the investment firm’s compliance with the law rather than adding yet another layer of regulation.

Finally, fostering a culture of compliance means that EU regulators should act decisively and consistently against misconduct. A strong commitment on the part of the Member States will be required to provide regulators with the necessary resources needed to accomplish this task, the outcome of which – if successful – will be a stronger, more dynamic and prosperous industry in the interests of all stakeholders and the EU economy as a whole.

Studies carried out by the Commission and by leading economists have unambiguously shown that the integration of European capital markets has significant and positive overall effects on EU economic growth. These implementing measures form an integral part of the European project to promote those economic benefits.

2.2. Choice of instrument and level of harmonisation

The first question that may be posed in relation to the choice of the legal instrument is whether it is indeed necessary to legislate at all. Could a non-legislative response or reliance on self-regulation prove to be more effective? Although there are regulatory areas where such non-legislative action may be preferred, important legal and economic imperatives impose a legislative solution. First, the Commission must act in accordance with the level 1 Directive, which states (Articles 13(10) and 19(10)) that level 2 measures are to be adopted in order to ensure uniform application of the level 1 provisions. In all of the domains dealt with in the level 1 Directive concerning the organisational and operating requirements for investment firms a diverse body of national law is already in place. Sometimes the legal obligations under those national legal systems diverge significantly and act as a barrier to further integration of the European capital markets. Therefore, only European legislative action is capable, through adequate harmonisation, of greater alignment of the national legal systems – the necessary basis for a uniform application of the level 1 provisions.

Second, there are also strong economic arguments for government intervention in respect of investment service providers. One of these arguments proceeds on the basis that investor confidence is a public good that crucially contributes to the development and efficient

functioning of the capital markets. In the absence of publicly produced and enforced investor protection measures, investor confidence may be undermined, leading to sub-optimal operation of the markets. This is because the high degree of informational asymmetry between investment firms and their clients diminishes the usual effect of competitive forces. In an environment where it is impossible or extremely costly for clients to effectively monitor and verify whether investment firms act in their best interest, it may be difficult to punish those service providers who choose to profit from their clients' relative lack of information and knowledge. Unscrupulous service providers would be allowed to free-ride on the reputation of the other investment firms who, in turn, would have fewer incentives to behave correctly. The case for a legislative intervention at level 2 is therefore very strong.

As far as the choice of the legal instrument is concerned, it is necessary to adopt the provisions in the area of organisational and operating requirements of investment firms in the form of a directive. This is in order to enable Member States, when transposing its provisions into national law, to not only adjust its requirements to the specificities of their particular market but also ensure coherence with other bodies of law. For example, the provisions dealing with the conduct of business regulate the relationship between investment firms and their clients, an area that is also governed by Member States' civil law. However, this should not imply that legal provisions in other existing areas of law which are inconsistent with the provisions of the implementing Directive should not be repealed or adjusted to ensure proper implementation.

The implementing Directive establishes a highly harmonised legal regime. The choice of exhaustive harmonisation reflects the demand formulated in the comitology provisions of the MiFID which, as mentioned already, explicitly and consistently state that the objective of adopting implementing measures is to ensure a uniform application of those provisions. It is therefore not intended that Member States and competent authorities should add supplementary rules to those strictly needed for the transposition of the implementing Directive, as this would be contrary to the goal of achieving uniform application.

3. ORGANISATION OF THE INVESTMENT FIRM

3.1. General policy in respect of the organisation of the firm (high level principles and flexibility)

Article 13 of the Level 1 Directive establishes the organisational principles that investment firms must follow. These include measures to ensure that firms comply with the general requirements of MiFID, that they abide by proper administrative and accounting procedures, establish internal and risk control mechanisms, provide for appropriate treatment of conflicts of interest, ensure business continuity, maintain rigorous arrangements for outsourcing, and provide an adequate level of protection of client assets.

The implementing Directive focuses first on the overall organisation of the investment firm and identifies the fundamental organisational elements that should be established by all investment firms to ensure their proper functioning. These general requirements constitute a sort of 'common organisational denominator' that is presented in the form of high level principles in Article 5.

Where possible and where investor protection is not compromised, measures relating to organisational requirements should be sufficiently supple to allow firms to choose the most

appropriate practical means of satisfying the regulatory objectives of MiFID. While the principles apply to all investment firms irrespective of their size or operations, the application of those principles should be proportionate and take into account the nature, scale and complexity of a firm's business. The specific provisions of Article 5 include measures requiring the establishment of a well-documented organisational structure that clearly assigns responsibilities, incorporates proper internal control mechanisms, and ensures a good flow of information. This Article also requires investment firms to employ personnel with the right skills, knowledge and experience, establish adequate systems to safeguard information and ensure business continuity and maintain proper accounting.

Specific important areas covered by Article 13 of the level 1 Directive require elaboration through further regulatory detail. These areas include compliance, internal audit, risk management, personal transactions, outsourcing, safeguarding of client assets and provisions related to conflicts of interest.

3.2. Compliance, risk management and internal audit

Three particular functions – compliance, risk management and internal audit – are singled out in the organisation of the investment firm because they play a particularly important role in the proper management and operation of the firm. The detailed provisions governing these functions are set out in Articles 6, 7 and 8 of the implementing Directive. The primary responsibility for the effective performance of these functions lies with the senior management of the firm who must establish, implement and effectively supervise the specific policies associated with each of the functions. However, these functions may be embedded in the organisation of the firm in different ways. These differences reflect the nuanced nature of these functions as well as the need for proportionality.

Article 6 requires all firms to establish a permanent compliance function and to appoint a compliance officer responsible for co-ordinating the various tasks associated with the firm's compliance policies and procedures, as well as for reporting to senior management. The compliance officer may be a member of the senior management. Nevertheless, the nature of the reporting line or other functional relationship between the persons involved in the compliance function, the compliance officer and senior management should be left to the discretion of the investment firm, and should reflect the manner in which its business is organised.

To further strengthen the independence of the compliance function, additional formal requirements are put in place. The function must have the necessary authority, resources, expertise and access to information; the compliance staff cannot perform the services they monitor; and the firm's remuneration policy should not undermine the objectivity of the compliance function. Nonetheless, flexibility is provided for investment firms in respect of the separation and remuneration requirements. Those requirements may be waived where their application would be disproportionate, provided that the firm's compliance function remains effective.

Article 7 requires all firms to establish, implement and maintain adequate risk management policies and procedures which identify and set the tolerable level of risk relating to the firm's activities and effectively manage those risks. However, the specific requirement to establish an independent risk management function responsible for the implementation of the risk management policies will not apply to all firms. The need to establish such a function will depend on the nature, scale and complexity of the business of the firm and also on the ability

of any firm that does not establish such a function to demonstrate that its risk management remains effective and fulfils the specified regulatory objectives.

Finally, Article 8 requires investment firms to establish an independent internal audit function that is separate from other activities of the firm where, given the size of the firm and the nature of its business, that is an appropriate and proportionate way of ensuring that the firm maintains sound internal control mechanisms.

Figure 1 indicates in diagrammatic form the organisational structures which firms should adopt in order to comply with the requirements of the MiFID. It is for illustrative purposes only, and does not determine the interpretation of the proposed Directive.

3.3. Complaints handling

It is important for investor protection that when retail clients lodge complaints with investment firms, those complaints are dealt with swiftly and appropriately. To this end, Article 10 of the implementing Directive obliges investment firms to maintain effective and transparent procedures for the reasonable and prompt handling of retail client complaints. Firms are also required to keep a record of each complaint and the measures taken for its resolution.

3.4. Personal transactions

Article 13(2) of the MiFID requires investment firms to adopt adequate and appropriate rules governing personal transactions by its relevant persons¹. The primary objective of the implementing measure is to ensure that investment firms prevent their employees who are subject to conflicts of interest or in a possession of inside information from entering into or procuring other persons to enter into transactions that would constitute the misuse of information they have acquired through their professional activity.

The provisions governing personal transactions, in Article 12 of the implementing Directive, set out the main objectives that an investment firm must achieve and specify the basic organisational or procedural rules which govern the notification and record-keeping of such transactions. The text complements the provisions of Directive 2003/125/EC ('the Market Abuse Directive'), and aims at ensuring that the rules concerning personal transactions are consistent with those in that Directive. Article 12(3) also provides appropriate exemptions to the rules that prevent the staff of investment firms from entering into personal transactions. Accordingly, certain transactions in units in collective investment undertakings or certain personal transactions effected by a discretionary portfolio manager are exempt from the rules. Those exemptions do not affect the scope of obligations under the Market Abuse Directive.

