

EXPLANATORY MEMORANDUM TO

THE FINANCIAL SERVICES AND MARKETS ACT 2000 (MARKETS IN FINANCIAL INSTRUMENTS) (AMENDMENT NO.2) REGULATIONS 2007
2007 No. 2160

1. Introduction

1.1 This explanatory memorandum has been prepared by Her Majesty's Treasury and is laid before Parliament by Command of Her Majesty.

2. Description

2.1 This statutory instrument amends the Financial Services and Markets Act 2000 (Markets in Financial Instruments) Regulations 2007¹ ("the MiFI Regulations"). These amendments arise as part of giving effect in the UK to the EC's Markets in Financial Instruments Directive ("MiFID").²

3. Matters of special interest to the Joint Committee on Statutory Instruments

3.1 None.

4. Legislative background

4.1 MiFID replaces the Investment Services Directive³ ("the ISD"). Under new arrangements for financial services legislation in the EU, additional detailed provisions were passed under powers in MiFID ("the implementing directive"⁴ and "the implementing regulation"⁵). The UK was required to give effect to the directives in its national law by 31 January 2007 and the measures must come into force on 1 November 2007. The implementing regulation has direct effect and so does not require transposition.

4.2 MiFID does three main things. It:

- establishes organisational requirements and rules governing behaviour towards investors for firms ("investment firms") who wish to be authorised to undertake activities linked to the buying and selling of financial instruments such as shares, bonds and derivatives;
- sets a regulatory framework for stock and derivative exchanges and other markets where the organised trading of financial instruments takes place;

¹ S.I. 2007/126.

² Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments (OJ No. L145, 30.4.2004, page 1).

³ Council Directive 93/22/EEC of 10 May 1993 on investment services in the securities field (OJ No. L141, 11.6.93, page 27).

⁴ Commission Directive 2006/73/EC of 10 August 2006 implementing Directive 2004/39/EC (OJ No. L241, 2.9.2006, page 26).

⁵ Commission Regulation (EC) 1281/2006 of 10 August 2006 implementing Directive 2004/39/EC (OJ No. L241, 2.9.2006, page 1).

- facilitates the carrying on of business by investment firms and stock and derivative exchanges and other organised financial markets across national borders in Europe.

4.3 In addition to this statutory instrument, the main body of eight statutory instruments that implement MiFID, including the MiFI Regulations, was laid on the 18th and 19th December. An earlier statutory instrument implementing MiFID (The Financial Services and Markets Act 2000 (Markets in Financial Instruments) (Modification of Powers) Regulations 2006⁶) came into force on 6th December. Two minor statutory instruments making consequential amendments as a result of the changes to the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001⁷ (“RAO”) were laid on the 31st January and in March a further statutory instrument (the Financial Services and Markets Act 2000 (Markets in Financial Instruments) (Amendment) Regulations 2007) was made which gave effect to an optional exemption within MiFID and contained additional transitional provision.

4.4 A transposition note setting out how the main elements of MiFID, and the Community legislation adopted under it, will be given effect in UK law is attached at Annex A⁸.

4.5 An Explanatory Memorandum on the Commission's proposal for a directive was approved by the Scrutiny Committee in the House of Lords on 27 January 2004 and the Scrutiny Committee in the House of Commons on 22 January 2003. The Merits Committee, when considering the main body of MiFID implementing legislation, drew it to the special attention of the House on the grounds that it gave rise to issues of public policy likely to be of interest to the House⁹.

5. Territorial Extent and Application

5.1 These Regulations apply to all of the United Kingdom.

6. European Convention on Human Rights

6.1 As this instrument is subject to the negative resolution procedure and does not amend primary legislation, no statement is required.

7. Policy Background

7.1 The intention of MiFID is to encourage the creation of deep and liquid capital markets in the EU and to ensure investors are adequately protected so that they can invest with confidence. As such, MiFID was a key element in the EU's Financial Services Action Plan ("the FSAP"), a legislative programme which was designed to make a significant step forward towards establishing a single market in financial services in Europe. The government endorsed the FSAP.

⁶ Statutory Instrument 2006/ 2975.

⁷ S.I. 2001/544 amended by S.I. 2006/3384.

⁸ The transposition encompasses all the main elements of MiFID.

