

# FSC Newsletter

Number 6 Year 2006



**Financial Services  
Commission**

## Markets in Financial Instruments Directive

### Introduction

This Newsletter is directed at firms and banks that are authorised under the Financial Services Ordinance 1998, as well as a small number of firms that are currently licensed under the Financial Services Ordinance 1989. The aim of the newsletter is to provide some background information to the imminent implementation of the Markets in Financial Instruments Directive.

### Implementation Committee

The Government of Gibraltar has, to facilitate the smooth implementation of the directive,, set up an implementation committee, via the Finance Centre. The Committee includes representatives from the Government, the FSC, the Gibraltar Bankers Association, the Gibraltar Association of Stockbrokers and Investment Managers, the Gibraltar Society of Chartered and Certified Accountancy Bodies, the Gibraltar Association of Compliance Officers and the Bar Council.

The role of the Committee is to assess how best the requirements of the Directive can be implemented and, where possible, incorporated into existing legislation.

### Background

The Investment Services Directive (ISD) 1993 set the legislative framework for investment firms and securities markets in the EU, and provided for a single passport for investment services. The aim of the ISD was to set out a number of high-level provisions governing how firms should be organised and what conduct of business requirements should apply to firms. It also aimed to standardise certain conditions governing the operation of regulated markets.

The EU's Financial Services Action Plan, which is designed to create a single market in financial services, highlighted, in 1999, the need to upgrade the ISD. This was because it was felt that there was a need to reflect the way markets currently operate and to make it flexible enough to respond to further market developments.

The Markets in Financial Instruments Directive (MiFID) will therefore replace the ISD. It is expected to be the most significant piece of EU legislation for investment firms and financial markets since 1995. Essentially, MiFID extends the coverage of the current ISD regime and introduces new and more extensive requirements that firms will have to comply with, in particular in relation to conduct of business and with special regard to internal organisation.

The Directive is designed to strengthen the legislative framework for investment services and regulated markets with a view to furthering two major regulatory objectives:



1. to protect investors and safeguard market integrity by establishing harmonised requirements governing the activities of authorised firms; and
2. to promote fair, transparent, efficient and integrated financial markets.

As a major part of the EU's Financial Services Action Plan, MiFID comprises two levels of European legislation. 'Level 1', the Directive itself, was adopted in April 2004. It provides, however, for its requirements to be supplemented by 'technical implementing measures' - so-called 'Level 2' legislation. These Level 2 measures are by way of implementing directives and regulations and are currently in the process of being agreed and finalised.

### **How does this affect Gibraltar?**

Gibraltar as part of the EU is required to transpose the Directive by 31 January 2007. Although the Level 1 directive has already been published, it is expected that the final implementing directives and regulations, under the Level 2 process, will not be published until some time after the Summer period of this year. Currently the FSC and the Implementation Committee are working from draft copies of these.

The requirements of MiFID will impact firms, and banks, currently authorised under the Financial Services Ordinance 1998, and to some extent, firms licensed under the Financial Services Ordinance 1989 where it is intended that those activities will fall within the scope of the new Directive.

### **Key Provisions of MiFID**

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

### **Passporting**

MiFID is intended to improve the operation of the 'passport' for investment firms by more clearly defining the allocation of responsibility between home state regulators and host state regulators. This will be especially relevant in relation to passported branches, and the Directive will also generally clarify some of the jurisdictional uncertainties that have resulted under the ISD.

MiFID will extend the range of 'core' investment services and activities that can be passported, and will:

- upgrade investment advice from a 'non-core' service to a 'core' service;
- introduce operating a multilateral trading facility (MTF)<sup>1</sup> as a new 'core' investment service; and

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<sup>1</sup> *An MTF is a multilateral system operated by an investment firm or a market operator which brings together multiple third-party buying and selling interests in financial instruments - in the system and in accordance with non-discretionary rules - in a way that results in a contract.*



- extend the range of investment instruments to which it applies to commodity derivatives, credit derivatives and financial contracts for differences.

Whilst investment advice becomes a 'core' activity it is limited to the instruments to which the Directive applies. In addition, the Directive allows for certain exemptions to be applied in certain cases.

Moreover, although commodity derivatives will be considered a financial instrument for the purposes of MiFID, not all firms trading commodity derivatives will necessarily fall within the scope of the Directive. Essentially the application of the Directive will depend on whether the firm is able to take advantage of any exemption contained in MiFID.

