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A legal update from Dechert's Financial Services Group

One Month to MiFID: A Final Check for Asset Managers

In a little over one month, the requirements under the Markets in Financial Instruments Directive (MiFID) will impact the financial services industry in Europe. Many investment firms have already implemented policies and procedures to address the changes that are scheduled to go into effect on or around 1 November 2007. Other firms are still in the process of looking at their business arrangements and procedures to see what amendments may be necessary.

Several Dechert clients have asked for an update on certain key topics under MiFID. These include Transaction Reporting, Conflicts of Interest, Outsourcing, Inducements, Client Categorisation, Suitability and Best Execution. Each of these topics is highlighted below.

1. Transaction Reporting

The UK Financial Services Authority (FSA) recently announced that the implementation date for the new MiFID transaction reporting system would now take place on 5 November and not on 1 November. The FSA feels that a mid-week transition to the new reporting scheme may cause a certain level of implementation risk for both firms and Approved Reporting Mechanisms (ARMs). FSA-regulated firms must continue to provide transaction reporting to their FSA-approved Permitted Reporting Systems (PRSs) in the currently required format up to and including Friday, 2 November.

MiFID requires all transactions in instruments admitted to trading on a regulated market to be reported through ARMs which comply with specific requirements detailed in Article 12 of the MiFID Level 2 Regulation. The reporting services currently operated by the FSA use the concept of PRSs and are listed in Chapter 17.7.8 of the FSA's Supervision Manual. All the existing PRSs now need to re-apply to become ARMs to provide similar services under MiFID.

Key Considerations:

- From 5 November, firms will have to submit transaction reports in the new MiFID compliant format. The old-style, pre-MiFID transaction reports will not be allowed;
- Managers will often be able to rely on their executing brokers to make the required reports, but should check whether there are any situations when this will not be the case;
- The FSA has asked firms to make "all reasonable attempts to ensure their reporting at cutover is as complete as possible";
- The FSA notes that CESR has agreed that transactions that have been executed through a firm's branches can be reported to the Host Member State competent authority, provided the investment firm chooses to do so. In these cases, transaction reports should follow the rules of the competent authority to which the report is made; and
- The FSA has noted that CESR has not made a decision on reporting arrangements for transactions involving derivatives and therefore such arrangements will not be implemented by the 5 November deadline. The FSA expects to provide transitional measures until permanent arrangements are established, most likely sometime in 2008.

2. Conflicts of Interest

In the current FSA rulebook, the requirement to deal with conflicts of interest only applies in relation to advising and discretionary management. Under MiFID it applies to a firm's

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conduct generally in relation to dealings with clients, and thus extends, for example, to a firm's placing as well as to the receiving and transmitting of such orders. This has always been the case under English common law so the substantive effect should not be too different.

MiFID requires firms to:

- identify conflicts of interest that exist between the firm and its clients and between one client and another;
- establish, implement and maintain a conflicts of interest policy, and a copy of this policy must be provided to the firm's retail clients. In practice, professional clients may also ask to see this policy;
- keep a record of circumstances in which a conflict of interest may arise or has arisen as a result of the activities carried on by the firm, and to update it regularly; and
- disclose the general nature and/or source of any conflict where the firm's arrangements are not sufficient to ensure that the risk of damage to a client's interests will be prevented.

Key Considerations:

- MiFID Connect (the joint project designed to support the U.K. implementation of MiFID) provided draft guidelines on 13 June 2007 on the application of the conflicts of interest requirements under FSA rules and Capital Requirements Directive rules implementing MiFID;
- firms should review their current conflicts of interest policy or develop a new policy that addresses the issues noted above. For asset managers, most conflict issues are likely to relate to conflicts between clients such as order allocations and intra-client transactions;
- firms should determine appropriate solutions to address and manage the conflicts of interest (i.e., Chinese walls, segregation of functions, removal of direct remuneration incentives, etc.); and
- asset mangers should also consider obtaining information from their brokers as to how the brokers' conflicts policies will operate. This information would form part of a manager's assessment of its broker's service quality and of any risks involved.

3. Outsourcing

Recent surveys indicate that firms are far from being ready for the 1 November deadline for outsourcing arrangements to be in compliance with MiFID. As the outsourcing obligations under MiFID are not merely an extension of the previous FSA rules, investment firms and service providers must look to their outsourcing arrangements as soon as possible to determine whether modifications are necessary to those arrangements. Outsourcing rules have a particular impact on "critical" or "important" operational functions including, in particular, the outsourcing of portfolio management responsibilities.

"Critical" or "Important" Functions

Under MiFID, the outsourcing of critical or important functions requires firms to comply with a host of obligations. Firms and service providers must enter into a written agreement which sets out the allocation of rights and responsibilities between the parties. Key requirements include the following:

- the investment firm must establish performance standards or levels for the service provider and have a sound policy for managing the outsourcing arrangement;
- the investment firm must take appropriate action if the outsourcing arrangement is not working effectively;
- the investment firm must ensure that the service provider cooperates fully with the firm if the outsourcing arrangement is terminated; and
- the investment firm and service provider should have an exit management strategy to ensure an efficient transfer of services to another service provider, if necessary.