⁹ 6th Report of Session 2006-2007, published 18 January 2007.

7.2 The European Commission decided that MiFID's predecessor, the ISD, needed to be replaced for two main reasons. Firstly, because it had been ineffective in promoting business across national borders in the single market. Second, because it did not cover important financial services activities such as investment advice, the operation of a multilateral trading facility ("MTF" - an organised market for the trading of financial instruments) and the trading of commodity derivatives.

7.3 MiFID is a significant piece of EU legislation. While MiFID was not subject to regulatory impact assessment at the EU level, the FSA and HMT have undertaken work to consider the costs and benefits of implementing MiFID. The FSA's work (which is discussed in more detail in the regulatory impact assessment¹⁰) suggests that the cost to UK firms of implementing MiFID could be around £1 billion pounds with ongoing costs of around £100 million¹¹. The analysis also identified benefits arising from MiFID. Estimates of the benefits are more complex but the most plausible scenario suggests there could be direct annual benefits of some £200 million and total second round benefits of some £240 million. A regulatory impact assessment was also carried out on this specific instrument, more detail is in Section 8.

7.4 The Treasury ran a public consultation on the legislative changes necessary to implement MiFID between the middle of December 2005 and the end of March 2006. A copy of a feedback statement on the consultation is available on the EU financial services section of the Treasury's website (www.hm-treasury.gov.uk). The Treasury ran a further informal public consultation on these Regulations between June and July 2007. The consultation was informal because it built on previous consultation undertaken by the FSA and the Treasury. A feedback statement on the consultation is included within the regulatory impact assessment for these Regulations.

7.5 These Regulations do three things they: introduce transitional provisions relating to firms' client classification limitations and requirements, and both extend and amend the passporting transitional provisions contained within the MiFI Regulations consequential on recent recommendations by the Committee of European Securities Regulators (CESR).

7.6 Client Classification Transitionals (Regulation 2(5) and 2(7)): UK firms typically have a limiting constraint (a "limitation" or "requirement") placed on their permissions under Part 4 of the Financial Services and Markets Act 2000 that says which sorts of customers they can deal with. MiFID introduces new terminology to describe the different classes of client. To address this the FSA and firms need to update firms' permissions to ensure that the old terms are replaced by the new MiFID terms.

7.7 The transposition of MiFID in January included FSA rules to give effect to the MiFID requirements about client classification. Firms suggested a broader transitional dealing with client classification references in Part 4 permissions would be helpful. The transitional in these Regulations provides for a mapping of client classifications in most firms' permissions from existing categories to the new MiFID categories, and covers some non-MiFID business. FSA consulted extensively on the scope of the

¹⁰ A copy of the regulatory impact assessment is available on the EU financial services section of the Treasury's website (www.hm-treasury.gov.uk).

¹¹ Calculated on a 'top-down' basis.

changes to the UK client classification regime and decided that it would be simpler to move most business to the new MiFID terminology.

7.8 Amendment of Passporting Transitionals consequential on the CESR guidance (Regulation 2(3) and (4)). The MiFID Regulations adopted in January provided a transitional mapping for UK firms' passports from the existing ISD services and activities to the new MiFID services and activities. This mapping was a domestic process as there had been no advice given at the EU level. The Committee of European Securities Regulators (CESR) – the Lamfalussy Committee charged with offering technical guidance on MiFID - has subsequently decided to tackle the issue of mapping activities and in May 2007 issued non-binding guidance. This came too late for use in our main transposition given the need to meet the January transposition deadline and moreover in 2006 it was not certain that CESR would provide guidance in this area.

7.9 The CESR mapping is identical to that used in the January legislation bar for one service. MiFID introduced (among other changes) a new ancillary service of “investment research and financial analysis” and elevated “investment advice” from an ancillary service to a core service¹². In the UK we provided that if the firm was permitted to passport “investment advice” then they could passport “investment advice” and “investment research and financial analysis”. The mapping reflected the wide scope of what had in practice been done within the definition of investment advice. CESR has only mapped “investment advice” to “investment advice”. While non-binding we feel it would be desirable to follow the CESR guidance. The Regulations ensure that the amendment will not require any new action from firms – the FSA will absorb the impact of the change in process.