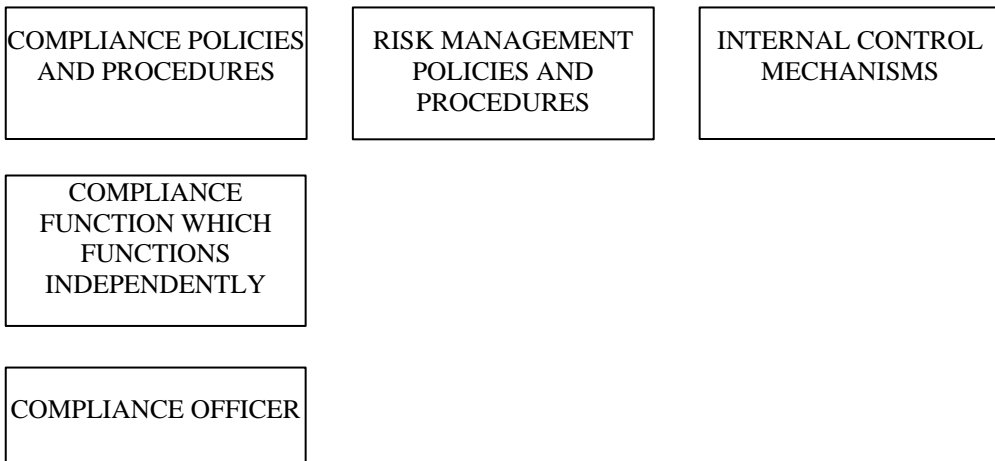
¹ The term 'relevant persons' is defined in Article 2 of the proposed implementing Directive and includes, broadly speaking, partners, officers, employees and tied agents of the firm and other persons who provide services to the firm.

Figure 1: Organisational requirements

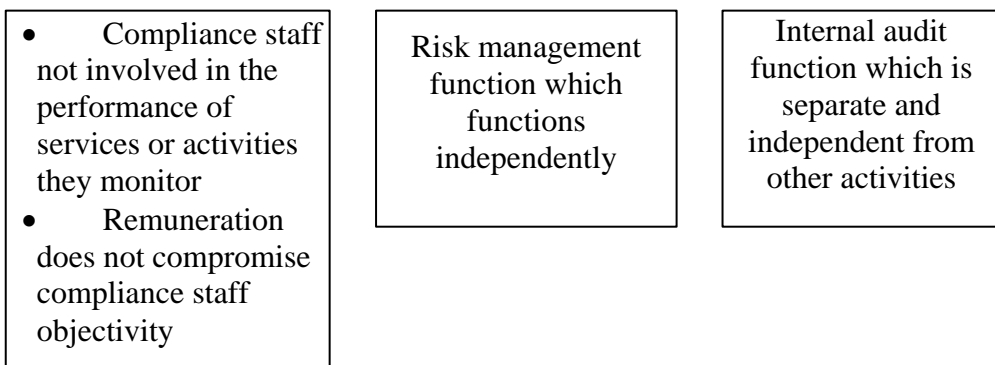


General requirement: the performance of multiple functions by the investment firm's staff should not prevent them from discharging any particular function soundly, honestly and professionally.

ALWAYS REQUIRED



REQUIRED WHERE APPROPRIATE



4. OUTSOURCING

Article 13(5) of the MiFID requires an investment firm to ensure that it takes reasonable steps to avoid undue additional operational risk when relying on a third party for the performance of operational functions which are critical for the provision of a continuous and satisfactory service to clients and for the performance of investment activities on a continuous and satisfactory basis. Furthermore, a firm may not outsource important operational functions in a way that materially impairs the quality of its internal control and the ability of the supervisor to monitor the outsourcing firm's compliance with all obligations. This result is achieved in the following ways.

First, the implementing measures define a critical and important operational function as any function characterised by the fact that a defect or failure in its performance would materially impair the continuing compliance of an investment firm with its obligations under the level 1 Directive, or impair its financial performance or the soundness or the continuity of the provision of its investment services and activities (Article 13). The implementing Directive also lists specific functions that are not to be considered to be critical or important².

Next, the measures focus on the conditions under which the investment firm is permitted to outsource critical and important operational functions, or any other investment services or activities (Article 14). These provisions provide the flexibility to outsource crucial parts of investment firms' operations, but at the same time impose very strict and rigorous conditions on any such arrangements to ensure that firms remain in charge of their business and comply with their regulatory responsibilities. The provisions on outsourcing also fully reflect the current international regulatory standards and address all the principal risks associated with outsourcing. Furthermore, outsourcing of investment services and activities should be considered as capable of constituting a material change of the conditions for the authorisation of an investment firm (Recital 18) and may therefore need be notified to the competent authority in line with Article 16(2) of the Directive. This is without prejudice to the particular notification arrangements present in each Member State, i.e. some Member States may require prior notification while others may not.

Finally, additional measures apply in cases where an investment firm outsources the management of retail client portfolios to a service provider located in a third country (Article 15). In such circumstances, the firm must ensure that the service provider is duly authorised to provide such a service and that appropriate cooperation agreements exist between its competent authority and the supervisory authority of the service provider in question.

However, the implementing Directive permits an investment firm to outsource to service providers in jurisdictions that do not regulate portfolio management, provided that it notifies its intention to outsource to its competent authority and the competent authority does not object to the proposed arrangement.

² These include the provision of advisory services and other services which do not form part of the investment business of the firm, such as the provision of legal advice to the firm, the training of personnel, billing services and the security of the firm's premises and personnel as well as the purchase of standardised services, including market information services and the provision of price feeds.

5. SAFEGUARDING OF CLIENT ASSETS

The MiFID requires investment firms to make ‘adequate arrangements’ to safeguard client assets (client funds and financial instruments) (Articles 13(7) and (8)). In order to be effective, such arrangements should take into account any applicable legal regimes that could affect the clients’ rights and their rights to property in particular. Article 16 of the proposed implementing Directive imposes a series of requirements relating to such arrangements, including record-keeping obligations, designed to ensure that assets held by firms on behalf of clients can be properly identified and accounted for, and that any risk of diminution to, or loss of, such assets is minimised. These measures are proportionate and flexible. In particular, they allow firms to take into account the substantive effect of the applicable law (including, in particular, the law of property or insolvency) when making the arrangements by which client assets are held, and to adapt those arrangements so as to ensure the effective protection of client assets under the law in question. However, this flexibility is only available in so far as it is used to ensure that the firm complies with the general requirements of the Level 1 Directive in relation to the safeguarding of client assets.

Article 17 of the implementing Directive permits investment firms to deposit client financial instruments with third parties, provided that specified conditions are met. One of those conditions is that the firm must exercise due care, skill and diligence in the selection of a third party depository. Another requires the firm to choose a depository which is subject to specific regulation, if applicable. Furthermore, an investment firm may only deposit client financial instruments in third country³ jurisdictions that do not regulate the safeguarding of financial instruments when it is necessary for the provision of the service⁴ or when a professional client expressly demands it. This provision will enhance the protection of client financial instruments.

Article 18 of the implementing Directive contains similar provision in relation to the depositing of client funds. Investment firms are required to deposit funds in specified kinds of institutions or vehicles, and must exercise due care, skill and diligence in making their selection. The permitted institutions or vehicles are central banks, authorised credit institutions, banks authorised in a third country, and high-rated money market funds which satisfy specified conditions. Allowing investment firms to deposit client monies into appropriate money market funds offers advantages to clients without a concomitant increase in risk. In order to eliminate risk to the greatest extent possible, Article 18(2) restricts the kinds of money market funds which may be used for the purpose of depositing client monies. These so-called ‘qualifying money market funds’ must meet a number of exacting criteria: for example, they must maintain the net asset value constant or at the value of the clients’ initial capital plus earnings, invest in the highest quality money market instruments and provide same- or next-day liquidity.

³ (i.e., non-European Economic Area)

⁴ For example, if an investment firm wishes to buy for its clients bonds issued by country A which does not regulate safeguarding of financial instruments, it may be more reasonable to hold those bonds with a third party in that country, even when that entity is not regulated. However, it would not be appropriate to hold in country A bonds issued by other countries that regulate safeguarding of financial instruments and have well functioning depositories.

