Financial Regulator
Rialtóir Airgeadais

Markets in Financial Instruments Directive (MiFID)

Feedback on Discussions of Conduct of Business Industry Working Group

October 2007

TABLE OF CONTENTS

INTRODUCTION

MiFID is a comprehensive regulatory regime covering investment services and financial markets in Europe and will introduce common standards for investor protection throughout the European Union. It applies to both investment firms and credit institutions when providing investment services, and to regulated markets. MiFID comprises two Directives and a European Commission Regulation. The two Directives were transposed into Irish law on 15 February 2007 by means of a Statutory Instrument, No 60 of 2007, entitled European Communities (Markets in Financial Instruments) Regulations 2007 [the MiFID Regulations]. The MiFID Regulations have been amended by Statutory Instrument No 663, issued on 26 September 2007. It is intended that further amendments will be issued shortly and that the MiFID Regulations and the amendments will be consolidated by the end of the year. The European Commission Regulation automatically becomes law and does not require transposition. The MiFID Regulations will come into effect on 1 November 2007. MiFID replaces the Investment Services Directive (93/22/EC)[1] [ISD] which is the basis on which investment firms have been regulated in Ireland and throughout the EU.

Why the need for MiFID?

The ISD was adopted in 1993 and is superseded by MiFID. There was a need to enhance consumer protection, eliminate barriers to cross-border trading and harmonise conduct of business rules so that the passport is more effective. It was also necessary to expand the services and instruments to take account of developments in financial markets.

What are the changes?

MiFID utilises the concept of full harmonisation, which means that the same rules will apply across the EU and individual countries can only impose additional requirements in limited circumstances. The range of financial instruments and services for which authorisation is required is expanded. Investment advice is included as a core service which can be passported to other EU countries in its own right. Additional financial instruments include contracts for differences, commodities derivatives, and exotic derivatives such as those relating to climatic variables, emission allowances and inflation rates.

Who does MiFID apply to?

MiFID applies to investment firms, stockbrokers, credit institutions when providing investment services, firms or market operators running Multilateral Trading Facilities, many futures and options firms and some commodities firms. It will not apply to those providing services in relation to insurance policies, tracker bonds or PRSAs. It will not apply to Multi-Agency Intermediaries or Authorised Advisors. However, existing Multi-Agency Intermediaries and Authorised Advisors should ensure they are not engaged in any of the new services or financial instruments that would require a higher level of authorisation.

---

[1] 10 May 1993.

Committee of European Securities Regulators [CESR]

In order to ensure the consistent implementation of MiFID and to foster supervisory convergence among Member States, CESR has issued guidance in a number of areas, including best execution and inducements. On 29 May 2007, CESR issued *Inducements under MiFID - Recommendations* and *Best Execution under MiFID - Questions and Answers*. These documents are available on our website at www.financialregulator.ie. They are also included in this document for ease of reference. *Inducements under MiFID - Recommendations* contains six recommendations and some illustrative examples. *Best Execution under MiFID - Questions and Answers* provides guidance on issues such as:

- the content of an execution policy,
- the use of a single venue,
- factors to be considered,
- information to be disclosed,
- consent, and
- review and monitoring.

The Financial Regulator intends to follow CESR guidance on inducements and best execution and, accordingly, firms should ensure they are familiar with and take account of the guidance when implementing the MiFID Regulations.

During development of its guidance, CESR requested and received an opinion from the European Commission on three issues relating to the scope of the best execution obligations. These questions were:

- In what circumstances do the best execution requirements apply to firms who operate by providing quotes and then dealing?
- What scope may "specific instructions" from a client cover?
- In what circumstances do portfolio managers and order receivers and transmitters "execute client orders"?

Firms should consider the opinion from the European Commission in deciding the extent of the duty of best execution in their business[2].

Industry Working Group

As part of the preparation for the implementation of MiFID, the Financial Regulator invited industry representatives to participate on a working group dealing with Conduct of Business requirements. The purpose of the working group was to consider issues other than those already being considered by CESR in its consultation process.

The Conduct of Business Working Group considered issues in relation to client categorisation, the provision of information to clients, suitability and appropriateness, reporting to clients, best execution, client order handling, inducements, investment research, conflicts of interest, complaints handling and personal transactions.

The Group issued feedback on 11 July, in a questions and answers format, dealing with the following areas:

- Client categorisation
- Suitability and appropriateness
- Provision of information to clients
- Reporting to clients
- Investment research.

No major issues were raised in relation to complaints handling and personal transactions.

[2] Commission Working Document ESC-07-2007, which is also appended to (but does not form part of) CESR /07-320, "Best Execution under MiFID - Questions and Answers".

The Group's feedback in relation to the following areas is now being issued, also in a questions and answers format:

- Best execution
- Client order handling
- Conflicts of interest
- Inducements
- Interaction between MiFID and the Consumer Protection Code.

For convenience, this document includes both parts of the Feedback from the Working Group and the CESR guidance on inducements and best execution.