7.10 Extension of Passporting Transitionals to Incoming firms and branches (Regulation 2(2) and (6)): MiFID requires that incoming EEA firms and branches can continue to exercise passport rights under existing passporting documentation. The UK has transposed this in these Regulations by providing for EEA firms to benefit from transitionals so that their ISD passporting notices are mapped to refer to the new MiFID services and activities. Given the uncertainty about how other countries would approach the mapping process we did not fully transpose this element in January. In the light of the CESR guidance it is now more certain how other countries will map their firms' permissions and so correspondingly how we should treat the incoming firms and branches. These Regulations ensure that firms and branches' existing passporting notices will be updated in line with the CESR guidance. The Regulations include provision that if the national approach differs from that used by CESR then the national approach is used.

8. Impact

8.1 A regulatory impact assessment of the effect of all the instruments transposing MiFID on the costs of business is available on the EU financial services section of the Treasury's website (www.hm-treasury.gov.uk). A limited regulatory impact assessment was made of these proposed Regulations which demonstrated that the

¹² MiFID and the ISD have two levels of services: core and ancillary (though the names differed). A MiFID firm can only do ancillary services if it also performs core services – it cannot have a passport solely for ancillary services.

Regulations should provide a small cost saving over either the FSA or firms addressing this issue. The saving was estimated to be around 1 million pounds relative to the FSA taking action. The regulatory impact assessment was proportionate to the limited nature of the Regulations. The regulatory impact assessment is attached to this memorandum.

9. Contact

9.1 Sarah Parkinson at HM Treasury: Tel 020 7270 5912 or e-mail: sarah.parkinson@hm-treasury.x.gsi.gov.uk can answer any queries regarding the Regulations.

Transposition note for Directive 2004/39/EC: the Markets in Financial Instruments Directive (MiFID)

Articles of Directive 2004/39/EC	Objectives	Implementation	Body responsible
1 and 4	Application of MiFID and definitions.	Article 1 requires no independent transposition. Article 4 definitions are transposed along with the provisions to which they relate.	HM Treasury and FSA
2 and Annex I and article 52 of Directive 2006/73/EC	These set the scope of the directive, establishing which services and activities and financial instruments the directive requires to be regulated and provide for exemptions.	<p>The services, activities and instruments falling within MiFID's scope are largely transposed by the RAO. The new activity of operating an MTF is added at article 25D by the RAO(A).</p> <p>MiFID requires a wider set of non-financial derivatives and credit derivatives to be brought inside the scope of UK regulation. This is done through changes to articles 83, 84 and 85 of the RAO made by the RAO(A).</p> <p>Exemptions are transposed by the RAO (as amended by the RAO(A)) and the EO (as amended by the EO(A)).</p>	HM Treasury
3	Member States may choose not to apply the directive to firms who cannot hold client funds and securities and who only receive and transmit orders and give investment advice.	Regulations 2-3 of the MiFI(A) amend MiFI to insert new provision. New regulation 4B ensures that exempt firms do not have the MiFID rights and new regulation 4C applies the limiting requirements to exempt firms.	HM Treasury
5-8 (excluding articles 5(2) and 6(3))	Authorisation of investment firms and withdrawal of authorisation.	<p>The authorisation requirement is transposed principally by section 19 of FSMA, the RAO and the Business Order.</p> <p>The remaining provisions are transposed by existing legislation, largely Part 4 of, and Schedule 6 to, FSMA, and FSA directions in the Perimeter Guidance section of the Handbook. The registration requirement is transposed by section 347.</p> <p>Amendments are made to section 45 of,</p>	HM Treasury and FSA