Key Considerations:

- the FSA confirmed in May 2007 that its supervision of outsourcing will take into account the guidance provided by MiFID Connect;
- firms should review all service level agreements to determine whether they meet MiFID requirements;
- firms should scrutinize their ongoing management of these arrangements; and

- firms should periodically test the service provider's disaster recovery procedures.

Portfolio Management

Where a firm acting for a retail client proposes to outsource to a non-EEA firm, it may do so, but only if there is a cooperation agreement in place between the UK and the relevant non-EEA national regulator, and the firm itself is prudentially supervised by its home regulator. Where this is not the case, the firm must obtain FSA approval before outsourcing to the non-EEA firm.

The most significant impact of this approach will almost certainly be on outsourcing to the United States, where managers are regulated but not subject to prudential rules. The detailed approval criteria set forth by the FSA is not particularly burdensome if the investment manager is an established manager, but the notification procedures could create an administrative burden and time delay.

Any firm which requires FSA approval for its outsourcings must obtain this before 1 November 2007.

4. Inducements

The current rules prohibit firms from accepting inducements if they are likely to conflict to a "material" extent with any duty firms owe their customers. There are also detailed rules relating to permitted inducements and disclosure, but these only apply to packaged product sales. Under MiFID, all firms, both wholesale and retail, are subject to the full inducements rule. The FSA has also extended the MiFID inducements rule to apply to retail non-MiFID business.

There are exceptions from the rule for payments made by or on behalf of the client, and for certain fees necessary for the provision of investment business or ancillary services such as custody costs, settlement and exchange fees, regulatory levies or legal fees, which by their nature do not give rise to conflicts.

Key considerations:

- currently firms are permitted to offer, receive or accept a benefit provided that it is unlikely to conflict to a material extent with any duty that a firm owes to its clients, whereas the MiFID provisions apply to all payments, fees or non-monetary benefits regardless of materiality;
- MiFID introduces a new requirement that a fee, commission or non-monetary benefit, where this is paid or provided to or by a third party, "must be designed to enhance the quality of the relevant service to the client";
- MiFID introduces a new requirement that firms must disclose to the client the existence, nature and amount of the fee, commission or non-monetary benefit or the essential details in summary form before providing the relevant service to the client;
- firms should review all existing arrangements, including fees paid for fund distribution, and benefits provided by executing and prime brokers, to check that they meet these new criteria, and make disclosure to clients as necessary;
- in making this assessment, firms should bear in mind that the disclosure duty is owed to the firm's clients and relates to payments made or received in connection with MiFID services. For example, the payment of a dividend by a firm to its parent is not an inducement because it is not made in connection with MiFID services.
- firms should review their existing conflicts policy to determine if it adequately deals with inducements considering, for example, the types of situations in which payments occur, the firm's policy with respect to each of those situations, and the firm's policy on distribution channel payments such as trail commissions; and
- firms should review the need to disclose any inducements.

5. Client Categorisation

The terminology relating to the categorisation of clients between the previous FSA category and the MiFID provisions are noted in the chart below:

Previous FSA Category	MiFID Category
Market Counterparty	Eligible Counterparty
Intermediate Customer	Professional Client
Private Customer	Retail Client

Although MiFID adopts the FSA's three-tiered categorisation of client, the boundaries between the client categorisations will change under MiFID. *Professional clients* under MiFID are entities such as corporates, large institutions or other types of authorised financial institutions. Firms should understand that the size thresholds when determining whether a corporate is a professional client applies on a company-by-company basis, rather than on a group basis. As a result, many corporate entities currently classified as intermediate customers will not be professional clients under MiFID. A person may only be classed as an *eligible counter party (ECP)* in relation to specific types of business–essentially transmitting, receiving and executing orders. ECPs are considered to be professional investors who are entitled to fewer protections than other client categories under MiFID. In particular, they are not entitled to best execution. *Retail clients* are the default category and are entitled to the highest level of protection under MiFID.

Key Considerations:

- clients may upgrade (and lose certain protections) or downgrade (in order to gain more protection) from one category to another. This can be done generally, in respect of a particular service/investment (with respect to retail clients/professional clients) or on a trade-by-trade basis (with respect to ECPs);
- upgrading from retail client to professional client on grounds of expertise will be difficult because there are quantitative and qualitative criteria that have to be satisfied. Previously, only a qualitative assessment was necessary. As a result, it is likely that many more clients will be classified as retail clients under MiFID;
- a number of the benefits from upgrading clients under previous rules will not be preserved under MiFID's rules. For example, under current FSA rules, clients upgraded to intermediate customer can waive best execution but will not be able to do so under MiFID. Therefore, although MiFID makes it more difficult to re-categorise from retail to professional client, it is not as crucial under MiFID because in many cases similar protections apply to both retail and professional clients;
- MiFID requires firms to notify their existing clients of changes to their categorisation only where this is different from the categorisation most closely related to its categorisation under the old rules. For example, no notification is necessary if a private customer is re-categorised as a retail client, but notification will be required if the private customer is re-categorised as a professional client; and
- firms must receive the client's express consent (i.e., signing a consent form) to re-categorise a retail client as a professional client, causing them to give up certain of the protections afforded to a retail client.