The participants on the working group for discussions in relation to the first part of the Feedback were:
Breda MacNamara and Enda McMahon, representing the Irish Association of Investment Managers, Sinéad Flanagan and Paul Cullinane, representing the Irish Stock Exchange, Martin Purdy and Robert Kelly, representing the Irish Banking Federation, Brendan Kelly, representing Financial Services Ireland, Claire Cunneen, representing Nexgen Capital Limited, John Caslin, representing Alder Capital Limited, Terry Murphy, Deirdre Norris and Clive Duignan, representing the Financial Regulator.

Aoife McGee replaced Breda MacNamara, representing the Irish Association of Investment Managers, for the discussions in relation to the second part of the Feedback and Philip Brennan replaced Clive Duignan, representing the Financial Regulator.

Alternates and other occasional participants:
Mary Dolan and Declan Darcy, representing the Irish Banking Federation, Ailish Byrne, representing the Irish Stock Exchange, and Karen Cullen, representing the Financial Regulator.

Conduct of business requirements

The conduct of business requirements are contained in the following documents:

- MiFID Regulations:
  - Part 7,
    - Regulations 74 to 78
    - Regulations 80 to 87
    - Regulations 92 to 103
    - Regulations 106 to 108
    - Regulation 111
  - Part 5, Regulations 38 and 39
  - Part 12, Regulations 151 to 155
- CESR guidance:
  - Inducements under MiFID - Recommendations
  - Best Execution under MiFID - Questions and Answers

This Feedback document may be of assistance to firms in the interpretation and practical implementation of the conduct of business requirements.

Preparation for MiFID

Prior to 1 November, firms should be familiar with the requirements set out in the MiFID Regulations and the guidance issued by CESR.

The MiFID Regulations set out detailed requirements in relation to conduct of business and other issues, e.g., the information to be provided to clients, the assessment of suitability and appropriateness, the obligation to take all reasonable steps to obtain the best possible result for clients when executing orders, conflicts of interest and inducements.

When doing business with clients after 1 November 2007, you must comply with the requirements of the MiFID Regulations. For example, the conduct of business requirements include obligations to:

- assess suitability or appropriateness in providing investment services to clients;
- obtain the client's consent to your order execution policy when you execute orders, or arrange for execution of orders, on behalf of a client;
- ensure you provide clients with the information specified in the MiFID Regulations, e.g., information in relation to the firm and its services, costs and charges, and risk information; and
- ensure you have categorised your clients as retail, professional or eligible counterparty and have notified them of their categorisation if that has changed.

You should also note that you may have further organisation, reporting, record keeping and other obligations under the MiFID Regulations that are not addressed in this document.

Interpretation

The contents of this document are intended to provide a helpful guide to the provisions of the MiFID Regulations. It does not amount to, and should not be regarded as amounting to, legal advice from the Financial Regulator or any other person or group. It is intended to restate the obligations set out in the MiFID Regulations in a way that may answer some questions that firms may have. The primary obligations remain in the MiFID Regulations and it is the MiFID Regulations to which a firm must turn to consider the full extent of its obligations. If necessary, a firm should seek legal advice in relation to the application of the MiFID Regulations to specific sets of circumstances. It is not possible, nor have we tried, to address all the myriad circumstances that can arise when conducting the business of providing investment services to clients.

When this document refers to 'investment firms', this should be understood to also apply to 'credit institutions' where applicable. Many of the obligations set out in the MiFID Regulations also apply to credit institutions when providing investment services.

1. CLIENT CATEGORISATION

The MiFID Regulations set out a three-tier categorisation system classifying parties as a) professional clients[3], b) retail clients[4] or c) eligible counterparties[5]. The MiFID Regulations attach different levels of regulatory protection and approaches to each party depending on the category he/she falls into.

The MiFID Regulations envisage some flexibility for clients to upgrade or downgrade between categories to obtain more or less regulatory protection.

Question 1.1
How do I decide whether a client should be newly classified as Retail, Professional or Eligible Counterparty under the MiFID Regulations?

Answer 1.1

(1) The MiFID Regulations specify that certain entities should automatically be regarded as professional. These include entities authorised or regulated to operate in financial markets, large undertakings, pension funds, collective investment schemes, national and regional governments, and institutional investors whose main activity is to invest in financial instruments[6].

(2) All other clients can be defined as a ***retail*** client and this category offers the highest level of MiFID protection.

(3) For certain types of services, clients who meet the criteria set out in Regulation 111 of the MiFID Regulations, may be categorised as eligible counterparties. These include investment firms, credit institutions, insurance companies, UCITS funds and their management companies and pension funds and their management companies. The services concerned are executing orders on behalf of clients, dealing on own account and receiving and transmitting orders. Thus, for these services only, certain of the clients who qualify to be treated as professional clients in (1) above, may be treated as eligible counterparties.

Retail clients may be treated as professional on request and thereby waive some of the protections afforded under the conduct of business regime[7]. The firm must be able to show that the client possesses the market knowledge and experience to make investment decisions and understand the risks involved. The MiFID Regulations specify a test for this, which is that the client must meet **two of the following three criteria**. The client must have:

a. carried out an average of 10 relevant transactions per quarter over the previous four quarters;
b. a relevant portfolio exceeding €500,000;
c. worked for at least one year in a relevant professional position in the financial sector.

