Briefing Note
MiFID Review – Compliance

BN-11-06 Last updated: July 2011

Overview
The Compliance Burden

The original Markets in Financial Instruments Directive's (MiFID) objectives have largely been successfully met, as the Directive was designed to bring efficiency to the European market through competition and to promote consistent investor protection across national boundaries. There is now a significant shift and expansion of policy requirements covering a much wider scope of products as part of the MiFID review. While MiFID I mainly covered equity markets, the review expands into non-equities including fixed income, FX, commodities and derivatives.

AFME agrees that regulatory improvements are required in certain areas, however it is vital that these are proportionate to the actual problems identified, underpinned by impact assessments, and do not encroach inappropriately on user choice, innovation, competition or market efficiency.

Whilst we support a regulatory framework which is both fit for purpose and appropriately future proofed, we recognise the potential for the MiFID review to result in substantial changes and consequent costs for the industry and therefore would seek the Commission's assurance that it will ensure new measures are fully supported by robust issue, impact and cost analyses.

AFME'S Position
Extension of a Transaction Reporting Regime

AFME is concerned about the degree of proportionality of requirements being applied across the board for the entire product range and the cost versus benefit analysis, especially given the significant build costs involved.

Some products, especially in the derivatives space, do not have internationally accepted instrument identifiers so the complexity of reporting information that is usable by the markets or the regulators increases substantially. The suggestion that order data is collected at the same time then simply increases costs and creates storage issues.

Approved Reporting Mechanism (ARM)

AFME does not support the Commission's proposal that third parties reporting on behalf of investment firms need to be approved by the supervisor as an Approved Reporting Mechanism. Many of our member firms report on behalf of their (smaller) clients, whereby the transaction reports are then sent to the chosen ARM of the investment firm. This is a bilateral agreement between the firm and its client. There is also a significant reputational risk to the reporting firm and so this helps focus attention on ensuring that appropriate attention is paid to a high level of data quality and accuracy.

If the Commission were to force all third parties reporting on behalf of investment firms to become an ARM we would have a situation whereby ARMs were reporting to ARMs and it is not clear that such a proposal is either justified or necessary. These third party firms would also incur a cost (of becoming an ARM), which will inevitably be passed onto their clients, making it more expensive to trade.

Nor do we support the proposal that ARMs should be subject to the same sanctions that apply to the firm on whose behalf the report is being made. We see the relationship between the ARM and the firm

as being contractual – and not a regulatory one. Moves to impose sanctions on ARMs will significantly tighten the liability provisions in contracts between firms and ARMs. Moreover, it is likely that the ARM will seek to cover this liability with insurance – the cost of which will be passed onto the clients of the ARM.

Investor Protection and Provision of Investment Services

AFME does not support the MiFID proposals in this section as we believe the proposed policy responses are disproportionate to the problems identified, which, in many cases, AFME does not necessarily recognise. We believe that the current MiFID requirements remain fit for purpose and enhance market efficiency. The "Execution only" and Investment Advice regimes both work well and the customer classification differentiation provides adequate, proportionate protection in the overwhelming majority of cases (although we are conscious of the issues arising from some of the definitions that are being raised by the venture capital industry).

Modifications to the inducements regime

We do not support the suggested changes in the inducements regime and request further work be carried out. Whilst we support appropriate high quality reporting to customers on complex products and derivatives, we believe these should be agreed as a bespoke service, rather than set in broad standard terms within an EU measure.

Some of the problems of interpretation of the MIFID Inducement rule have arisen from the fact that its terms have been set so broadly. Currently there is ambiguity as to how far these rules apply and whether they cover areas such as commission sharing agreements and intra-group tax sales credits. This leads to inconsistent application of the Directive across Europe. We consider it would help to clarify the application of the rule to consider whether a revision is in order, whereby inducements are limited to those payments specifically intended to induce firms to act in a way that could call into doubt their obligation to act solely in the best interests of their client.

In principle we agree that the use of summary disclosure concerning inducements could be reduced and encourage firms to make suitably explicit pre-trade disclosures to clients, so assisting them to make more informed investment decisions. We believe that with adequate pre-trade disclosure there should be no need to make more detailed disclosures mandatory. Clients should retain the right to request additional information if they so wish.

MiFID Client Classification

We believe the current tiered approach to customer categorisation provides appropriate levels of investor protection to the three categories. Our experience has shown that transactions executed since the implementation of the regime have not resulted in significant numbers of client complaints and that the regime provides a proportionate and graduated system of investor protection. Although relatively recently introduced – and not without significant cost – the framework is maturing well. The ability of clients to opt for greater regulatory protection at any time is an important safety feature already built into the process and should not be overlooked in suggesting any changes to the regime.

Moreover, any move towards imposing retail client-oriented conduct of business standards on relationships with professionals might encourage frivolous charges of misconduct, for example if the market were to move against a client's position. This could reduce a firm's willingness to provide services. Equally, such a change in regulatory emphasis would have the attendant impact of requiring supervisory resource to focus disproportionate attention on dealing with professional clients as opposed to the protection of retail clients for whom the Commission's proposals in this regard are intended.