6. CONFLICTS OF INTEREST

6.1. Existence of a conflict, the conflicts policy, management of conflicts, disclosure of conflicts

Part 5 of the proposed implementing Directive regulates the identification, management and disclosure of conflicts of interest for the purposes of Articles 13(3) and 18 of the MiFID. Section 6.2 below deals with conflicts of interest in the context of investment research. .

The aim of these provisions is to ensure that investment firms take a holistic approach to conflicts management, regularly reviewing their business lines to ensure that at all times their policies reflect the full scope of their activities and the possible conflicts that may emerge.

Article 13(3) of the MiFID requires firms to have effective organisational and administrative arrangements for preventing conflicts of interest from adversely affecting the interests of clients. Article 18(1) of the MiFID defines the scope of the relevant conflicts of interest as, broadly, conflicts of interest between investment firms and their clients or between one client and another arising in the course of providing investment and ancillary services.

Article 21 of the proposed implementing Directive in turn sets out criteria for determining the types of conflicts of interest that arise in the course of providing any investment or ancillary services the existence of which may damage the interests of a client. The provision is not intended to constitute an exhaustive list, and firms should be aware that conflicts of interest might arise in other circumstances. However, Recital 20 makes it clear that conflicts of a kind covered by Article 18(1) of the MiFID arise only in cases where the interests of the firm (or a relevant person or other specified person) conflict with the duty the firm owes to a client, or where there is a conflict between the different interests of two or more clients, to whom the firm owes in each case a duty. The ‘duty’ referred to may be a fiduciary duty arising under contract or other national or Community law, as well as a duty imposed under the MiFID.

Article 22(1) of the implementing Directive requires a firm to establish, implement and maintain an effective conflicts of interest policy. The policy should be in writing and should be appropriate to the nature of the firm. Where the firm is a member of a group, its policy should take into account any circumstances of which the firm is or should be aware which may give rise to a conflict arising as a result of the structure and business activities of other members of the group. Recital 22 gives additional guidance as to the activities to which the firm should give special attention when drawing up its conflict of interest policy.

Article 22(2) of the implementing Directive specifies necessary elements that a firm must include in its conflict of interest policy. The policy should identify, with reference to specific investment and ancillary services and activities, the circumstances which may give rise to a conflict of interest entailing a material risk of damage to the interests of one or more clients; and specify procedures to be followed and measures to be adopted in order to manage such conflicts.

Article 22(3) of the proposed implementing Directive introduces the theme of independence in these provisions: persons involved in different activities where a conflict of interest is present must carry them on with an adequate degree of independence which reflects the size and activities of the firm and the degree of risk to client interests. Article 22(3) also puts flesh on the bones of this scheme by setting out a series of measures and requiring firms to adopt those which are necessary and appropriate to ensure that degree of independence. However, where the specified measures will not achieve the required objective, the last subparagraph of

Article 22(3) requires the firm to put in place alternative or additional measures which will ensure the necessary degree of independence.

The implementing Directive gives effect to the ‘identify, manage and disclose’ structure set up by Articles 13(1) and 18 of the MiFID to deal with conflicts of interest. In line with the level 1 Directive, Article 22(4) of the proposed Directive puts strict limits on the ability of firms to rely on disclosure as a means of complying with the conflict of interest regime of the MiFID. Disclosure of a conflict of interest to a client is a ‘last resort’, and should only be used in specific cases where measures adopted in accordance with MiFID and Article 22 of the implementing Directive may not prevent risk of damage to the client in case of that specific conflict. In other words, the firm should not base its conflicts management policy on the disclosure of a general class of conflicts which it will not seek to manage. In line with this, Recital 23 makes clear that investment firms should aim to identify and manage the conflicts of interest arising in relation to their various business lines under a comprehensive conflicts of interest policy, and that an over-reliance on disclosure without adequate consideration as to how conflicts may appropriately be managed should be avoided.

Article 22(5) regulates the method and extent of disclosure of the general nature or source of a conflicts of interest pursuant to Article 18(2) of the level 1 Directive. Article 23 of the implementing Directive requires firms to keep a record of services or activities giving rise to detrimental conflicts of interest.

6.2. Investment research

Article 25 of the implementing Directive complements the general scheme for managing conflicts of interest by adding supplementary special rules to address the particular conflicts that can affect the production and dissemination of investment research. The requirements are based in large measure on the *Principles for Addressing Sell-side Equity Research Conflicts of Interest* published by the International Organization of Securities Commissions in 2003. However, the provisions relating to investment research apply to all financial instruments, and not just equities, as well as to all investment firms and not just sell-side institutions.

Article 25 applies to investment firms which produce or arrange for the production of investment research that is intended or likely to be subsequently disseminated to clients or to the public under their own responsibility or that of group members. The concept of dissemination of investment research to clients or the public does not include dissemination to entities within the group of the investment firm (Recital 30). Investment research is defined in Article 24 of the proposed Directive as a sub-category of recommendations as defined in the Market Abuse Directive. In order to qualify as investment research such recommendations must be labelled or described as investment research, or otherwise presented as objective or independent, and must not constitute investment advice. The aim of this ‘positive labelling’ approach is to bring recommendations that are positively labelled as research, or otherwise presented in similar terms, within the strict conflicts management regime set out in the implementing Directive.

It is intended that the MiFID and the Market Abuse Directive should operate together as a seamless and comprehensive regulatory regime for the regulation of investment research and other recommendations.

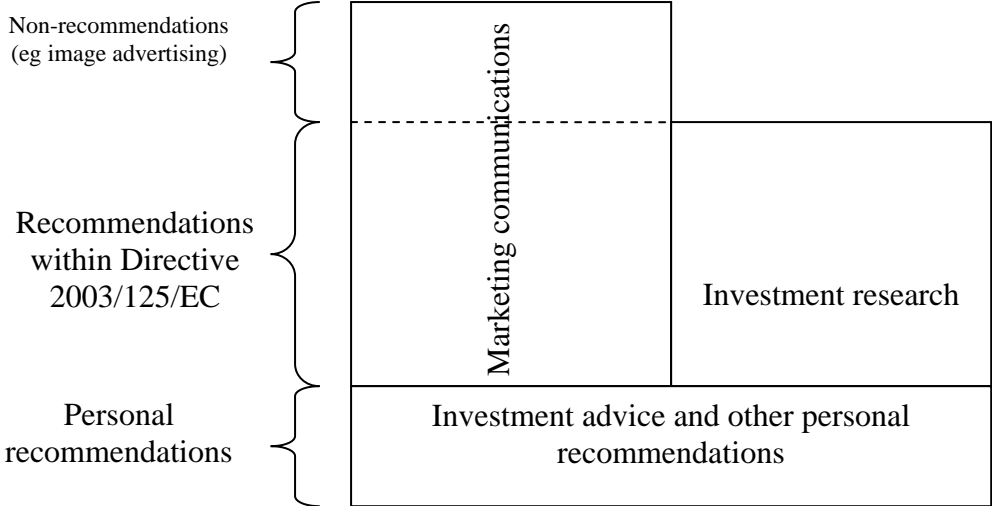
Recommendations within the meaning of the Market Abuse Directive that do not constitute investment research will be treated as marketing communications for the purposes of the

MiFID (Article 24(2)). They must therefore be clearly identifiable as marketing communications in accordance with Article 19(2) of the MiFID. Such recommendations must also contain a clear and prominent statement that (or, in the case of oral recommendations, to the effect that) they have not been prepared in accordance with standards designed to promote the objectivity of investment research (Article 24(2)).

General recommendations which are considered as marketing communications and those which constitute investment research for the purposes of the MiFID remain, of course, subject to the provisions of the Market Abuse Directive as to the fair presentation of investment recommendations and the disclosure of conflicts of interest.

The diagram in **Figure 2** explains the broad relationship between the concepts of recommendation, investment advice and investment research. It is for information purposes only, and does not determine the interpretation of the MiFID or the implementing Directive.

Figure 2: Recommendations and research



When Article 25 of the implementing Directive applies, the investment firm must ensure that it implements all the measures in Article 22(3) in relation to analysts and other persons whose responsibilities or business interests may conflict with the interests of recipients of the research. Recital 27 explains that those other persons should include corporate finance personnel and persons involved in sales and trading on behalf of clients or the firm. Recital 26 clarifies that the measures adopted by an investment firm to manage the conflicts of interests that might arise from the production and dissemination of investment research should protect the objectivity and independence of financial analysts and of the investment research they produce. Those measures should ensure that financial analysts enjoy an adequate degree of independence in relation to the investment firm or its clients, where the interests of the firm or its clients may conflict with the interests of the persons to whom the material is disseminated.