		<p>paragraph 2 of Schedule 6 to, FSMA (see Schedule 5 to MiFI). Provision transposing article 7(1) is included at regulation 4 of MiFI.</p> <p>Guidance in the FSA's SUP and ENF sections of the handbook are also relevant here.</p>	
9	To ensure that investment firms are run by people of probity and competence.	This is transposed mainly through existing section 41 and Part 5 of, and paragraph 5 of Schedule 6 to, FSMA and the Supervision section of the FSA's Handbook. The legislation is unchanged but some changes are being made to the FSA's Handbook.	HM Treasury and FSA
10	To ensure that investment firms are owned by people of probity.	This is transposed mainly through existing section 41 and Part 12 of, and Schedule 6 to, FSMA. These provisions do not need to be changed to implement this article. FSA rules in the Supervision section of the Handbook are also relevant: SUP 11.4.2R and SUP 16.4.5R.	HM Treasury and FSA
11, 12, 13, 18 (and articles 5 to 23, 25 and 51 of Directive 2006/73/EC)	Investment firms and credit institutions must be members of an investor compensation scheme, and have adequate systems and controls to carry out their business in a way which enables them to discharge their obligations. The systems and controls must include adequate measures to deal with actual and potential conflicts of interest. Investment firms must have adequate capital.	Transposition is mainly through FSA Rules, and see also sections 41 and 213 of, and Schedule 6 to, FSMA. The UK already has a comprehensive set of systems and controls requirements in the Senior Management Arrangements, Systems and Controls Section of the FSA's Handbook. There is substantial overlap between the existing requirements and those in the directive but differences in wording and scope of application. The existing Handbook requirements are being updated to reflect the scope and wording of the directive. The MPR amend section 138 of FSMA to extend FSA's rule-making powers and insert new section 158A of FSMA (guidance on outsourcing by firms).	HM Treasury and FSA
15	Relations with third countries	This is transposed by sections 405 to 408 of FSMA as amended by Schedule 5 to MiFI.	HM Treasury
16 and 17	Ongoing compliance with conditions for authorisation and	These provisions are transposed by Part 4 of, and paragraph 6 of Schedule 1 to, FSMA and FSA rules. Schedule 5 to	HM Treasury and FSA

	monitoring of investment firms and credit institutions	MiFI amends paragraph 6 to secure that FSA's enforcement powers extend to Regulation 1287/2006. FSA rules in SUP 15 and guidance in COND 1.2.2 of the Handbook also transpose these articles.	
5(2), 14 & 26	That MTFs meet certain minimum standards of operation to protect investors.	The UK already has provisions dealing with MTFs, in the RRR for MTFs operated by exchanges, and in the Market Conduct section of the FSA's Handbook for those run by investment firms and credit institutions. MiFID requires these provisions to be updated. For MTFs run by exchanges these articles are transposed by the RRR, as amended by the RRR(A), see in particular new paragraph 9A of the Schedule to the RRR. The provisions dealing with MTFs run by investment firms and credit institutions are being implemented by changes to the FSA's Handbook.	HM Treasury and FSA
19 (and articles 3, 24, 26 to 45 and 47 to 49 of Directive 2006/73/EC)	To ensure that clients are treated honestly, fairly and professionally by investment firms and credit institutions. This includes ensuring that clients get adequate information about the firms and their products and services, and that firms have adequate information about clients when providing investment advice or discretionary portfolio management services, or where the client is buying higher risk investments.	These provisions are transposed mostly by FSA rules. The UK already has extensive obligations in this area in the Conduct of Business section of the FSA's Handbook. The provisions in MiFID are less detailed in some areas and more detailed in others than those in the FSA's current rules and involve some differences of substance. The FSA are revising the relevant conduct of business provisions in their Handbook. The MPR amended section 145 of FSMA to enable FSA's financial promotion rules fully to transpose MiFID.	HM Treasury and FSA
20	Provision of services through medium of	This is transposed by FSA rules in COBS 2.4.4 in the Handbook.	FSA