In addition to the above assessment, the following procedure must be followed:

- the client must state in writing that he/she wishes to be treated as a professional client;
- the firm must give a clear written warning of the protections the client may lose; and
- the client must state in writing that he/she is aware of the consequences of losing such protections.

[3] Professional client is required to meet the criteria laid down in Schedule 2 to the Regulations.
[4] Retail client is one who is not a professional client. (Regulation 3).
[5] Eligible counterparty defined in Regulation 111(1).
[6] Paragraph 2 of Schedule 2 of the Regulations.
[7] Paragraph 3 of Schedule 2 of the Regulations.

Question 1.2
My firm provides investment advice and portfolio management services to clients. I understand that there is a new client category under the MiFID Regulations called eligible counterparty aimed at more sophisticated clients. Will I be able to apply this client categorisation to my clients?

Answer 1.2

The MiFID Regulations adopt two main categories of client, retail and professional. There is a separate and distinct third category called eligible counterparty for a limited range of business. As with the existing regulatory regime, the MiFID Regulations attach different regulatory protections to each of these categories. Thus, clients falling into the retail category, deemed to be less experienced, knowledgeable and sophisticated investors, will be afforded a higher level of protection than that afforded to investors in the professional or eligible counterparty categories.

The facility to categorise a client as an eligible counterparty is limited to the following specific types of business:

- executing orders on behalf of clients; and/or
- dealing on own account; and/or
- receiving and transmitting orders.

Since treatment of clients as eligible counterparties is restricted to the above circumstances, if a firm is providing the services of advising and portfolio management a client may not be treated as an eligible counterparty irrespective of how sophisticated he/she may be.

Question 1.3
What obligations do I have to an eligible counterparty?

Answer 1.3

Due to the fact that eligible counterparties are the most experienced type of client they are afforded a lower level of protection under the MiFID Regulations. Specifically, the MiFID Regulations provide for the fact that where an investment firm is providing certain services to an eligible counterparty the general conduct of business and best execution obligations <u>do not</u> apply[8]. An investment firm which enters into a transaction with an eligible counterparty other than those entities that are considered eligible counterparties in accordance with Regulation 111(1) must obtain the express confirmation from the prospective counterparty, either in the form of a general agreement or on a transaction-by-transaction basis, that it agrees to be treated as an eligible counterparty.

[8] Regulation 111(2).

Question 1.4
How do I decide if a corporate client (such as a company or a trust) has "worked for at least one year in a relevant professional position in the financial sector?"

Answer 1.4

You should consider the person or persons authorised to carry out transactions on behalf of your client – for example, your client company has a Chief Financial Officer with relevant experience and qualifications and the client's decisions are being made through the authority and expertise of the Chief Financial Officer.

Where a corporate client company has the benefit of expert advisers, you may wish to consider the advisers' experience in deciding the client categorisation. In this situation, you should be satisfied that the expert adviser's experience is relevant to the transactions or services envisaged, and that your client can use the advice received to understand the risks involved in its investment decisions.

Question 1.5
Do I have to communicate MiFID categorisations to my clients?

Answer 1.5

Customers that are new to the firm after 1 November 2007 as well as those customers whose categorisation has changed under the MiFID Regulations need to be notified of their categorisation.

In addition, clients who requested treatment as professional clients under existing Codes of Conduct and who will continue to be treated as professional clients under the MiFID Regulations must be informed about the conditions for the categorisation of clients, which are set out in Paragraph 3 of Schedule 2 of the MiFID Regulations.

Question 1.6
Do I have to inform clients of the possibility of changing their MiFID categorisation?

Answer 1.6

Yes. You should advise:

- retail clients that they may request a change to professional categorisation once they meet the necessary criteria;
- professional clients that they may request a change to retail categorisation or eligible counterparty categorisation;
- eligible counterparties that they may request a change to retail or professional categorisation.

You should also inform your clients of the procedures for, and of the main consequences of, such changes.

Question 1.7

A client is seeking increased protection through a change in categorisation (in general or with regard to a product or transaction). What must I do?

Answer 1.7

This situation occurs when a professional client or eligible counterparty requests treatment as a retail client or when an eligible counterparty requests treatment as a professional client. In so doing, clients are exercising a right under the MiFID Regulations.

Your firm does not have to agree to the requests for recategorisation. You may provide the client with the reasons for the refusal, and options available to the client, though the MiFID Regulations do not oblige you to do so. You should retain good records of the request for categorisation change and the reasons for refusal, and pay particular attention to suitability and appropriateness checks in concluding any associated business.

Question 1.8

A client wants to "upgrade" his/her categorisation to gain access to business terms or services normally reserved for higher classes of clients which will decrease the level of protection afforded them. What should I do?

Answer 1.8

Clients may seek upgraded status through a change in categorisation in general or with regard to a product or transaction. This may be to gain access to business terms or services normally reserved for other classes of clients, or to preserve their standing and reputation.

- If a retail client requests treatment as a professional client with regard to a product or transaction, you should confirm that the client meets the eligibility criteria with regard to that product or transaction and follow the procedure outlined in Question 1.1[3]; if not, you should refuse the request.

- If a retail client requests treatment as an eligible counterparty, you should always refuse the request.