Recital 33 elaborates upon the steps which are likely to be necessary to preserve the independence of financial analysts: analysts and other persons involved in the production of investment research should not be involved in activities other than the preparation of

investment research, including attending or participating in pitches or ‘road shows’, where such involvement is inconsistent with that person’s objectivity.

Article 25(2) also requires investment firms to take other specified steps designed to ensure the objectivity of the investment research. Importantly, the firm must prevent dealing ahead of investment research under Article 25(2)(a), as well as personal transactions contrary to recommendations under Article 25(2)(b). The restriction on dealing ahead covers cases of the firm’s principal dealing, as well as client dealing and personal transactions.

Recital 32 of the proposed Directive explains that the requirements which apply to the production of research should also apply to the substantial alteration of investment research produced by a third party. A firm which simply disseminates research which has been produced by a third party is not required to comply with organisational requirements imposed by Article 25(1), provided that certain conditions are satisfied. Those conditions are specified in Article 25(3). Most importantly, the disseminating firm must not substantially alter the research, and must verify that the producer of the research is subject to requirements, or has established a policy, equivalent to the requirements of the implementing Directive.

Recital 34 also recommends that producers of investment research that are not investment firms should consider adopting internal policies and procedures designed to ensure that they also comply with the principles set out in the implementing Directive promoting the independence and objectivity of that research.

7. OPERATING CONDITIONS AND PROTECTION OF CLIENTS

7.1. General approach to client protection

The detailed disclosure requirements in this implementing Directive are designed to give regulators and investors the necessary tools to be able to discern and punish inefficiency and unprincipled conduct by firms. Articles 19, 21 and 22 of the Level 1 Directive and the accompanying implementing measures in the implementing Directive establish a rigorous investor protection regime that clearly stipulates the basic information requirements and the fiduciary obligations of investment firms towards their clients. The implementing Directive provides for a balanced combination of information disclosure in some areas (making the client responsible for the analysis and evaluation of that information) and stronger fiduciary duties for the firm⁵ to take care of the client interests in other areas. By avoiding excessive reliance on information disclosure, the implementing Directive avoids imposing unnecessary formalities on investment firms – formalities that would not necessarily increase investor protection in practice.

Of course, the regulatory response to the challenge of investor protection should be proportionate and appropriate in light of the demonstrable risks incurred by different types of investors. This implementing Directive, following the general principles of the level 1 Directive, distinguishes clearly between the rules that apply only to retail clients and those that also apply to professional clients (conduct of business obligations do not generally apply to eligible counterparties – the most sophisticated type of investors).

This is why many of the specific rules established in the implementing Directive – especially those dealing with disclosure of information – refer specifically to retail clients. Unlike retail

⁵ Areas such as best execution, inducements, etc.

clients, professional clients should have the knowledge, expertise and resources necessary to protect their own interests in the market and, in particular, to determine what information they need from their service providers⁶. However, where the implementing measures do not contain detailed rules in relation to professional clients, this does not reduce or in any way modify the protection to all clients afforded by the principles set out in the level 1 Directive. Since the application of the conduct of business rules depends on the type of client to whom the service is provided, it is necessary to describe the detailed rules governing client classification.

7.2. Prohibition of inducements

Article 19(1) of the Level 1 Directive requires an investment firm to act honestly, fairly and professionally in accordance with the best interests of its clients. This means that firms may not offer or accept payments or any other benefits – inducements – if such compensation would be detrimental to the interests of their clients.

Article 26 of the implementing Directive complements Article 19(1) so as to regulate the giving and receipt of inducements by investment firms. Under Article 26, an investment firm may only give or receive inducements in connection with the provision of investment or ancillary services in two kinds of case. The first is where inducements are given to or received from clients or persons acting on their behalf. The second is other circumstances where full disclosure is made of the inducement, the inducement improves the quality of the service to the client, and the inducement does not impair compliance with the firm's duty to act in the best interests of the client. Recital 36 clarifies, by way of example, that in cases where a client receives unbiased advice or general recommendations that were paid for by a third party, this is capable of enhancing the quality of the investment advice and therefore not necessarily contrary to the provisions of the implementing Directive. Article 26 also provides that proper disclosure of inducements for the purposes of Article 26 requires comprehensive, accurate and understandable disclosure.

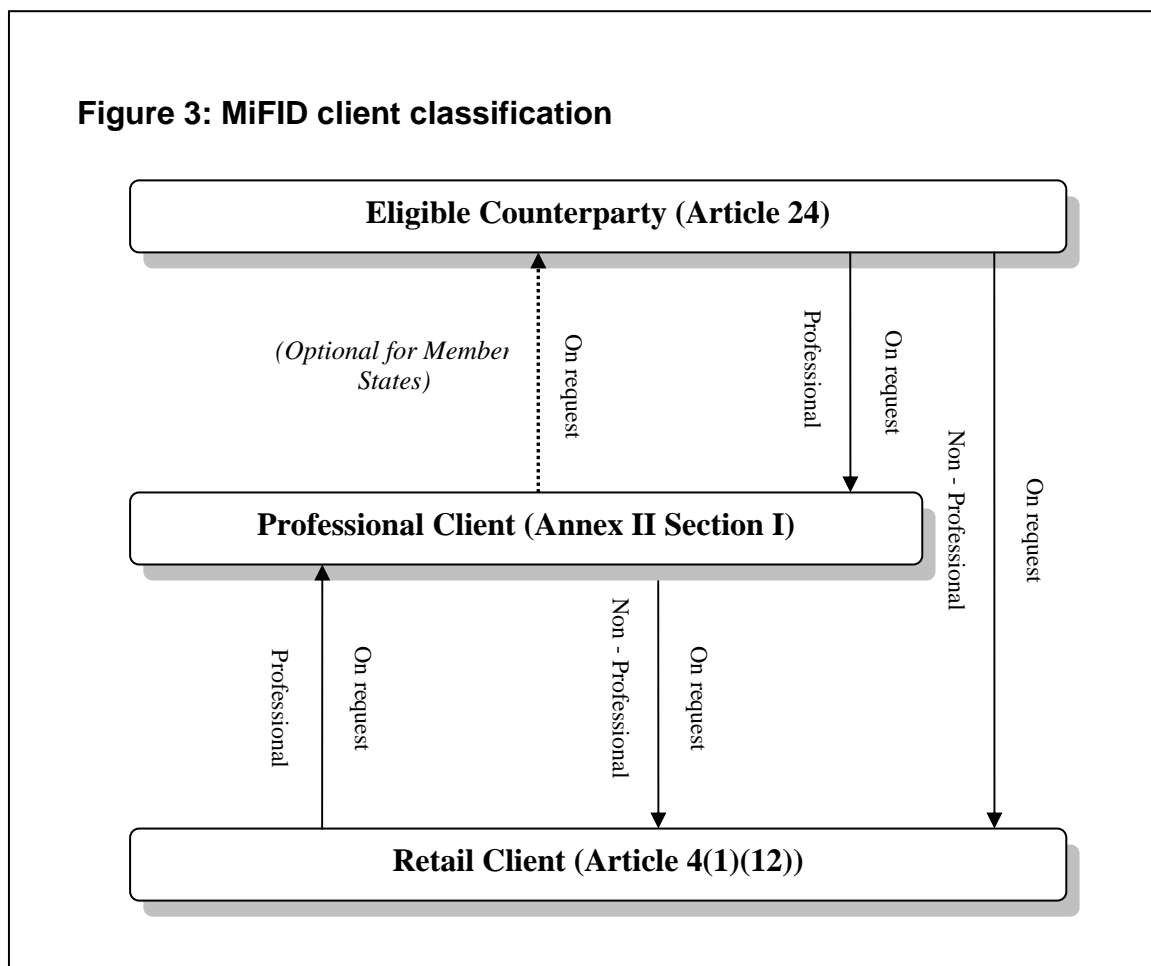
7.3. Client classification and eligible counterparties

Together, the level 1 Directive and the implementing Directive create a comprehensive system of client classification. The Regulation adds some important elements to the provisions of the Directive.