	another firm.		
21 (and articles 44 and 46 of Directive 2006/73/EC)	To ensure investment firms and credit institutions when buying and selling financial instruments on behalf of clients do so in line with a policy designed to obtain the most favourable possible terms for the client.	This is transposed by FSA rules. The FSA already has a similar regulatory obligation, known as "best execution", in the Conduct of Business provisions of its Handbook. The provisions in MiFID have a wider scope and some difference in detail. The FSA are revising the existing provisions in their Handbook.	FSA
22 (and articles 47 to 49 of Directive 2006/73/EC)	To ensure investment firms and credit institutions treat the orders of different clients fairly and do not seek to unfairly profit themselves from knowledge of the orders of their clients.	These provisions are transposed by FSA rules. The FSA already has similar obligations, known as "client order handling", in the Conduct of Business provisions of its Handbook. The provisions in MiFID have some differences of detail from the existing rules. The FSA are revising the existing provisions in the Handbook.	FSA
23	To allow investment firms and credit institutions to do business through tied agents (ie firms who are not themselves regulated but act on behalf of a regulated firm) if their Member State permits.	The UK already permits firms to use tied agents, known domestically as "appointed representatives" under section 39 of FSMA and the ARR. Whilst the concepts are similar, there are some differences of detail between the domestic regime and MiFID. Schedule 5 to the MiFI revises sections 39 and 347 of FSMA (the latter deals with the FSA's register), and inserts section 39A to bring the domestic provisions into line with MiFID. The ARR(A) revise the ARR. FSA rules in the Supervision section of their Handbook also transpose this article, and are being revised.	HM Treasury and FSA
24 (and article 50 of Directive 2006/73/EC)	To enable clients who are sufficiently knowledgeable to look after their own interests to enter into transactions with investment firms and credit institutions without the firms having to comply with conduct of	The UK already has a system of client categorisation and requirements for firms in respect of the classification of clients. This is included in the Conduct of Business section of the FSA's Handbook. MiFID introduces different rules in respect of what type of person can fit in each category of client and the information firms must provide to clients about their classification. The FSA are revising the existing provisions	FSA

	business obligations.	in the Handbook.	
25 (and article 12(2) of Regulation 1287/2006)	To ensure that regulators get information from investment firms and credit institutions about transactions to help curb market abuse.	<p>The UK already has transaction reporting requirements in the Supervision part of the FSA's Handbook. The FSA are revising the existing provisions in its Handbook to give effect to the wider scope of the MiFID transaction reporting requirements.</p> <p>Schedule 5 to MiFI inserts new sections 412A and 412B of FSMA which allow the FSA to approve and monitor trade-matching and reporting systems (as required by Regulation 1287/2006). The FSA is also revising its Handbook to take account of this change.</p> <p>Section 293A of FSMA, inserted by Schedule 2 to MiFI, allows FSA to obtain information for the purpose of monitoring investment exchanges' compliance with this article.</p>	HM Treasury and FSA
6(3), 31 and 32	To ensure that investment firms can do business outside of the Member State in which they are based without facing additional authorisation requirements (so-called "passporting").	<p>This is transposed by existing Schedule 3 to FSMA amended by Schedule 4 to MiFI, the PRR amended by the PRR(A) and changes to FSA guidance in SUP 13, 14 and 17 of the Handbook.</p> <p>Passporting rights for market operators operating an MTF are inserted as sections 312A and 312C of FSMA by Schedule 2 to MiFI.</p>	HM Treasury and FSA
33, 34, 35 and 46	To ensure open access across the EEA to exchanges, clearing houses and securities settlement bodies for investment firms; the right for users of regulated markets to choose where they settle transactions; regulated markets and MTFs have open access to clearing and settlement infrastructure across the EEA.	This is principally transposed by paragraphs 4, 7B, 7C, 7D and 21A of the Schedule to the RRR as amended or inserted by the RRR(A), and paragraph 28 of Schedule 1 to the USR inserted by the USR(A). FSA SUP App 3.6.26 is also relevant.	HM Treasury

36 to 39, 41 to 43 and 47	To ensure that regulated markets are operated in a manner which protects investors and ensures they operate in an efficient manner	<p>The recognition system and existing obligations placed on investment exchanges are contained in Part 18 of FSMA and the RRR. In the UK to run a regulated market it will be necessary to be a recognised investment exchange under FSMA.</p> <p>Part 18 of FSMA is amended by Schedule 2 to the MiFI, see in particular amendments to sections 287 and 297 and new section 292A. The RRR are amended by the RRR(A), see in particular amendments to paragraphs 1 to 4 and 8 of the Schedule to the RRR and new paragraphs 7B and 7E. FSA rules in REC, COBS and MAR sections of the Handbook also transpose these articles.</p> <p>Article 38(3) of MiFID requires that the FSA is notified in advance of the acquisition of a controlling stake in a recognised exchange, and has the opportunity to block the acquisition where it threatens the market being run properly. This is transposed by new Chapter 1A of Part 18 of FMSA inserted by Schedule 2 to MiFI.</p> <p>New Part 18A of FSMA inserted by Schedule 3 to MiFI transposes article 41.</p> <p>New sections 312A and 312C of FSMA inserted by Schedule 2 to MiFI transpose new passporting rights for market operators in article 42, and the EO(A) makes a consequential amendment to the EO.</p> <p>Article 47 does not require transposition.</p>	HM Treasury and FSA
40	To ensure financial instruments admitted to trading on regulated markets are capable of being traded in a fair, orderly and efficient	The UK currently enforces a similar principle to that in MiFID through paragraph 4(2)(b) of the Schedule to the RRR. To accommodate the extra detail in MiFID, the RRR(A) inserts new paragraph 7A to the Schedule to the RRR.	HM Treasury