### **Capital requirements**

Essentially, Most firms that fall within the scope of MiFID will also have to comply with the new Capital Requirements Directive (CRD)<sup>2</sup>. Those firms that, as a result of the wider scope of the new Directive, will be subject to MiFID requirements will therefore also be subject to the CRD capital requirements.

### **Organisational requirements**

The MiFID requirements are relatively extensive and will cover compliance arrangements, internal systems and controls, outsourcing, record-keeping, management of conflicts of interest, and safeguarding of client financial instruments or money held by firms. Whilst some of the requirements regarding this are already reflected in the recently issued Conduct of Business (Investment Firms & Insurance Intermediaries) Regulations 2006 [CoB Regulations] and the Financial & Accounting Regulations, some changes to these two pieces of legislation will be required.

### **Conduct of business**

Common conduct of business standards are also further established in MiFID. These standards are extensive and will likewise require further changes to the current CoB Regulations. The starting point for many of these changes is the introduction of a new client categorisation regime which specifically introduces, for the first time in Gibraltar financial services legislation, the concept of 'market counterparties'.

### **Client categorisation**

MiFID will establish a common EU framework for classifying customers as professional clients, market counterparties or retail clients. As indicated above, whilst some of the requirements under MiFID are already reflected in the CoB Regulations, some changes to this piece of legislation will be required. The application of the various requirements under MiFID will also vary depending on the classification of the particular client.

### **Best Execution**

The MiFID requirements on best execution will mean some important changes to the current regulatory regime. Firms will be required to take all reasonable steps to obtain

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<sup>2</sup> See Newsletter 5 of 2006 "Background to the Capital Requirements Directive (Basel II)"



the best possible deal for their clients taking not just price into consideration, but also other factors such as cost, speed and the likelihood of execution and settlement.

### **Suitability and appropriateness tests**

For those firms that provide investment advice or portfolio management, MiFID will require that a “suitability test” be applied. This means that firms will be required to collect information about (a) the client’s knowledge and experience in the investment field relevant to the product or service, (b) the client’s financial situation and (c) the client’s investment objectives. These requirements are fairly similar to the current provisions in the CoB Regulations.

MiFID will, however, also require that firms apply an “appropriateness test”, where a client is not relying on a firm’s recommendations or expertise e.g. where the firm is a broker or dealer, including where the service is provided on an execution-only basis. Whilst this assessment is less onerous than the suitability test, firms will be required to assess whether the client has the knowledge and experience necessary to understand the risks involved in relation to the specific type of product or service. Whilst there will be certain exemptions from this requirement, these will only apply if certain conditions are satisfied e.g. where the service provided relates to non-complex products (shares, bonds or UCITS).

### **Regulated market and MTF standards**

MiFID will establish new minimum standards for regulated markets (i.e. exchanges) and for MTFs. The Directive will also create a new regime for ‘systematic internalisers’<sup>3</sup> of retail order flow in liquid equities.

### **Pre-trade equity transparency**

MiFID will also establish minimum standards of pre-trade transparency for shares traded on regulated markets and MTFs. It will oblige an investment firm that is a ‘systematic internaliser’ to undertake what is effectively a public market-making obligation. What this means is that a firm must provide a definite bid and offer quote in liquid shares for orders below a certain level i.e. below ‘standard market size’, which is being defined as the “average size” of orders executed in the market.

### **Post-trade equity transparency**

All types of trading in shares, whether on regulated markets, MTFs or OTC (over-the-counter) will also be subject to a post-trade transparency obligation. Certain exemptions, for example for block trades, will however be available.

### **Transaction reporting**

MiFID will require transaction reports for any instrument admitted to trading on a regulated market – this will include commodity instruments admitted to trading on exchange. The Directive also transfers responsibility for transaction reporting monitoring

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<sup>3</sup> *An internaliser is a firm dealing on own account i.e. trading against proprietary capital resulting in the conclusion of transactions in one or more financial instruments, by executing client orders outside regulated markets or MTFs.*



to home/host state regulators of firms and away from the regulator of the market on which the instrument is traded. It is envisaged, however, that certain exemptions may apply.

### **Investor protection**

MiFID will also considerably enhance investor protection by setting minimum standards for the mandate and powers that national competent authorities must have at their disposal. The Directive will also establish effective mechanisms for real-time cooperation in investigating and prosecuting breaches of rules.

### **Implementation timescale**

The Directive which requires transposition by 31 January 2007 and commencement by 1 November 2007. The relevant laws and rules will therefore need to be in place by 31 January 2007 and, as from 1 November 2007, firms will be expected to comply with the amended requirements.

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