The MiFID establishes three categories of client – retail, professional and eligible counterparties – and establishes criteria for classification of clients into one of those categories. It also provides rules that allow clients to change their initial classification on request. **Figure 3** represents diagrammatically the ways clients are classified and allowed to move between the different categories, with references to the relevant legislative provisions. The text below provides a detailed explanation of the basic idea, represented in Figure 3, that clients may, under certain conditions, move between all categories.

⁶ In many areas, professionals are entitled to receive the same information as retail clients upon request: see section 7.3 below. See also Article 29(8) of the Implementing Directive.

Figure 3: MiFID client classification



7.3.1. Retail clients

Retail clients form a residual category, defined negatively as those clients who are not professionals (Article 4(1)(10) of MiFID). A retail client may request treatment as a professional if the criteria and the procedure established in Section II of Annex II of the level 1 Directive are complied with.

7.3.2. Professional clients

Annex II of the level 1 Directive establishes which clients are considered as professionals. Undertakings listed in Section I of Annex II are automatically recognised as professional clients. These are the so called '*per se* professionals'. For example, investment firms, credit institutions, insurance companies, some institutional investors as well as defined large undertakings are in this category. Additionally, clients that are not on the list of *per se* professionals in Section I of Annex II may be treated as professional clients on their request, provided that they fulfil the criteria and follow the procedure set out in Section II of Annex II. Furthermore, *per se* professionals may request the protection granted to retail clients. The procedure for this is set out in paragraphs 2 to 4 of Section I of Annex II.

7.3.3. Eligible counterparties

The level 1 Directive recognises that the most sophisticated classes of investors and capital market participants – the so-called 'eligible counterparties' – do not need some of the

protections afforded by the conduct of business rules. Thus, Articles 19, 21 and 22(1) of the level 1 Directive do not apply to investment firms when providing the following services to eligible counterparties: execution of orders, dealing on own account, reception and transmission of orders, or any directly related ancillary service. The fact that certain entities are treated as eligible counterparties only in respect of these specific services is crucial to an understanding of the overlap between the categories of professional clients and eligible counterparties. For example, investment firms are both professional clients and eligible counterparties, but their status as eligible counterparty is limited only to the services mentioned above.

Entities that are explicitly mentioned in Article 24(2) of the level 1 Directive are automatically recognised as eligible counterparties. These are the ‘*per se* eligible counterparties’ and include, for example, investment firms, UCITS and their management companies. *Per se* eligible counterparties may also request treatment as a class of client which benefits from the protection given under the conduct of business rules.

Furthermore, the level 1 Directive gives Member States the option to recognise as eligible counterparties entities other than the *per se* eligible counterparties defined in Article 24(2) of the MiFID, provided that such entities meet certain criteria and have requested to be treated as eligible counterparties. The proposed implementing Directive sets out those criteria.

7.3.4. *Technical elements incorporated in the implementing Directive*

The elements of client classification explained above refer to the legal contents of the Level 1 Directive. This section details how the proposed implementing Directive complements and completes the Directive in respect of client classification. This is done in three ways.

First, Article 28 of the implementing Directive recognises that the right for clients to choose different client classification needs to be complemented by an adequate information regime. The principle behind Article 28 is that clients should always know not only the category in which they are classified but also the legal consequences of such classification and the options open to them to change this classification.

Secondly, Article 50(2) of the implementing Directive specifies the procedure regulating the way in which *per se* eligible counterparties may request a client treatment which would allow them to benefit from the higher level of conduct of business protection to which they are entitled under the second sub-paragraph of Article 24(2) of MiFID.

Thirdly, Article 50(1) of the implementing Directive sets out the criteria for determining which entities can be classified as eligible counterparties on request when Member States choose to exercise their discretion under Article 24(3) of the Directive to recognise other categories of undertaking as eligible counterparties. In doing so, the implementing Directive recognises that the client has a choice whether to request treatment as eligible counterparty, and assumes that such entities are able to make that choice provided that they have received the necessary information and that all other conditions set out in the level 1 Directive⁷ are satisfied. Accordingly:

- The first subparagraph of Article 50(1) of the implementing Directive allows Member States to recognise as eligible counterparties all the entities that are *per se*

⁷ For example, the need to give express confirmation.

professional clients that are not *per se* eligible counterparties, excluding those *per se* professionals mentioned in paragraph 4 of Section I of Annex II of the Directive; and

- The second subparagraph of Article 50(1) of the implementing Directive allows Member States to recognise as eligible counterparties all the entities that can be classified as professional clients if they so choose. The right of an entity of this kind to be recognised as an eligible counterparty is limited to the services and transactions for which it could be treated as a professional client.

7.4. Information provided to clients

7.4.1. General considerations

When making investment decisions clients need to be adequately informed. The level 1 Directive requires firms to provide their clients with appropriate information so that clients can understand the nature and the risks associated with particular investment services and financial instruments (Article 19(3)). The provisions of Section 2 of Chapter VII of the implementing Directive specify the nature and extent of information to be given to clients as well as the times when and the ways in which firms should provide this information.

In specifying the information requirements, the proposed implementing Directive also takes into account the nature of the client and calibrates the application of the provisions in respect of professional and retail clients. It is assumed that professional clients should be able to identify for themselves the information which they need to take an investment decision and therefore be given only the information that they themselves request. Nevertheless, in some important areas, and in conformity with the level 1 Directive, the implementing Directive explicitly recognises that certain information should be given to all types of clients (for example certain information relating to safeguarding of client financial instruments or funds, mentioned in Article 29(2)).

7.4.2. Criteria for determining when information, including marketing communication, is fair clear and not misleading

Article 19(2) of the level 1 Directive requires that all information, including marketing communications, addressed to clients be fair, clear and not misleading. Article 27 of the proposed implementing Directive introduces the specific objective standards that specify how information provided to clients should satisfy these conditions. When applying these requirements, firms and regulators need to take proper account of the means of communication and the information contained in it. Given the large number and diverse range of communications that are covered by these requirements, Recital 41 clarifies that it would not be appropriate and proportionate to apply such requirements to marketing communications that contain only a very limited amount of information (such as the logo or image of the firm, contact point, etc).

7.4.3. Timing and means of provision of information

Investment firms must give a client the necessary information in good time before the client takes any decision. Under Article 29⁸, certain general information about the firm and the

⁸ Unless certain derogations designed to accommodate cases covered by the Distance Marketing Directive 2002/65/EC apply.

services it provides (specified in Article 30) must be made available *at the earlier of the time the client is bound by any agreement and the time of the provision of the services*. Other types of information – information to be provided under Articles 31 to 33 – are more relevant to the particular service and have to be provided in good time *before the provision of this service*. For example firms are not obliged to furnish clients with information about all types of financial instruments at the beginning of the client relationship when it may not be clear whether the client would undertake any transactions in all types of instruments. It is up to the firm to decide when exactly it provides the information to its clients (whether it gives all information at the beginning of the relationship or provides it in stages as the relationship develops), provided that it satisfies the general requirement to ensure that the client has the information for sufficient time to enable him to take an informed decision.

The implementing Directive obliges the firm to provide the required information in a durable medium. Article 3 of the implementing Directive provides for the possibility to supply clients with the information by means of a web page, provided the client expressly chooses it and that certain other conditions are satisfied. Finally, investment firms may provide the information either separately, as part of marketing communication or (where applicable) by incorporating it in a client agreement (Recital 44).

7.4.4. *Client contract*

The implementing Directive does not impose requirements as to the form, content and performance of contracts for the provision of investment services. The regulation, if any, of these issues is left to the discretion of Member States.

7.5. Suitability and appropriateness tests

7.5.1. *General considerations*

The level 1 Directive establishes for investment firms the obligation to obtain or seek information from their clients in order to assess whether the provision of a particular service would appropriately reflect a client's characteristics and objectives. There are three regimes governing the requirements firms have to fulfil in the area of information gathering and evaluation. The stringency of those regimes – the different degree of information gathering and the rigour of assessment necessary – depends on the type of service provided and the types of financial instrument involved.

First, for those investment services that entail an element of recommendation on the part of the firm (investment advice and portfolio management), the Directive requires the highest level of knowledge by firms of client experience, financial sophistication, needs and objectives. In such cases the firm must apply a '*suitability test*' under Article 19(4) of the Level 1 Directive. The suitability test requires the firm to collect 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 or potential client the investment services and financial instruments that are suitable for him.