	manner to protect investors.		
27, 29, and 44	To ensure investors have adequate information available about expressions of interest in the trading of shares when making their investment decisions.	<p>MiFID requires that specific rules are introduced for trading in shares on regulated markets and MTFs and on an OTC basis.</p> <p>Article 27 is transposed by FSA rules. Articles 29 and 44 are transposed new section 286(4A) and (4B) of FSMA (inserted by the MPR) and new paragraph 4A of the Schedule to the RRR inserted by the RRR(A). The FSA is making changes to the Market Conduct section of its Handbook to impose obligations on MTFs run by investment firms and credit institutions, and on OTC trading.</p>	HM Treasury and FSA
28, 30 and 45	To ensure investors have adequate information about completed transactions in shares when making their investment decisions. MiFID provides much more specific obligations about the information that must be made available after a transaction has been completed and the circumstances in which the release of such information can be deferred.	<p>Currently recognised investment exchanges are subject only to a general obligation to ensure investors have adequate information about share trading through paragraph 4(2)(a) of the Schedule to the RRR.</p> <p>Article 28 is transposed by FSA rules. Articles 30 and 45 are transposed new section 286(4C) and (4D) of FSMA inserted by the MPR and new paragraph 4B of the Schedule to the RRR inserted by the RRR(A). The FSA is making changes to the Market Conduct section of its Handbook to impose obligations on MTFs run by investment firms and credit institutions, and on OTC trading.</p>	HM Treasury and FSA
48 to 51	To ensure that responsibilities for enforcing the directive are clearly delineated and that the relevant regulatory bodies have adequate powers to discharge their responsibilities; and that there are appropriate administrative sanctions available.	<p>The FSA as the UK's financial services regulator will have responsibility for enforcing MiFID in the UK: for its responsibilities see generally Part 1 of, and Schedule 1 to, FSMA.</p> <p>The FSA already has extensive powers of enforcement under FSMA. The powers MiFID requires regulators to have are similar to those the FSA already possesses, but in some cases slightly broader. FSA's main relevant powers (including administrative sanctions) are in Parts 4, 5, 11, 13, 14,</p>	HM Treasury

		<p>18, 25 and 27 of FSMA. Section 354 is FSA's duty to cooperate with other regulatory authorities.</p> <p>The main changes to FSA's enforcement powers are made by Schedule 1 to MiFI, paragraphs 7 and 8 of Schedule 2 to MiFI, Schedule 3 to MiFI which inserts new Part 18A of FSMA, and paragraphs 5, 7 to 11, 13 to 15 and 17 of Schedule 5 to MiFI.</p> <p>FSA guidance in ENF section of the Handbook is also relevant here.</p>	
52 and 53	To ensure that decisions under MiFI are subject to a right to apply to the Courts and that there are extra-judicial methods of redress.	<p>Many decisions under FSMA are subject to a right to refer the matter to the Tribunal, and in the absence of such a right there is a right to seek judicial review. Provision to transpose article 52 in relation to exchanges is made by paragraphs 4 and 12 to 14 of Schedule 2 to MiFI.</p> <p>For extra-judicial methods of redress see Parts 15 and 16 of FSMA.</p>	HM Treasury
54, 58 and 63	Safeguards surrounding the disclosure of confidential information and exchange of information with third countries.	This is transposed by sections 348 and 349 of FSMA and the DCI as amended by the DCI(A).	HM Treasury
55	Auditors' duties to report.	This is transposed by the FSMA 2000 (Communications by Auditors) Regulations 2001 (SI 2001/2587).	HM Treasury
56 to 62	To ensure that regulators across the EEA have the powers to enable them to work effectively together to deal with the challenges posed by regulating firms doing business on a cross-border basis.	<p>The FSA already has the authority, under provisions in Parts 11 and 23 of FSMA and the DCI to co-operate with other regulatory bodies. FSA's powers of intervention in relation to incoming firms are at Part 13 of FSMA.</p> <p>Relevant changes to implement MiFID are made by Schedule 1 to MiFI which amends Part 13 of FSMA, Schedule 2 to MiFI which inserts new section 312B of FSMA and the DCI(A).</p>	HM Treasury and FSA
64 - 73	Procedural provisions under MiFID,	Article 66 is transposed by amendments to articles 83 to 85 of the RAO made by	HM Treasury