- If a professional client, other than those listed in Regulation 111[1], requests treatment as an eligible counterparty, you should obtain express confirmation that the client agrees to be treated as an eligible counterparty, either in the form of a general agreement or on a transaction-by-transaction basis. A professional client who has been categorised as such in accordance with Paragraph 3 of Schedule 2, i.e., "clients who may be treated as professionals on request", may only be permitted to opt up to eligible counterparty status for those services for which he/she has been treated as a professional client.

Your firm does not have to agree to the requests and may decline for good reason. You may provide the client with the reasons for the refusal, and options available to the client, though the MiFID Regulations do not oblige you to do so.

Question 1.9
Can I accept client furnished information in order to categorise clients under the MiFID Regulations?

Answer 1.9

Yes. A firm is permitted to take the information provided by the client, and can use this as the basis for its client categorisation, provided that the firm has acted reasonably in doing so. When considering the criteria for treating a retail client as a professional client, firms can take into account the fact that the client has developed experience through a business relationship with another firm. Of course, the firm should use its own sense of judgment, and if it comes to the firm's attention that certain information appears inconsistent or inaccurate the firm must take appropriate action. The firm should be able to rely on information provided by any other regulated investment firm. The firm may also rely on information provided by a third party acting on behalf of the client provided the firm has no reason to doubt the accuracy of the information.

Question 1.10
Do firms have an obligation to monitor that clients continue to meet the stated criteria?

Answer 1.10

Retail clients do not require monitoring as they hold the highest level of protection afforded under the MiFID Regulations.

The MiFID Regulations require professional clients, including those who have requested treatment as eligible counterparties, to keep the firm informed of any change that could affect their categorisation. As a result, it is not necessary to monitor such clients to ensure they continue to satisfy the criteria. However, firms should draw clients' attention to this obligation in their terms of business and, if the firm becomes aware that the client no longer fulfils the criteria for treatment as a professional client, it must take appropriate action.

Question 1.11
Our firm's customers, both institutional and corporate, fit comfortably within the definition of professional client. May I categorise any of these clients as an eligible counterparty and what requirements must I fulfil?

Answer 1.11

Yes. A client which meets the criteria of professional client may be considered and categorised as an eligible counterparty subject to written notification to the client of eligible counterparty status and, for clients other than those listed in Regulation 111(1), express confirmation of the client's agreement to be treated as an eligible counterparty. The client should also be advised of the right to request higher protection generally or on a product or transaction basis.

Question 1.12

Under the Code of Conduct for Investment Business Services of Credit Institutions, I automatically treated the following types of customers as professional clients:

- **Companies with securities listed on any EEA regulated market**
- **Non-listed companies with called-up share capital or net assets of at least €12.5m**
- **A partnership or unincorporated association with net assets of at least €12.5m**

Can I grandfather these clients to professional status under the MIFID Regulations?

Answer 1.12

Entities that are automatically considered professional clients under existing Codes of Conduct and are also included in the categories of clients listed in Paragraph 2 of Schedule 2 of the MiFID Regulations can continue to be considered professional clients.

Entities that are automatically considered professional clients under existing Codes of Conduct but are not included in the categories of clients listed in Paragraph 2 of Schedule 2 of the MiFID Regulations cannot automatically be considered professional clients but must be subject to an assessment by the firm and meet the criteria set out in Paragraph 3 of Schedule 2 of the MiFID Regulations.

Question 1.13

Under the existing Codes of Conduct for Investment Business Services, certain individual clients opted up to professional client status in accordance with the procedures set out in those Codes. Can I treat these clients as professional clients under the MiFID regime?

Answer 1.13

Clients who were granted treatment as a professional client in compliance with the existing Codes of Conduct for Investment Business Services may continue to be treated as professional clients under the MiFID Regulations, provided that this categorisation has been granted on the basis of an adequate assessment of the expertise, experience and knowledge of the client which gives reasonable assurance that the client is capable of making his/her own investment decisions and understands the risks involved. Such an assessment is a requirement under the existing Codes of Conduct.

Investment firms must inform such clients about the conditions established in the MiFID Regulations for the categorisation of clients, including the obligation on professional clients to advise the firm of any change that could affect their categorisation.

2. SUITABILITY AND APPROPRIATENESS

Suitability

Suitability tests are required to be conducted by an investment firm to ensure that its investment advice or its portfolio management services are suitable for a potential client (whether a retail or professional client)[9].

Firms must obtain sufficient information about the client to enable them to make an adequate and objective assessment of an investment's suitability. Suitability for these purposes must be based on the client's relevant experience, knowledge, financial situation and investment objectives.

Where a potential client does not provide the required information the investment firm should not recommend investment services or products to the potential client[10].

Appropriateness

Sufficient information about the client must be obtained by an investment firm to assess the client's experience and knowledge and ultimately to assess the appropriateness of the investment firm's investment services and activities for the client.

Sufficient information includes an assessment of the types of service and financial instrument with which the client is familiar, the nature, volume and frequency of the client's transactions and the client's level of education and profession[11].

Investment firms are obliged to warn their client if they conclude that a particular investment service or product is inappropriate[12]. Where sufficient information is not forthcoming from a client the firm must warn the client that it cannot determine whether the service or product is appropriate[13].