6. Suitability

Under the suitability principle, a personal recommendation or discretionary decision to trade must be suitable, taking account of the client's knowledge and experience, financial situation, and investment objectives. Importantly, the MiFID rule now extends to include professional clients, who will now have to provide firms with know-your-customer information, including financial information. The firm must find out such information as is necessary for it to understand the essential facts about the client and have a reasonable belief that:

- the service meets the client's investment objective;
- the client can financially bear any risks consistent with those objectives; and
- the client has the necessary experience and knowledge to understand the risks.

Key Considerations:

- the suitability test applies when personal advice is given. This typically occurs when discussions take place on a one-to-one basis and is more likely to occur when a retail client is involved;
- the suitability test will probably not apply where the advice is given generally, without regard to a person's personal circumstances, such as in a pre-recorded tape or a presentation to an audience at a seminar, but could stray over the boundary if the advice was (a) addressed to an audience who consisted of, and deliberately tailored to, a particular type of client, or (b) followed up afterwards on a one-to-one basis with a particular individual;
- firms should consider reviewing current practises with professional clients; and

- firms should make a suitability assessment of marketing scenarios such as road shows, Q&A sessions, brainstorming with clients, market speculation, market colour/context conversations, risk management/hedging, or discussions on trading strategies.

7. Best execution

Under MiFID Article 21, a firm must take all reasonable steps to obtain the best possible result, taking into account price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order. In support of this process-based approach, firms must:

- have effective execution policies in place that explain what factors the firm will consider when executing orders;
- provide information about the execution venues;
- assess the execution venues in its execution policy at least annually and consider including other execution venues;
- monitor the effectiveness of its execution arrangements; and
- if requested, show that a client's order has been executed in line with the firm's execution policy.

Key considerations:

- Unlike the current FSA rules, MiFID does not provide a mechanism to exempt particular products or activities from best execution requests (i.e., spread betting, venture capital and stock lending);
- Although certain client (eligible counterparties) may transaction without any conduct of business (COB) protections, MiFID does not permit clients to waive selected elements of the COB protections, such as best execution. As a result, clients may be less able and less inclined to forego best execution and firms may need to set up best execution arrangement in markets where they do not provide best execution now;
- clients must give prior consent to the firm's execution policy (or material changes to the policy) and, if trades are executed outside a regulated market or multilateral trading facility, then the client must give prior express consent; and
- firms will not be subject to the best execution rule if they are not executing "on behalf of" a client.

Best execution for Portfolio Managers

Although managers are legally executing transactions when they pass them to a broker, the approach taken under MiFID is that it is the broker who executes in this situation, not the portfolio manager. A portfolio manager passing execution orders to a broker is still required to act in the best interests of its clients, take all reasonable steps to obtain best possible result, formalise this in a policy, and give appropriate information to its clients on this policy. However, the manager does not have to:

- duplicate the work of the executing broker;
- include information on venues and reasons for venue choice in its best execution policy (though it does appear that managers are expected to include similar information on the brokers they use);
- obtain retail client consent to its policy;
- disclose substantive information on their policy to their clients (including certain prescribed information for retail clients);
- notify clients of material changes in its execution policy; or
- on request by a client demonstrate that that client's order was executed in accordance with the firm's execution policy.

Where the manager executes trades directly with a counterparty rather through a broker, it will operate under the best execution regime first described above, and not under the special regime for managers described in this sub-section. This means that most managers will have to have two best execution policies, one for when they pass orders to a broker and one for when they execute directly with the counterparty.

Key considerations for Portfolio Managers:

- firms should amend their execution policy to comply with MiFID requirements. If applicable, a portfolio manager may have two execution policies in place as described immediately above;

- firms should obtain the prior consent of clients on the firm's execution policy, and, if the firm intends to trade "off exchange", obtain the client's prior express consent to this;
- determine whether the firm provides only portfolio management activities in which case certain of these requirements are not applicable (as they would be applicable to executing broker);
- firms should assess the execution policy disclosures provided to them by their brokers and if necessary ask for further information;
- the manager should also establish whether the broker it deals with is acting on the manager's behalf (in which case the manager is entitled to best execution) or is simply dealing with the manager on an arm's length basis, in which case there is no best execution entitlement and the manager is executing the trade itself with a counterparty; and
- seek confirmation from any broker they deal with that the broker will provide them with best execution when dealing on their behalf and not treat them as an ECP.

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