Secondly, for other investment services, where clients do not rely on a firm's recommendations or expertise, Article 19(5) of the level 1 Directive imposes on firms a requirement to apply an '*appropriateness test*'. This assessment is less wide-ranging than the suitability test, and firms are required to assess only whether the client has the knowledge and

experience necessary to understand the risks involved in relation to the specific type of product or service in question (Article 37 of the implementing Directive).

Thirdly, firms do not need to collect any information from their clients, or assess suitability or appropriateness, before the provision of the ‘execution only’ investment services (that is, investment services that consist only of execution, or reception and transmission, of client orders, with or without ancillary services) provided that certain conditions are satisfied. (Article 19(6) of the level 1 Directive). One of those conditions requires that the service provided to the client relates to non-complex products (such as, shares, bonds or UCITS). The assumption is that the structure of these instruments is sufficiently simple that clients can be expected to understand the characteristics and the risks associated with these instruments.

The implementing Directive aims at clarifying the steps that an investment firm needs to take when assessing the suitability or the appropriateness of a service or transaction and specifies criteria for the provision of ‘execution-only’ business by defining the concept of non-complex financial instruments. The following sections explain in greater detail the rules governing each of the three regimes.

7.5.2. *Assessment of suitability*

When providing investment advice or portfolio management the investment firm must obtain the information regarding the client’s or potential client’s knowledge, experience, financial situation and investment objectives which is *necessary* to enable the firm to recommend to the client the investment services and financial instruments that are suitable for him.

Article 36 of the implementing Directive defines what information is considered necessary for the purposes of the suitability test. Once such information is obtained from the client, an investment firm must assess it and, when acting, have a reasonable basis for believing that the specific transaction recommended or entered into will be suitable for the client (Article 36(1)). Article 36(1) of the implementing Directive also identifies the criteria for the assessment of the suitability of a transaction: it has to meet the client’s investment objectives; the client must have the knowledge and experience to understand the risks involved in the transaction; and the client has to be able to bear the risk associated with the transaction in question. The extent of the information that needs to be gathered should be calibrated with regard to the nature of the client, the nature and the extent of the service to be provided and the type of product envisaged (Article 38(1)).

It would be disproportionate to require firms to assess the suitability of a service or transaction for professionals in the same way as for retail clients. Professional clients will have higher levels of expertise and knowledge. Therefore, Article 36(2) provides for a lighter regime for the assessment of suitability of transactions for professional clients. An investment firm should be entitled to assume that a professional client possesses sufficient level of knowledge and experience with regard to transactions for which that client is considered as professional. Additionally, a firm that provides investment advice to a professional client is allowed to assume that this client is able financially to bear the risk of any loss related to the investment.

The Directive recognises that an investment firm cannot assess suitability if it does not receive the information necessary for it. Article 36(5) of the implementing Directive clarifies this principle by stipulating that if the firm does not obtain the information that it considers necessary for the assessment of suitability it must not recommend an investment service or

transaction. Recital 53 makes it clear that a recommendation given or a request made by a portfolio manager to the effect that the client should alter the mandate to the portfolio manager that defines the limits of the manager's discretion should be considered as recommendation for the purposes of the suitability test.

7.5.3. *Assessment of appropriateness*

Article 37 of the implementing Directive requires investment firms, when assessing whether an investment service referred to in Article 19(5) of the level 1 Directive is appropriate for a client, to determine whether the client has the necessary experience and knowledge in order to understand the risks involved in the transaction or investment envisaged. If, after the application of the appropriateness test, the firm considers that the service or product would not be appropriate for that client in this sense, the firm can still provide the service in question provided that it warns the client that it considers such a transaction to be inappropriate (Article 19(5) second sub-paragraph of the level 1 Directive).

In contrast to the suitability requirement, the obligation of the firm with regard to the appropriateness test is to *seek* information, rather than to *obtain* it. Accordingly, if a client that fails to provide sufficient information regarding his knowledge and experience, the firm may nevertheless provide such services provided that it warns the client that it cannot determine whether the service or product envisaged is appropriate for that client (third sub-paragraph of Article 19(5) of the level 1 Directive).

As with the suitability test, the implementing Directive establishes a graduated regime and entitles the investment firm to assume that a professional client has sufficient knowledge and experience to understand the risks involved in relation to those particular services or transactions, or types of transaction or product, for which that client is considered as professional⁹.

7.5.4. *'Execution only'*

For the purposes of the 'execution only' provisions in Article 19(6) of the level 1 Directive, it is important to note that the complexity of a financial instrument *per se* is not necessarily synonymous with the risk associated with that instrument. Rather, complexity for the purposes of the Directive is determined by the way that an instrument is structured. This is because, typically, the level of complexity of a financial instrument's structure will affect the ease with which the risk attached to the product may be understood. For example, all derivatives are assumed to be complex because their value is derived from another financial instrument or asset, adding a level of complexity to the understanding of the characteristics and valuation of those instruments.

The first tier of Article 19(6) of the level 1 Directive specifies a number of instruments that should be considered non-complex for these purposes. Article 39 of the implementing Directive in turn sets out two kinds of criteria for determining what other types of financial instruments should be considered as non-complex:

⁹See Annex 2 of the Directive

- 1) as to the type of instrument, all derivative instruments¹⁰ are explicitly excluded from the category of non-complex instruments; and
- 2) as to the characteristics of the financial instrument, it requires, *inter alia*, that adequate information on the financial instrument is publicly available and is likely to be understood by an average retail client.

Firms will not be able to provide investment services in relation to instruments that do not fall under the definition of ‘non-complex’ financial instrument without assessing the appropriateness of the service to the client (or its suitability in the case of investment advice or portfolio management).

However, in many Member States ‘execution-only’ markets have developed and flourish in what will be deemed complex instruments by the Directive and the implementing Directive (derivatives, covered warrants, etc). A number of clients have already gathered experience in dealing with such products and Recital 52 recognises this previous experience. Clients who were engaged in dealing with such instruments before the date of application of the Directive should therefore be presumed to have the necessary experience and knowledge in order to understand the risks involved in relation to that specific type of instrument. This should be considered to satisfy the appropriateness test. The Recital also provides that the appropriateness test need not be re-applied on the occasion of each separate transaction in a course of dealings.

7.6. Reporting to clients

Clients have to be informed on a regular basis and in sufficient detail on the type of service that has been provided to them. To that end, Article 19(8) of the level 1 Directive requires that clients receive adequate reports about the services provided. The implementing Directive specifies more details relating to this obligation and requires that clients receive the information that is necessary for them to verify the type of services that have been provided, the costs and the price paid by them for those services, and the quality of the service they have received (Article 40). Additionally, Articles 41 and 42 of the implementing Directive set out specific reporting requirements for portfolio management in order to enable clients to monitor the state and the performance of the portfolio. Finally, Article 43 introduces an obligation on investment firms that hold client financial instruments or client funds to send to each client a statement detailing, among other things, the financial instruments or funds held by the investment firm for the client at the end of the period covered by the statement. The reporting provisions give firms and clients some flexibility with respect to the frequency and the nature of the reports required.

7.7. Best execution

Best execution obligations, as set out in Article 21 of the level 1 Directive, are central to the structure and logic of the Directive. They not only form a fundamental element of investor protection, but are also necessary to mitigate possible problems associated with market fragmentation. Article 21(1) states that when executing client orders, investment firms must take all reasonable steps to obtain the best possible result for the client. In doing so, the firms should take into account a variety of factors such as price, cost, speed of execution or the

¹⁰ i.e. financial instruments mentioned in paragraphs (4) to (10) of Section C of Annex I of the [Level 1 Directive]), and transferable securities included in Article 4(1)(18)(c) of the [Level 1 Directive]

nature or size of the client order. **Figure 4** indicates in diagrammatic form the steps firms may need to take to comply with the best execution requirements. It is for illustrative purposes only, and does not determine the interpretation of the proposed Level 1 Directive or the proposed implementing Directive.

The measures in Articles 44 to 46 of the implementing Directive complement the Directive in three main areas: they clarify the process of achieving best execution by investment firms, the scope of application of the best execution requirements, and the principle of best execution for retail clients, where the Commission considers that strong, common investor protection standards are required.

7.7.1. Clarification of best execution process: Recital 56

Further precision as to the application of the best execution requirements is needed to prevent divergent interpretation and application of this crucial aspect of the Directive. Accordingly, Article 21 of the level 1 Directive provides that an investment firm should follow a basic three step approach in establishing and implementing its execution policy.