Question 2.1
What is the difference between "Suitability" and "Appropriateness"?

Answer 2.1

"Suitability" must be determined where a firm provides investment advice or portfolio management services to a client. A firm may conclude that a product or transaction is suitable for a client where it reasonably determines:

- that the client is able to financially bear the investment risks (including actual losses or loss of access to funds) in the context of the investment objective/strategy of the client and the type of client;
- it meets the objectives of the client; and
- the client can understand the risks involved in the investment.

---

[9] Regulation 94.
[10] Regulation 94(6).
[11] Regulation 94(9).
[12] Regulation 76(5).
[13] Regulation 76(6).

"Appropriateness" must be determined where providing services other than portfolio management and investment advice. However, when executing or receiving and transmitting orders in non-complex instruments at the initiative of the client, it is not necessary to determine appropriateness provided the firm has informed the client that it is not required to assess for suitability and that the firm complies with the conflicts of interest obligations[14]. A firm may conclude that a product is appropriate where it reasonably determines that the client understands the risks involved in the investment.

Question 2.2
Is there a list of the data I have to gather to determine suitability and appropriateness? Is there a standard form?

Answer 2.2

As there are many potential investment services, and the appropriate information will vary by service and by client, the MiFID Regulations do not provide a single list of data items that must be collected. The MiFID Regulations do, however, list the types of information you should consider in determining suitability and appropriateness, and says that you should gather the necessary information in the context of the client type and service provided. The types of information required to assess suitability relate to the client's:

- knowledge and past experience
- financial situation
- investment objectives.

The information required to assess appropriateness relates to the client's:

- knowledge and past experience.

Question 2.3
What will need to be obtained in respect of past experience?

Answer 2.3

The types of service, transaction and financial instrument with which your client is familiar and the nature, volume and frequency of such relevant transactions as well as the level of education and profession of your client, all form part of your client's experience. Firms may apply their own judgment as to the extent and level of detail that is necessary for the firm to satisfy its obligations in relation to the assessment of suitability or appropriateness.

It would be expected that a client's experience, if any, with your firm would be taken into account. You can accept a client's information on their past activity without requiring production of evidence such as statements of activity with other firms.

---

[14] Regulation 99(1).

Question 2.4
What will need to be obtained in respect of education?

Answer 2.4
The MiFID Regulations state that relevant information regarding the client's knowledge and experience includes level of education and profession. However, this information only needs to be obtained to the extent appropriate to the nature of the client, the nature and extent of the client's relationship with the firm, the client's general level of professional experience, the nature and extent of the service and the type of product or transaction, including their complexity and the risks involved. Firms can use their own judgement in relation to the extent of information that may be required to satisfy the firm's obligations.

Question 2.5
What will need to be obtained in respect of financial situation?

Answer 2.5
The source and extent of a client's regular income, assets, investments and regular financial commitments are all types of financial information that may be relevant to MiFID products or services for a client.

Firms must obtain some financial information but can use their own judgement as to what information is relevant to the products or services under discussion.

Question 2.6
Is it necessary to have all of this information in one document, such as a fact-find?

Answer 2.6
No. The information does not have to be in one document. The necessary information can be gleaned and stored in a variety of ways, once it is accessible and can be retrieved when required. For instance, the minutes of a series of meetings could form part of the Know Your Client information record.

Question 2.7
What are the consequences of non-provision of Know Your Client information?

Answer 2.7
A firm will generally require some level of Know Your Client information to address other obligations, such as anti-money-laundering requirements. The extent to which you can provide MiFID services depends on the level of information you have about a client, and the services that the client requests.

Investment advice and portfolio management
The MiFID Regulations[15] set out the specific types of information required before the services of investment advice or portfolio management can be provided. If a client does not provide this information, your firm cannot recommend investment services or financial instruments. However, you may be able to provide such a client with other services, such as reception and transmission of orders.

---

[15] Regulations 76 and 94.

Execution and/or receipt and transmission of orders in non-complex instruments (Execution-only business)

Firms may provide services that only consist of execution and/or receipt and transmission of orders without obtaining Know Your Client information, as outlined in Answer 2.2 above, provided the following conditions are met:

- the service relates to non-complex instruments;
- it is provided at the initiative of the client;
- the client has been clearly informed that the firm is not required to assess suitability; and
- the firm complies with the conflicts of interest requirements.

Other services

The firm must warn the client that the non-provision of sufficient information regarding his/her knowledge and experience will not allow the firm to determine whether the product or service is appropriate[16].

Question 2.8

The MiFID Regulations detail certain criteria that a financial instrument must meet in order for it to be considered non-complex (in addition to those instruments included in Regulation 99). What should I do in order to classify an instrument as non-complex?

Answer 2.8

The MiFID Regulations state that in order for a financial instrument to be considered non-complex, it must meet the following criteria[17]:

- The instrument in question is not a derivative,
- The instrument is highly liquid,
- The instrument does not involve an actual or potential liability which exceeds the cost of acquiring the instrument, and
- Adequate information on the instrument is publicly available and easily comprehensible.

