

10 March 2006

A Legal Update from Dechert's Financial Services Group

FSA Calls for Advance MiFID Planning

Impending legislation from Brussels is about to trigger a significant rewrite of UK financial services regulation. The Markets in Financial Instruments Directive (MiFID), due to replace and extend the old Investment Services Directive ("ISD"), will impose significant demands on many FSA-regulated investment firms - both in terms of their day-to-day business operations and their interaction with customers. For reasons outlined in this update, implementation of the rules is shaping up to present a significant exercise for the sector.

The timetable is changing continuously. With the new rules planned to come into operation in November 2007, the FSA is expected to begin a series of consultations on UK implementation from April onwards.

Although the detail has not yet been agreed, broadly speaking, MiFID will:

- apply detailed conduct of business rules for the first time throughout the EU. New regulatory regimes have to be introduced all over Continental Europe, requiring the FSA to undertake a major re-write of the UK rules;
- apply new transparency principles to equity dealing (which may be extended in the future to bond and other markets);
- expand the range of EU "core" investment services and activities to

include investment advice, commodities broking, and multilateral trading facilities (hitherto usually known as Alternative Trading Systems or Electronic Communications Networks) which will now be entitled to the European passporting facility;

- run in parallel with new capital requirements to be introduced under the Capital Requirements Directive.

MiFID has been developed at the European level through two principal legislative tiers:

- Level 1 - the Directive itself
- Level 2 - the "technical implementing measures", issued by the European Commission in February, and now being reviewed by the European Parliament.

How will your business be affected?

MiFID will impact on all firms carrying on designated investment business - essentially broker-dealers, asset managers, and corporate finance advisers. It generally does not affect commercial banking, occupational pension schemes, UCITS collective investment schemes, or mortgage and insurance broking.

Specific MiFID Issues

See Appendix for overview chart

1. Internal Organisation

MiFID specifies that:

- the firm's compliance function must be operated independently;
- there must be an effective and independent risk management function;
- there must be separate internal audit;
- there are new rules and requirements for outsourcing and record keeping.

These look broadly similar to existing UK requirements. The FSA interpretation of what is required to achieve "independence" will be an important issue but is required to be "proportionate", and the risk function requirement will be new.

2 Outsourcing

The requirements are similar to the existing FSA rule, but could have significant impact in some situations. The new requirements will extend to any outsourced service, whether or not this is a regulated activity. Outsourcing to suppliers outside the EU will be more difficult – it is restricted to authorised firms subject to prudential regulation, and to jurisdictions with whom the EU has a cooperation agreement in place.

No delegation of responsibility is allowed – this could be a particular problem for custodians and brokers delegating to unfamiliar markets.

The requirement for prudential regulation appears to prevent the UK subsidiary of a US asset manager delegating asset management to its parent. The requirement for a cooperation agreement to be in place appears to prevent outsourcing to Japan.

Outsourcing through letter box operations will not be allowed, which may force some activities on-shore.

3. Marketing communications

Impact uncertain but there will be changes. Historic simulated figures are to be banned, putting an end to the use of historic figures by clone funds. The FSA has promised a major overhaul of financial promotion on the back of the MiFID changes, with a possible move to a more principles-based regime.

4. Client classification

An area of major change. The three existing categories are preserved under new names but with more client protection and more clients being shunted into the protected categories. This will impact on firms with mixed client bases or which currently seek to deal only with intermediate customers and market counterparties. Retail firms will be largely unaffected.

5. Information provided to clients

New formal disclosure requirements will be introduced, including the firm's conflicts of interest policy, best execution policy, and how it holds client assets.

The new requirements will mean that many client accounts will have to be repapered again. A big impact for firms with large client lists.

6. Suitability

The duty to assess suitability is extended to intermediate customers and counterparties who receive advisory and discretionary services, applied on a transaction-by-transaction basis. The suitability assessment must be based on certain know-your-customer information.

The impact could be significant, but is difficult to assess. The dividing line between execution and advisory services could be a key issue.

7. Appropriateness and Execution Only

Firms which do not provide advice or discretionary management will still have a duty to assess whether the service is appropriate to the client. If the conclusion is that it is not appropriate, they must warn the client of this before proceeding.

8. Conflicts of Interest

A firm must have a written conflicts of interest policy which identifies circumstances which constitute, or

may constitute, a conflict of interest and specify procedures to manage such conflicts.

The firm must also have procedures for personal account dealing. MiFID extends this requirement to the staff of firms to whom business has been outsourced.

9. Best Execution

Express client consent must be obtained to execution outside a regulated market or a Multi-lateral trading facility (MTF).

New rules on order handling are broadly similar to the existing regime. There is some doubt about whether warehousing will be permitted.

Best execution is described in language which makes it sound like an absolute standard. This may be more rhetorical than substantive, but it remains to be seen what approach the FSA will take.

The post-trade confirmations regime may become more prescriptive. Examples of new requirements include reports on the execution venue, the total expenses and commission charged. There is also a proposal that any leveraged account must report monthly, but without a definition of leverage.

10. Markets and Transparency

Pre-trade transparency:

The pre-trade publication of quotes in equity shares is imposed on Multi-lateral trading facilities and systematic internalisers ("SIs"). An SI is (very broadly) a market maker or similar.