First, depending on the nature of the clients and their needs, an investment firm should decide which factors affecting the result of execution should be given priority for clients generally or particular groups of clients. As a minimum, it should establish a process by which it determines the relative importance of these factors in light of its duty to deliver the best possible result to its clients.

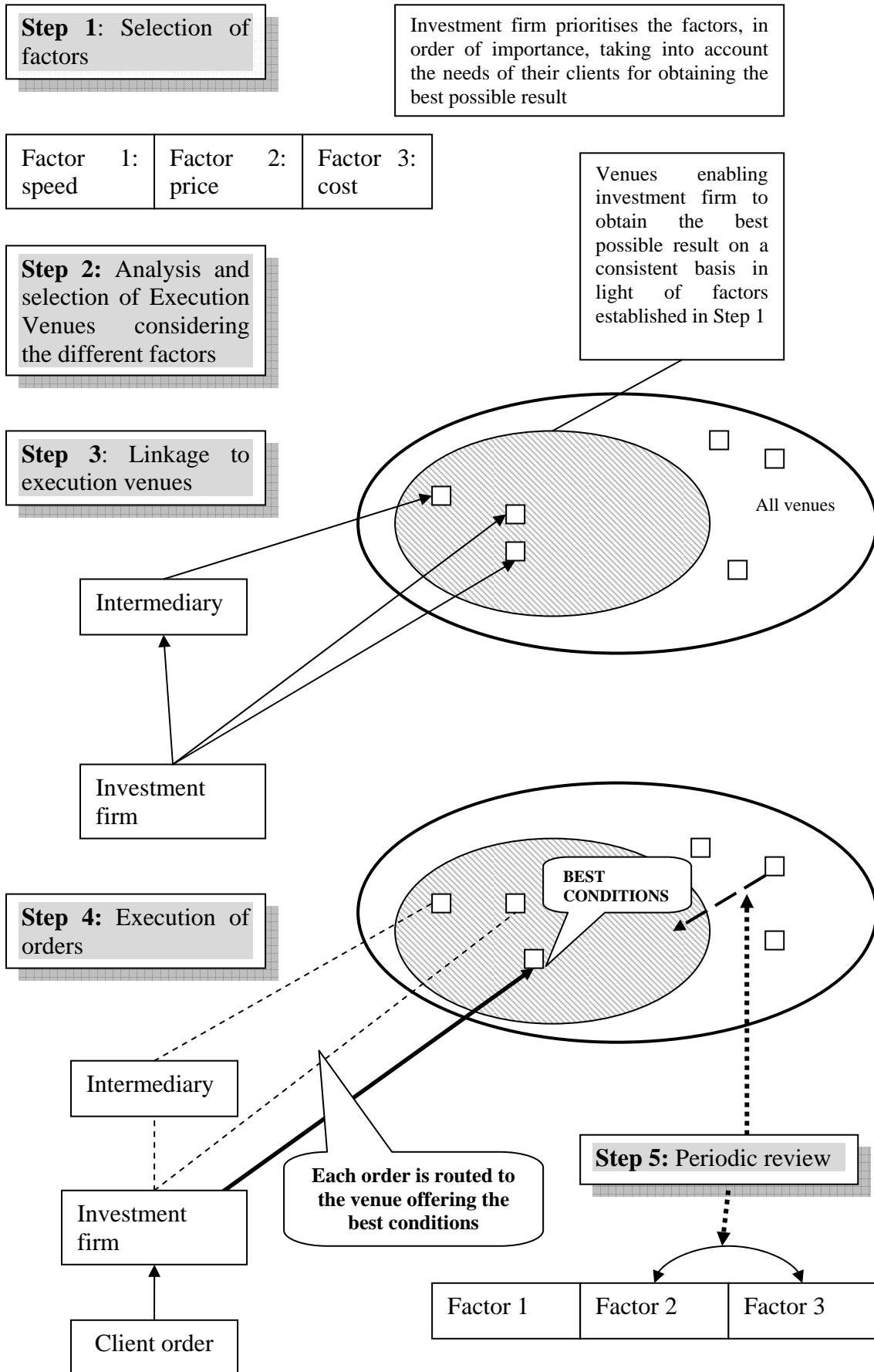
Secondly, in accordance with Article 21(3) of the level 1 Directive, the investment firm should analyse the available execution venues in order to identify those venues that will enable it to obtain the best possible result and take the necessary steps to make it possible to execute its client orders in those venues. Access may be direct or through an intermediary. This does not mean that every investment firm will have to connect at any cost to almost every execution venue. If the costs of connecting to certain execution venues would be disproportionate and lead to a heavy overall increase in fees, it is not expected that firms should be obliged to connect to such venues. This is consistent with the principle that firms must take all *reasonable* steps to deliver the best possible result.

Thirdly, client orders should be routed, on an order-by-order basis, to the appropriate venues, taking into account the relative importance of the factors as set out in its best execution policy.

It is important to stress that the best execution obligation should apply on an order-by-order basis¹¹. This is not only in the immediate best interest of the clients but also in order to promote competition between execution venues in the longer term. Trade should be driven to those venues that can consistently provide the highest quality results, and the best execution obligation ensures that firms are not able to ignore such venues.

¹¹ This is that the selection of the venues, amongst that are included in the execution policy of the firm, to which the order is to be routed has to be done for each order received.

Figure 4: The cycle of best execution



This choice does not impose significant new burdens on firms. Data vendors already consolidate information from a multitude of venues. Technology is available which is capable of consolidating pan-European quotes and order books as well as identifying in real-time, for example, the best available price including any related explicit costs (commission, exchange transaction fees, taxes, clearing, settlement) and allowing for currency conversion where necessary. The means also exist to enable firms to route orders to the European execution venue offering the best conditions.

Furthermore, for smaller firms, services combining algorithms that identify venues offering the best conditions along with routing capability to those venues are already quite common in the market place. These firms already rely on various intermediaries when routing their orders. This can remove most of the complexity and set-up costs of electronic market access for the smaller institution.

7.7.2. *Scope*

The scope of the best execution obligation needs to be carefully calibrated in order to provide investment firms with the necessary flexibility to organise the execution of orders in a way that best fits their business model whilst ensuring their customers are properly protected as provided by the best execution obligation.

This is why firms providing the services of reception and transmission of orders and portfolio management are also required to comply with requirements analogous to the best execution requirements (Article 45). Such firms will often not execute client orders directly on execution venues, passing them instead to other intermediaries for execution. The possibility of such delegation of best execution should be allowed provided that there is no delegation of *responsibility* for best execution.

The implementing Directive does not require a duplication of effort as to best execution between an investment firm which transmits orders or manages portfolios, and any firm to which that investment firm transmits its orders for execution (Recital 63). Accordingly, without removing the obligation of the first firm to its client to deliver best execution, the first firm should take all reasonable steps to choose the firm that is most likely to deliver best execution, and that it should monitor the execution quality delivered by the other firm and correct any deficiencies when they arise. Subject to the proper fulfilment of these duties, the first firm should be entitled to rely on the ability of the second firm to deliver best execution, and to fulfil its best execution obligations to the client in that way.

7.7.3. *Retail clients*

The needs of the typical retail investor related to the execution of his orders usually differ from those of, say, a large institutional investor or a hedge fund. Retail clients have very little opportunity to monitor whether the investment firm that executes orders on his behalf has indeed complied with the best execution obligations, since they are unlikely to have the time or specialist knowledge to understand or evaluate detailed disclosures related to best execution. Neither, in most of the cases, do they have the resources to make an effective comparative evaluation of the execution policy of the firm.

In order to maintain investor confidence it is therefore necessary that a clear benchmark is set for the execution of retail client orders. Article 44(3) of the implementing Directive provides

that, in respect of retail client orders, the total consideration paid by the client in terms of price and costs should be the most important factor in determining what constitutes the best possible result for the purposes of the best execution obligation.

But this does not mean that all the other aspects that could have an influence on the total consideration paid by the client should be neglected (Recital 60). In addition to direct costs, which may be accurately anticipated, transactions are also subject to indirect costs such as market impact (when the trader's own activity moves the market against him) and implementation shortfall (when the market moves in the direction anticipated by the trade, but before the trade is complete). Such costs, which are difficult to estimate, may be part of the calculation to determine the total consideration payable by the client. But it is not anticipated that this type of cost would normally constitute a significant portion of the cost, because of the small size of typical retail orders.