A firm must assess whether or not a financial instrument is non-complex in light of the above criteria. Any such decision should be well documented and contain the reasons for determining that the instrument meets the criteria set out in the MiFID Regulations. For example, shares that are listed on the Irish Enterprise Exchange (IEX) do not automatically fall within the scope of non-complex instruments as listed in Regulation 99. However, if any shares listed on IEX meet the criteria listed above, a firm may determine that these instruments are non-complex for the purpose of the MiFID Regulations. Similarly, if shares listed on the Alternative Investments Market (AIM) and shares listed on US regulated markets meet the criteria a firm may determine that these instruments are non-complex.

[16] Regulation 76(5) and (6).
[17] Regulation 95.

Question 2.9

How do the obligations to perform suitability and appropriateness checks differ between retail and professional clients?

Answer 2.9

Assessment of suitability

Retail:

As this category of client is afforded the highest level of protection, a firm must obtain all relevant information required by the MiFID Regulations depending upon the services offered.

Professional:

Some of the information required by the MiFID Regulations can be assumed in the case of professional clients, i.e.,

- When providing **investment advice or portfolio management services** to a professional client, a firm can assume that the client has the necessary level of knowledge and experience for the product or service for which the client has been categorised as professional.
- When providing **investment advice** to a client that automatically meets the criteria of a professional client (as defined in Paragraph 2 of Schedule 2 of the MiFID Regulations) a firm can also assume that the client is able to financially bear the risks in respect of the product recommended by the firm[18].

The assumption that a client may financially bear the risks involved may never be made in the case of retail clients or for portfolio managed services to professional clients.

Assessment of appropriateness

Retail:

As this category of client is afforded the highest level of protection, a firm must obtain all relevant information required by the MiFID Regulations depending upon the services offered.

Professional:

A firm can assume a professional client has the necessary knowledge and experience to understand the risks involved in relation to a particular product, service or transaction[19].

[18] Regulation 94(3).
[19] Regulation 94(8).

Question 2.10
What other factors should I take into consideration when relying on my client's categorisation as a professional in determining the level of Know Your Client information required?

Answer 2.10

In relying on your client's professional categorisation, you should ensure that the categorisation remains correct. For example:

1. If your professional client has used only non-complex instruments in the past and wants now to use complex instruments, you should ensure that the client still meets the criteria for *professional* categorisation with regard to these instruments. If not, your client may become a *retail* client for the purpose of these products or transactions.

2. If your professional client is trading in familiar instruments but significantly increases the volume or value of trades, you should ensure that the trading remains suitable in the light of the client's investment objectives.

Question 2.11
As regards the suitability and appropriateness obligations, can I rely on information already held for existing clients?

Answer 2.11

Under the appropriateness test (applicable to all services except for investment advice, portfolio management or certain transactions in non-complex instruments) a service or instrument can be deemed to be appropriate for a client, if you have information showing that the client has previously used the service/instrument (i.e., prior to 1 November 2007)[20].

However, under the suitability obligations (required in relation to investment advice or portfolio management) the firm is required to obtain the appropriate information for the client as set out in the MiFID Regulations.

Question 2.12
Does this Know Your Client information have to be gathered again from scratch?

Answer 2.12

No. If you believe your existing Know Your Client information to be accurate and up to date, you can use it in suitability and appropriateness assessments. If you believe you require additional information to complete these assessments, you should gather it separately.

[20] Recital 59 of MiFID Level II Implementing Directive.

Question 2.13

If a client employs a consultant or a professional advisor, whose remit it is to retain portfolio managers or seek investment advice (e.g., a pension fund employing a consultant, a company employing an accountant, or a personal client using the services of a regulated financial advisor) can a firm rely on the information provided by the consultant/advisor (even if the consultant is not regulated) for the suitability or appropriateness assessments?

Answer 2.13

Where information, such as the Know Your Client information specified in Regulation 94, is provided by a third party on behalf of a client, a firm can rely on such information provided the firm has no reason to doubt its accuracy.

A firm can rely on a recommendation made by another investment firm.

In all other cases, firms must obtain the necessary information, as outlined in Regulation 94, either from the client or from a third party acting on behalf of the client, to enable the firm to recommend an investment service or financial instrument that is suitable.

Where a professional firm (such as a law firm, accountancy firm or actuarial consultant) refers a client to an investment firm for discretionary portfolio management services and the professional firm has suggested a certain strategy for the portfolio, it will generally be reasonable for the discretionary portfolio management firm to manage the portfolio in accordance with the instructions without being obliged to check whether the proposed strategy is suitable for the client. Of course, the investments recommended or decided upon by the investment firm in such circumstances must themselves be suitable in the context of that strategy.

Where a client is subject to legal restrictions on investment, as in the cases, for example, of trustees of a pension fund or credit unions, information in relation to such restrictions will be relevant when performing the assessment for suitability. A firm cannot assume that all legally permissible investments are suitable and must ensure that the proposed investment is suitable having given due consideration to the client's knowledge and experience, financial situation and investment objectives.

Of course, the circumstances will vary in individual cases and the Financial Regulator will take into account all of the relevant facts that are available, or that reasonably should have been available, to an investment firm when considering compliance with the obligations of suitability and appropriateness. It is not possible to prescribe precise steps for all given cases as the circumstances of each case may dictate or require differing consideration, and will depend on the facts of any given case.