	amendments to other Community legislation, transposition and transitional provisions	the RAO(A); article 67 is transposed by FSA rules; article 68 is transposed by FSA rules and Schedule 3 to FSMA; consequential amendments resulting from article 69 are at Schedule 6 to MiFI; provision transposing article 71 is at Part 3 of, and Schedule 7 to, MiFI, regulations 4 and 6 of MiFI (A) and regulation 2 of MiFI (A2), regulation 7 of the DCI(A) and in regulation 15 of the PRR(A). The remainder of these provisions do not require specific transposition.	and FSA
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REGULATORY IMPACT ASSESSMENT FOR:

Client Classification transitionals as part of implementation of MiFID.

Purpose and intended effect of measure

Objective

2. MiFID was passed in April 2004 and is due to come into effect on 1 November 2007. It is a directive dealing with the buying and selling of shares, bonds, money market instruments, units in collective investment undertakings and derivatives, and the regulation of the markets where financial instruments are traded. It replaces the Investment Services Directive (“ISD”)¹³. MiFID is part of the EU’s Financial Services Action Plan (“FSAP”) which is aimed at integrating Europe’s capital markets to bring down the cost of capital and facilitate enhanced growth and employment. The UK transposed the main MiFID implementing legislation in January 2007.

3. The Commission recognised that firms would face challenges in moving from ISD to MiFID and so MiFID contained certain transitional provisions to ease that process. We have identified a further area where a transitional would be helpful. The proposed legislation would provide a mapping from the client types that firms are currently allowed to deal with, to the new client classifications that are introduced by MiFID. This issue was only covered for *existing* clients in the transitionals contained within MiFID (and transposed by FSA rules) and so does not provide a future proof solution.

Background

4. MiFID categorises clients into three types (retail, professional and eligible counterparty) and distinguishes between them in terms of client protections – with the most protective regime reserved for retail clients. This is similar in principle to the current UK regime, but we have different terminology (private, intermediate and market counterparties) and slightly different criteria for allocating individuals to a particular class (so, for example, more clients are likely to be classed as retail than were previously classed as private).

5. Post MiFID the UK will change its terminology to use that adopted by MiFID, for simplicity the same terms will be used for most non-MiFID business but there may be slight differences in how customers are allocated to the categories. The FSA consulted extensively with firms on this approach and it was deemed simpler to bring most business onto the same framework (these change will not affect those limitation types relating broadly to insurance mediation activities, other than life business, and home finance activities).

6. UK firms typically have a limiting constraint placed on their permission that says which sorts of customers they can deal with. This means, for example, that if only allowed to deal with market counterparties, they would not be able to deal with private customers unless they

¹³ Council Directive 93/22/EEC of 10 May 1993 on investment services in the securities field (OJ L141, 11.6.93, page 27).

upgraded their internal systems and sought approval from the FSA via an application for variation of permission.

7. MiFID provides that firms can treat most *existing* clients as falling within the equivalent new categories but does not speak to new clients. This would mean that a UK firm with a current permission to deal with intermediate clients would be allowed to continue dealing with those clients under the new professional regime. However, they would not necessarily be able to take on all *new* professional clients. This issue arises because the definitions do not overlap perfectly.

8. The solution to this is to update firms' permissions to ensure that the old terms are replaced by the new MiFID terms. There are a variety of ways in which this could be done, this consultation seeks views on whether we have identified the most efficient way of delivering this change.

Rationale for government intervention

9. FSA and firms cannot simplify the change to firms' permissions without legislative support because the normal process is set out in FSMA and hence cannot be altered without HM Treasury involvement.