Post trade transparency:

MiFID requires regulated markets and MTFs to publish their share trades in real time. Off-exchange trades (including crosses) will also

have to be published in real time. Both parties to the trade have this responsibility.

These requirements will have a major impact on broker-dealers, and a knock-on effect on asset managers.

11. Regulatory transaction reporting

Under MiFID, all trading in instruments on a regulated market must be reported to the relevant home state regulator, which must send on relevant details to other EEA regulators. For brokers this is similar to the current regime. For managers there is an expectation that they can rely in most, but probably not all, cases on the brokers' reporting.

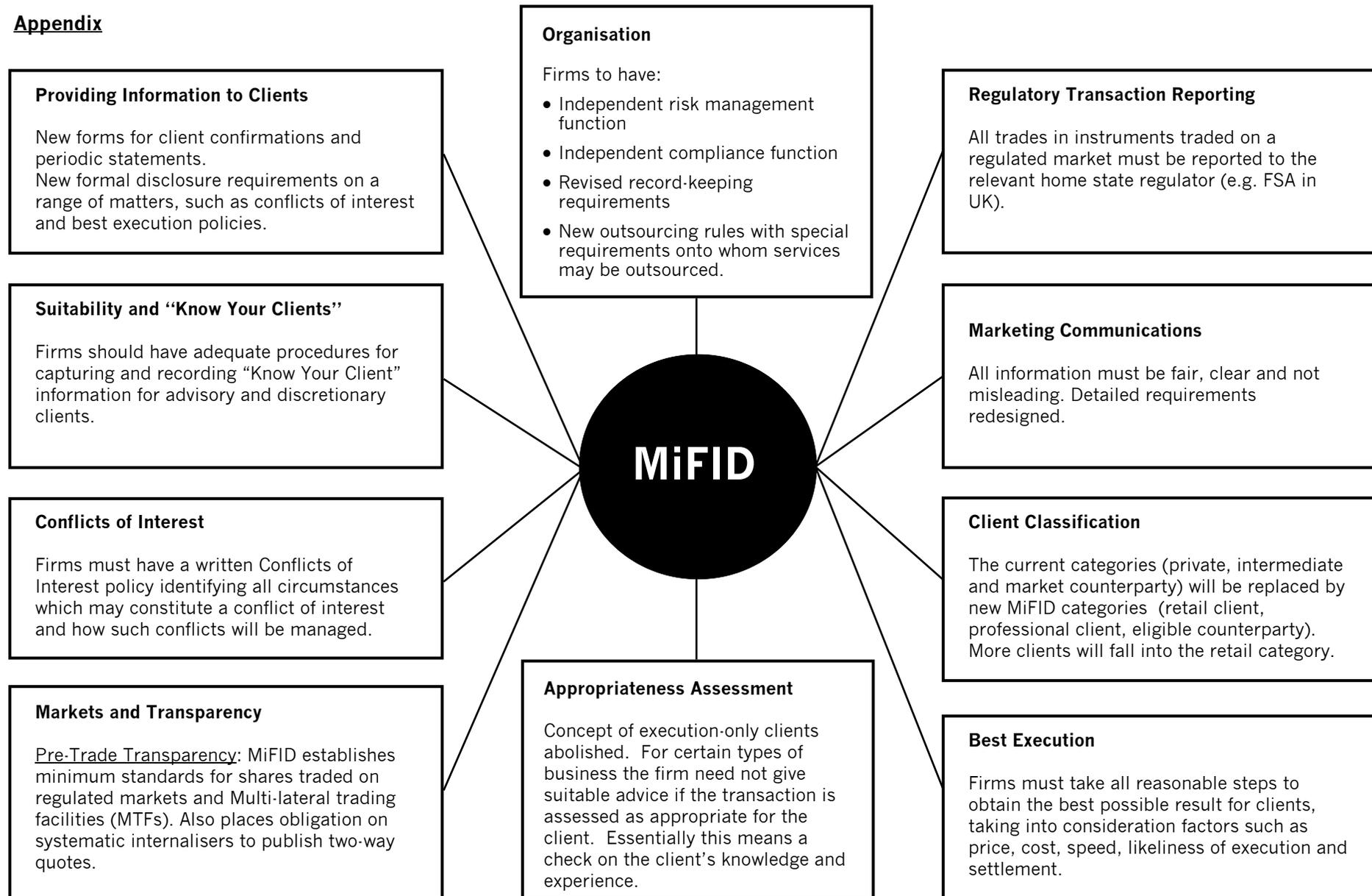
Next steps

What should you do about MiFID?

The FSA has stressed the importance of firms starting their planning for MiFID sooner rather than later. Issues which should be considered include:

- Planning: Identifying how your business is impacted by MiFID, the different resources which will be needed to address this (compliance, legal, accounting, IT and systems, staff training, client relationships, etc.); how they will be coordinated into a project; and the project timetable;
- Paying: What the costs of this will be - both one-off and continuing, and how these will be paid for;
- Staffing: how the project will be staffed, different skills and commitments drawn from appropriate internal and external personnel.

Appendix



Practice group contacts

For more advice on any of the above, please contact either of the lawyers listed or the Dechert lawyer with whom you regularly work.

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