Question 2.14

Can firms rely on existing client information and knowledge to meet the 'knowledge and experience' requirements of the MiFID suitability and appropriateness tests?

Answer 2.14

Yes. Firms may rely on existing client information and knowledge for the purpose of meeting the 'knowledge and experience' requirement under suitability and appropriateness tests. Firms are not obliged to re-confirm this information as part of any fact-find exercise, provided they are satisfied that the information is sufficiently accurate and up to date for this purpose.

Question 2.15
Where appropriateness has been established for a client for given MiFID categories of investment services and/or financial instruments, is there any obligation to re-establish appropriateness for subsequent transactions in those same categories?

Answer 2.15
There is no need to re-establish appropriateness for subsequent transactions within the same category of investment services and/or financial instruments, unless the client advises the firm of a material change to their circumstances which would impact on the firm's existing determination of appropriateness.

A firm may decide to establish appropriateness for certain product types at the start of the relationship so that the firm does not need to establish appropriateness for each new transaction in those product types.

Question 2.16
If a firm has obtained the information required to determine appropriateness, is the firm under an obligation to update this information where the client does not transact in a complex instrument immediately?

Answer 2.16
The MiFID Regulations do not specify when the information should be sought prior to providing the service so firms need to decide this for themselves. However, where information has been obtained significantly in advance of the provision of the service, a firm may need to consider whether the information should be updated[21].

Question 2.17
Where a firm determines, on the basis of sufficient information from the client, that a proposed transaction or service is not appropriate to that client, and having warned the client in the prescribed format, can the firm complete the transaction on the customer's instruction?

Answer 2.17
Yes. Where a client requests the firm to proceed with a transaction and the firm has provided the required warning, it may proceed on the client's instruction.

[21] Regulation 94(11).

3. INFORMATION TO CLIENTS

Prior to making an investment decision, clients must receive adequate information to assist them in making an informed decision. For example, retail clients must receive general information about the investment firm and the services which it provides[22]. Clients must also receive sufficiently detailed information about the specific type of financial instrument[23] and information about the costs and charges involved[24].

Question 3.1
Initially what information should firms send to retail clients?

Answer 3.1

One of the key changes introduced under MiFID is the significant increase in the volume of information which must be given to retail clients. As retail clients are provided with a greater amount of protection they are required to be provided with more detailed information in order to assist them in making their investment decisions. One of the new information requirements under the MiFID Regulations is the obligation to notify new clients and clients whose categorisation has changed of their client categorisation[25]. Other information requirements include providing retail clients with general information about your firm and its service[26], information about the specific type of financial instrument, the terms of their agreement with you, the nature and risk of the product they are buying and the costs and charges that the retail client has to pay.

A table of the key information requirements under the MiFID Regulations for retail and professional clients is contained in Appendix 1. Please note that this table is provided to assist you in identifying your obligations and is not intended to be exhaustive.

Question 3.2
Initially what information should firms send to professional clients?

Answer 3.2

Professional clients are perceived as being more sophisticated investors. They are regarded as being equipped with the relevant knowledge, experience and expertise to take an investment decision and properly assess the risks that it incurs. Less detailed information is therefore required to be given to professional clients.

For more information, see tables in Appendix 1.

---

[22] Regulation 82.
[23] Regulation 84.
[24] Regulation 92.
[25] Regulation 81(1).
[26] Regulation 82.

Question 3.3
What information do I need to provide to my existing clients under the MiFID Regulations?

Answer 3.3

The information to be communicated to a firm's existing clients may vary depending on your client's categorisation and the services that the firm provides. However, in general a firm must be able to demonstrate that the following information has been provided to its existing clients. Industry practice may vary as to whether such information will be provided in a single communication or as a series of separate communications.

- Supplementary Terms of Business/Management Agreement
- Notification of client categorisation (where applicable)
- Order Execution Policy/Execution Policy as applicable (depending on whether the firm is an entity that executes client orders or transmits/places orders for execution)
- Summary of conflicts of interest policy to retail clients.

Firms should be conscious that the obligation to provide information to their clients may overlap with other MiFID obligations such as record keeping. The Financial Regulator will draw up a list of minimum records that will assist investment firms in determining which records they will be required to maintain[27].

Question 3.4
Post MiFID, what information do I need to send to new clients that are classified as eligible counterparties?

Answer 3.4

The full conduct of business rules and the detailed information disclosure provisions do not apply to eligible counterparties. Under Regulation 81 of the MiFID Regulations a firm must only notify these clients of their categorisation as eligible counterparties and any rights which they may have to request a different categorisation. Eligible counterparties typically would include capital market participants such as investment firms and banks.

Question 3.5
Must I send all my information to my client by post? Can I provide information by another means, for example, directing him/her to a webpage?

Answer 3.5

The MiFID Regulations require certain information to be provided in a durable medium. This may include provision via a website where the website qualifies as a durable medium according to the criteria in the MiFID Regulations[28].

The MiFID Regulations also allow some information to be provided by means of a website that does not qualify as a durable medium, as long as the website satisfies certain other criteria[29].

---

[27] Regulation 40(5).
[28] Regulation 3.
[29] Regulation 77(2).