The combination of price and cost is vital because a simple comparison between displayed bids and offers is not sufficient to identify the exchange most suitable for executing a customer's order. A proper assessment should take into account the different costs that order would attract if executed at each of the competing venues. Costs that should be taken into account include commissions, fees, taxes, exchange fees, clearing and settlement costs or any other costs passed on to the client by intermediaries participating in the transaction. The vast majority of these costs should be known in advance, calculated and duly incorporated in the best execution policy without significant difficulties.

The implementing Directive distinguishes between external and internal costs of execution of retail client orders, and only the external costs mentioned in the previous paragraph are to be included in the calculation of the total consideration to be paid by the client. The firm's internal commissions have been excluded from the calculation because to include a firm's own commissions in the concept of the best possible result could create problems by introducing an element of self-reference. That might imply that once a firm has found the venue where it intends to execute a client order, it ought to examine whether it is not possible to provide its client with a 'better' result by comparing its own commissions with those of other firms and reducing them to the lowest level in the market. Furthermore, it would be disproportionate and unreasonable to expect an investment firm to know about the commissions charged by competing firms.

However, the internal commission charged by the firm to the client for the execution service should be non-discriminatory, in the sense that any differences in commissions between venues must reflect differences in underlying costs to the firm (Article 44(4) and Recital 61). In addition, firms should not structure their commissions in such a way as to overcharge clients for the most used venues since this would contravene the principle to act in the best interest of the client.

The opinion has been put forward that best execution obligations have been designed with a particular market structure in mind – that of equity markets – while ignoring particularities of other, dealer-dominated or quote-driven markets such as bonds or foreign exchange markets. On these grounds, it has been argued that best execution should not apply in relation to instruments predominantly traded in such markets because clients should be considered to be counterparties to whom investment firms owes no fiduciary interest for the purposes of such transactions. Such an interpretation is contrary to the letter and the spirit of the Directive. It is therefore clarified in Recital 58 of the implementing Directive that dealing on own account with clients is subject to the best execution obligations. Unless the client expressly requests that

an investment firm deals with him at the price quoted by that firm, the firm is under an obligation to search the market to see whether a better price may be on offer elsewhere.

However, the implementing Directive recognises that, due to differences in market structures as well as the nature of certain financial instruments, it is not possible to apply best execution obligations in the same manner in all cases. For example, when a firm enters into a highly customised transaction involving an OTC derivative contract, it may not be possible for it to obtain a ‘better’ result by going to the market-place in search of an equivalent financial instrument in the same way an investment firm may do so when executing client orders in relation to shares for example. This is because the contract involves a unique relationship between the firm and the client which is based on a series of judgements including that related to the counterparty risk associated with the particular client. Other service providers, when asked to price a derivative contract of this sort, would only be in a position to provide hypothetical answers as they would not be in the possession of adequate knowledge about the client. Nevertheless, the lack of a precise or wholly reliable benchmark comparison does not relieve an investment firm of its duty to act in the best interest of the client and hence its best execution obligations. This means that the pricing of the instruments should be sound to the extent it takes reasonably into account the market values of the variables that enter into the pricing process or, where possible, uses available comparisons and realistic assessment of risk. Recital 59 therefore makes it clear that investment firms, though always subject to best execution obligations, are not expected to meet such obligations in the same way for each type of instrument.

7.8. Order handling

Article 22 of the level 1 Directive obliges investment firms to handle their client orders in a manner that ensures that the interests of the clients will be adequately protected¹². The implementing Directive sets out the conditions which the firm must satisfy in order to comply with the general principles of the Directive.

Article 47(1) of the implementing Directive clarifies that the principle that the client orders have to be executed sequentially in accordance with the time of their reception has to take account of the channel through which the order was received. Recital 66 clarifies that investment firms are not obliged to execute sequentially orders received by different media where that is not practicable.

Article 47(3) of the implementing Directive protects the clients of the firm from the ‘front-running’ of their orders by prohibiting the investment firm from misusing information relating to pending client orders and requiring it to take all reasonable steps to prevent such misuse by any relevant persons. This means that an investment firm must not take advantage of its knowledge of its clients’ order flow to place its orders ahead of those of its clients. Recital 66 further clarifies this by stating that dealing on own account on the basis of the information of pending client orders should be considered as misuse of information for the purposes of Article 47(3)¹³.

¹² Client orders have to be executed in a ‘prompt, fair and expeditious’ manner and in the order that they are received by the firm.

¹³ Front running by employees and other relevant persons of the firm to their own benefit or that of their associates is also dealt with through the personal transactions regime in the proposed implementing Directive.

Articles 48 and 49 of the implementing Directive detail the conditions under which client orders can be aggregated with other client orders or with the investment firm's own transactions. The provisions consist of a mixture of information disclosure requirements and prescribed allocation policies designed to promote the principle that only the client should gain an advantage from order aggregation.

7.9. Record-keeping

Article 13(6) of the level 1 Directive contains a general record-keeping requirement that obliges investment firms to keep the records necessary to enable competent authorities to monitor compliance with the Directive. The level 1 Directive assumes that record-keeping requirements should be flexible and adapted to the specific nature and business of each investment firm if they are adequate to fulfil the objectives established in the Directive. This principles-based approach at level 1 would not preclude the implementing Directive from establishing a series of 'standard' records in relation to areas or obligations that are common to most of firms. However, such standards would almost certainly need to be supplemented by more specific requirements.

For these reasons, the implementing Directive refrains from establishing a minimum list of records. Instead, (in conjunction with the implementing Regulation) it imposes particular record keeping requirements in specific areas¹⁴. Nevertheless, in order to provide a degree of legal certainty, it establishes that the competent authority of each Member State shall draw up and maintain a list of the records that must be kept by investment firms (Article 51(3)). Article 51 of the implementing Directive also prescribes the form and manner in which records must be kept, for a minimum retention period of 5 years¹⁵. However, client agreements should be kept for at least the duration of the client relationship.

Finally, the implementing Directive explicitly states that the record-keeping requirements under the Level 1 Directive and in the implementing Directive do not affect or remove the right of Member States to impose obligations relating to the recording of telephone conversations or electronic communications involving client orders (Article 51(4)). This leaves Member States free to retain any recording requirements they already put in place or to impose additional requirements where they did not previously exist, provided that such requirements are not inconsistent with any obligations imposed by or under the Directive.

8. DEFINITIONS FOR THE PURPOSES OF THE DIRECTIVE

8.1. Investment advice

In contrast to the Investment Services Directive¹⁶, the MiFID includes investment advice as an investment service subject to authorisation (Section A(5) of Annex I). It defines investment advice as the provision of personal recommendations in respect of one or more transactions relating to financial instruments (Article 4(1)(4)).

Article 52 of the implementing Directive specifies when a recommendation should be considered as personal. It will be considered as such when it is presented either as suitable for the client or as based on the consideration of the circumstances of the client or potential client.

¹⁴ For example the need to keep records of the orders, of the execution policy, etc.

¹⁵ This limit is aligned with the limit applying to transaction recording under Article 25 of the Directive.

¹⁶ Directive 93/22/EC

This is in contrast with general recommendations, which are not to be understood to be suited to, or based on a consideration of, the information recipient's personal circumstances. In determining whether a communication falls within the scope of investment advice, all the relevant circumstances such as the type of the relationship between the investment firm and a client need to be taken into account.

However, not all personal recommendations are to be considered as investment advice. The implementing Directive specifies (Article 52) that only those personal recommendations that refer to particular financial instruments fall under the scope of the level 1 Directive. It excludes what is called 'generic advice'; that is, personal advice that refers to a type or types of financial instrument (e.g. technology stocks) rather than a particular financial instrument. The exclusion of generic advice from the scope of the definition avoids the danger of regulating financial planning entities that, in many cases, operate as charities providing valuable financial advice free of charge. Making such entities subject to authorisation could risk withdrawing such a service from those who need it most. The exclusion also reflects a policy decision as to the regulatory 'threshold': this determines the level of generality at which the investment service should commence, and therefore the point in the provision of the advice at which service providers should be bound by the conduct of business rules.

The above does not mean however that clients or potential clients will be completely unprotected when provided with generic advice. Recital 68 expressly notes that, under the general regulatory framework of the Directive, an investment firm which presents personal recommendations, such as generic advice, as suitable or based on the personal circumstances of the client, when they are not, will be acting in breach of Articles 19(1) or (2) of the Directive, i.e. is, it will not be acting honestly, fairly, and professionally in accordance with the best interests of the client, or it will be conveying information that is misleading.