Liability of firms providing services

We understand the MiFID proposals to mean that the Commission envisages civil liability obligations will apply to all client types, including professional clients. Such obligations in relation to investment business for professional clients could give rise to moral hazard, and destabilise EU markets, by encouraging claims for breaches where the market moves against professional clients' positions.

Whilst we disagree with the need to introduce a general principle of civil liability a provision in MiFID on civil liability should:

- Be limited to specifying, in high level terms, that Member States should introduce a civil liability regime
- Be limited to claims by retail clients
- Be limited to circumstances where the client can demonstrate that it suffered loss as a direct result of the rule breach; and
- Not encourage competition or uncertainty between European liability tests and national regimes.

In order for European markets to remain competitive and a place where international firms are confident in doing business without the potential for vexatious legal action, any provisions in the Directive on civil liability must be limited to retail clients only. Professional clients have other means to approach firms either directly or through the courts if they believe there has been a breach of contract. If the right to sue for breach of a rule were extended to professional clients, there is a risk that they could use unfounded reasons to sue in the courts for a breach of MiFID. Professional clients have the knowledge and skill to know the risks they take when they enter a trade and they must not be able to use the courts to bypass this responsibility. We also believe that any provisions in the Directive must also be accommodated and subject to local Member State legal principles and jurisprudence.

Segregation of Clients' Assets

Those of our members who offer title transfer collateral arrangements to clients, via stock loan, repo or OTC derivative products, generally do so through the Private Banking or Wealth Management divisions that deal only with clients who have significant assets available for investment. These clients also usually have a sophisticated outlook on the financial markets and understand the risks involved as they often have many years experience of the investment market across a variety of products and services. On many occasions, these clients require customised products. We do not support a blanket prohibition of title transfer collateral arrangements involving retail clients and believe that this suggestion has not been justified.

Where customers grant firms direct access to clients' collateral, firms are better placed to hedge the client position and thus offer better prices to clients than would otherwise be the case.

AFME opposes the suggestion of Member States being granted the option to extend the prohibition of title transfer collateral arrangements between investment firms and their non retail clients. We oppose this proposal on the basis that non-retail clients generally have the sophistication and experience to understand the risks involved in title transfer collateral arrangements. We would highlight that existing EU regulation[1] recognises the validity of title transfer collateral arrangements to increase their efficacy in secured financing transactions.

Non-retail clients generally have immediate access to legal advice, either from in-house lawyers or from an external law firm.

We do however believe it is important that these title transfer collateral arrangements are accompanied by sufficient routine reporting to clients, in clearly understandable form, and relate to their pledged assets and collateral.

[1] Including Financial Collateral Directive 2002/47/EC

Telephone and Electronic Recording

AFME would support a common regulatory framework for telephone and electronic recording and agree with the recording requirements outlined in the consultation. The recording process should provide a complete and accurate audit trail concerning how a transaction is marketed and executed, and be specifically aimed at enabling the competent authority to access data when investigating market abuse. It should be clear that no obligation arises on the firm to review recordings unless it has reason to believe that a rule breach has taken place.

Retention requirements should be proportionate and not impose undue cost burdens on firms. Regulators should be encouraged to complete preliminary investigations of suspected cases quickly, and have the ability to ask firms to retain specific records beyond a short retention period.

We believe that **six months retention would be a suitable and cost effective time frame**. The costs of implementing a retention period of three years would outweigh the benefits realised by Competent Authorities in terms of market abuse detection and resolution of client issues.

Firms' current systems generally do not have the capacity to support a retention period of three years. Indeed the technology itself for the recording and storage of all types of telephonic recordings (i.e., to record and store mobile phone calls, store SMS messages, store MMS messages, store instant message (IM) conversations, record and store video communications, store outgoing and incoming emails and store pin-to-pin messages – used in Blackberry to Blackberry communications) has only been available since fairly recently. Estimates from a representative group of our membership have indicated that the total set up and ongoing works required for a retention of six months (for both mobile and landline records) will cost EUR 1.3m per firm on average. This increases incrementally to EUR 7.5m per firm when looking at a three year retention period.

However, the report published on behalf of the UK FSA in October 2009 titled "Consideration of a Mobile Phone Recording Requirement – Final Report by Europe Economics to The Financial Services Authority" is based on more comprehensive data and illustrates the cases where 30% and 100% of employees with fixed lines within a firm are affected by any requirement to record and retain data generated through a mobile phone. Our own figures appear rather conservative against the FSA survey, and one global investment bank estimated an annual cost of nearly EUR 3m for six month retention.

We consider that it would be appropriate for the Commission to expect Competent Authorities to improve their initial identification of suspect cases in order to avoid these additional costs.