Consultation

10. We have consulted primarily via the MiFID standing group (which brings together trade associations, firms, lawyers and other affected parties) with whom we have shared many MiFID documents. The consultation was also available on the HMT website and publicised by the FSA and HMT through a variety of MiFID meetings and documents. Given that the proposal merely builds on existing legislation and the time constraints, this was an informal consultation of four weeks.

11. We had seven responses to our consultation. All those commenting welcomed the legislation and agreed with the approach taken. A minor technical change was made as a result of the consultation. Those responding also highlighted the importance of continuing efforts to raise awareness in the industry about the changes and both HM Treasury and FSA are continuing to do so.

Options

Option 1 – FSA uses its powers

12. FSA could review and alter all existing regulatory permissions to replace the current UK terms with the new MiFID terms (eg to replace private clients with retail clients). There is a formal procedure for this sort of amendment to firms' permissions that cannot be (without legislation) circumvented. FSA would therefore need a process for identifying and writing to all the firms concerned, the firms would then need to allocate time and resources to considering the issue and potentially responding.

Option 2 – introduce the proposed measures

13. The proposed legislation would mean that the current client limitations in firms' permissions would acquire the equivalent MiFID meanings. The FSA then plan to update their database to replace the current terminology with the MiFID terms. Firms that wanted to

seek an alteration to their client limitations would have opportunity to do so via the usual variation of permission route. The timing of this legislation is designed to ensure that firms have clarity about their mapped permissions in time to assess whether they wish to alter their permissions ahead of November 2007.

Option 3 – firms request alterations to their permissions

14. If neither FSA nor HMT take any action then firms will need to request alterations to their permissions. This would involve considerable effort by firms to prepare the requests and the FSA to process them.

We recommend Option 2. This provides maximum simplicity for the firms and FSA.

Costs and Benefits

Option 1 – FSA uses its powers

15. Some 7000 or so firms would be affected. FSA would need to write to each, the firms would then need to review the letter. We estimate firms will spend on average 2 hours considering the correspondence from the FSA and 5 hours for those firms with the more complex limitation type of “intermediate customers and market counterparties”. Therefore the aggregate cost across the industry will be material – potentially some £2.5 million. FSA would then need to update all register entries and handle any technical questions – a similar exercise suggests that some 10% of firms would contact the FSA.

Option 2 – introduce the proposed measures

16. FSA would need to do some general promotional work to ensure firms were aware of what was happening and to highlight the opportunity to request a change to their client limitations. This would form part of their general MiFID promotional work and so would have marginal additional cost. FSA would need to alter the register. This approach should yield some minor savings to FSA relative to Option 1 of some £100,000.

17. Firms would need to consider the effect of the legislation and whether they were content with the new scope of their client limitations. Because the legislation offers a simpler, more robust solution than an FSA approach we expect firms would require less time to consider the change. The benefits to firms relative to Option 1 could be in the region of £1 million pounds.

18. Time and effort at HM Treasury in drafting and consulting on the legislation. This is unlikely to be significant.

Option 3 – firms request alterations to their permissions

19. Firms would need to write to FSA requesting a change to their permission. FSA would need to review and respond to the requests. The FSA would also still need to do some general promotional work to ensure firms were aware of what was happening and applied in good time to make the necessary changes. This would be a large exercise with significant costs for FSA and firms.

Option 2 provides savings to firms and the FSA that could be in the region of £1 million pounds. We therefore recommend Option 2.

Small firms Impact Test

20. Small firms may be more likely to find managing regulatory change difficult. The proposed regulation would smooth the process of the change from ISD to MiFID and may therefore be of particular benefit for small firms.

Competition Assessment


21. This should have no appreciable impact on competition as the benefits will be available to all firms.

Enforcement, sanctions and monitoring

22. This legislation would have no impact on enforcement, sanctions and monitoring. Firms would be able to alter the effect of the mapping by applying for a variation of permission in the normal way.

Declaration

I have read the regulatory impact assessment and I am satisfied that the benefits justify the costs.

A handwritten signature in black ink, appearing to read "Kitty Jester". The signature is written in a cursive style with a large initial 'K' and 'J'.

Economic Secretary to the Treasury

July 2007

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