Administrative Measures and Sanctions

Our members are in favour of consistent application of MIFID rules and therefore support administrative measures which have the effect of putting an end to a breach of the provisions of the national measures implementing MiFID[2]. We welcome the Commission's recent communication on reinforcing sanctioning regimes in the financial services sector[3]

Administrative sanctions and periodic penalty payments must be proportionate and meaningful in order to be considered effective and dissuasive; however they must also be calibrated to take into account such factors as whether the breach was planned, deliberate or repeated, involved misrepresentations, was self reported, and whether actual damage was suffered by a third party.

A minimum level of financial penalty may help move towards a more consistent regime but we would suggest a broader EU-wide agreed framework would be required to achieve a significant level of

[2] A copy of AFME's response to the European Commission Public Consultation on the Review of the Markets in Financial Instruments Directive (MiFID) is available on request

[3] COM(2010) 716 final, 8 December 2010

consistency. However we believe within this framework it is important that national authorities retain jurisdiction and the ability to tailor judgements to the particular circumstances of the case.

Criminal sanctions are the ultimate deterrent and should therefore be available as a tool for prosecutors in the most serious infringements for both firms and individuals.

Consideration should be given to the variances in evidential burden required in different jurisdictions and the need for a more consistent and coherent criminal sanctions regime across Member States. We believe that private censure remains a valid and effective regulatory tool when used properly and would not support an initiative to have public disclosure of every regulatory action. The competent authorities should have the option to make actions public as part of their toolkit, but only after the investigation and enforcement process is complete.

Access of Third Country Firms and Ban on Products

Whilst we welcome initiatives which help to promote globally consistent requirements and a level playing field in regulation, the issues here are wider than MiFID and should be properly analysed and debated, along with the other EU proposals in this territory. We do not support the proposals in MiFID for an "equivalence" regime. We have reservations that a strict equivalence regime could in fact encourage protectionism, reduce global market access for the users of financial services and be cumbersome to administer. AFME are strong supporters of the current national regimes that efficiently address this topic at present.

We believe there are significant issues both in theory and in practice with a European system of prohibitions and bans on individual products and services. Given that products are used by different investors for different purposes it will be extremely difficult to label products as "bad" or "good". We are concerned that bans may increase uncertainty and systemic risks, while also being seriously detrimental to investor confidence. Suitability requirements and rules on mis-selling should ensure adequate levels of investor protection and we believe concerns regarding particular products, practices or operations should always, in the first instance, be addressed as part of the ongoing supervision of individual firms. The scope and conditions under which any such powers could be used by the Commission should be clearly and explicitly set out and include robust and conclusive market failure analysis and full consultation.

Role of The European Securities and Markets Authority ("ESMA")

AFME is generally supportive of the process that delegates detailed technical requirements to the European Supervisory Authorities. However, we have concerns over the scope of the intended role for the European Securities and Markets Authority (ESMA) in MiFID given its recent establishment and seemingly limited resource. Developing technical standards, setting thresholds and collecting and analysing enormous amounts of data, as well as participating fully in supervision and regulatory oversight processes, will create a major burden on a fledgling institution. Inappropriate and poorly thought out regulation has the potential to cause additional significant systemic risk, rather than removing it from the financial services and markets systems.

To militate against this, we urge the Commission to set a realistic implementation timetable and recognise the need for a suitable transitional regime that allows firms to meet what, in many cases, will be significant changes.

Definitional Consistency

As the Commission is aware, there are a significant number of other important policy initiatives in progress, in particular, the Market Abuse Directive (MAD), Packaged Retail Investment Products (PRIP), European Market Infrastructure Regulation (EMIR), Corporate Governance as well as the establishment of the new ESAs. Many elements of these initiatives are interrelated and it is critical that a process is in place that ensures definitional consistencies across the various measures.

Whilst we agree that regulatory improvements are required in certain areas, it is vital that these are proportionate to the actual issues identified. They should be based on robust and thorough impact assessments that demonstrably support any new legislative requirements, and not encroach

inappropriately on user choice, innovation or competition. Getting this balance right can be extremely difficult. We believe, in particular, that the MiFID consultation process has been extremely short for the range and complexity of issues under review and therefore extra safeguards, checks and supporting evidence must be incorporated into the process as it moves forward.

Further information

MiFID is an extremely complex and comprehensive piece of regulation. AFME has broken down positions on the key issues in more specific briefing notes:

- BN-11-01 MiFID Review Briefing Note Overview
- BN-11-02 MiFID Review Briefing Note on Equities including market structure issues, venue definition, high frequency trading etc
- BN-11-03 MiFID Review Briefing Note on Fixed Income including price transparency
  - BN-11-03A MiFID Review Briefing Note on Rates (yet to be published)
  - BN-11-03B MiFID Review Briefing Note on Credit (yet to be published)
  - BN-11-03C MIFID Review Briefing Note on Securitisation (yet to be published)
- BN-11-04 MiFID Review Briefing Note on Foreign Exchange
- BN-11-05 MiFID Review Briefing Note on Corporate Finance

See also briefing notes covering AFME led initiatives:

- Post Trade Transparency Framework for Fixed Income
- OTC Equity Trading Report

AFME's response to the MiFID Review Consultation can be found here

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