Information that must be provided in a durable medium includes information about conflicts of interest policy, information concerning client categorisation, and periodic statements. Information that may be provided by means of a website (where that does not constitute a durable medium) includes information to retail clients about the firm and its services, financial instruments and execution policy.

A durable medium is defined as "any instrument which

a) enables a client to store information addressed personally to that client in a way accessible for future reference and for a period of time adequate for the purposes of the information, and
b) allows the unchanged reproduction of the information stored".

Where information must be provided in a durable medium, it may be provided in a durable medium other than paper if that medium is appropriate and if the client, when offered a choice between paper and that other medium, specifically chooses that medium.

Where information may be provided by means of a website and that information is not addressed personally to the client, firms must ensure that this is an appropriate medium in the context of the business to be carried out. A firm can electronically notify and direct clients to a relevant website address. However, clients must specifically consent to receive the information in this manner and the information has to be up to date and continuously available on the webpage to ensure that the client may access it.

Question 3.6
When should information be given?

Answer 3.6

Retail clients must be given adequate information before they make an investment decision, to enable them to make a decision on an informed basis[30]. As retail clients are regarded as being less experienced they are given more detailed information. They must also be given such information 'in good time', before the provision of services so that they have sufficient opportunity to read and understand the specific information provided before taking an investment decision. Industry practice will vary as to what 'in good time' will entail, depending of course on the nature of the product and the client and what is reasonable in the circumstances.

On occasion, the nature of the transaction may require flexibility in the timing of the provision of information. An investment firm may provide the required information after a contract has been concluded in limited circumstances. Typically, this would occur where a client has specifically requested that the contract be concluded via electronic means. The use of distance communication may prevent the firm from providing the information at an earlier stage [31].

For example, where a client wants to buy shares immediately in a listed company on an execution-only basis, there is no requirement for a firm to wait until a certain period has elapsed in between providing information to the client and trading for the client. However, this approach may not be appropriate in all cases and is dependent upon the nature of the product and service being offered by the firm. It is up to each firm to take a reasonable approach as to the appropriate interpretation of this requirement.

[30] Regulation 81.
[31] Regulation 81(7)(b)(i).

Question 3.7
Must I change my advertising practices under the MiFID Regulations? What will I be required to do? Does it only apply to retail clients?

Answer 3.7

The MiFID Regulations provide that any marketing communications should be clearly identified as such[32]. Although advertising is not an investment or ancillary service under the MiFID Regulations, firms must be careful to ensure that the content of their advertising complies with the requirement that information must be fair, clear and not misleading.

An investment firm is under an obligation to act in the best interests of its clients[33]. Regulation 76(2)(a) provides that: "All information, including but not limited to marketing communications, addressed by an investment firm to clients or potential clients is fair, clear and not misleading"[34].

Clients in this instance, means all clients (including potential clients) and not merely retail clients. However, there are specific requirements in place in relation to the provision of marketing communications to retail clients[35]. Many of these requirements should already be familiar to firms from existing legislation, codes and industry practice. Regulation 152(1) provides for certain restrictions in relation to advertising whereby firms should not advertise for services where the provision of such services would be in breach of Regulation 7, i.e., a firm advertises the provision of services for which it does not hold the appropriate authorisation under the MiFID Regulations. A due diligence exercise should be conducted to review existing business practices with respect to advertising and sale of products and services as MiFID provisions have higher level requirements than those under the ISD.

Question 3.8
Our firm transacts both MiFID and non-MiFID business. Does this mean that we should have separate "Terms of Business" documents?

Answer 3.8

It is not necessary to have separate "Terms of Business" documents given the common areas which exist under the MiFID Regulations and the Consumer Protection Code. A single Terms of Business document must meet the relevant requirements of both the MiFID Regulations and the Consumer Protection Code.

---

[32] Regulation 76(2)(b).
[33] Regulation 76(1).
[34] Regulation 76(2).
[35] Regulation 80.

Question 3.9
In general what types of information should I consider providing to my clients prior to the provision of MiFID services?

Answer 3.9

This will depend both upon the client's categorisation and the services provided. In general, prior to the provision of MiFID services a firm should provide the following information to retail and professional clients:

Content	Retail	Professional
Written agreement[36]	✔	N/A
Inducements and fees paid to third parties[37]	✔	✔
Client's categorisation under MiFID[38]	✔	✔
The firm and services to be provided[39]	✔	N/A
Nature and risks of financial instruments[40]	✔	✔
Safeguarding of clients instruments[41]	✔	✔
Costs and associated charges[42]	✔	N/A
Conflicts of Interest: - Disclosure of conflicts[43] - Description of policy[44]	 ✔ ✔	 ✔ N/A
Order execution policy[45]	✔	✔

A more detailed table has been included at Appendix 1 to assist firms in understanding their obligations under the MiFID Regulations in respect of the provision of information to clients.

Question 3.10
I wish to send promotional material related to a MiFID complex instrument to my clients. Do I have to assess appropriateness prior to provision of the material?

Answer 3.10

No. The promotional material must meet the obligations detailed in Regulation 80. The appropriateness test must be conducted prior to the completion of the transaction or entering into the service, not prior to sending the promotional material itself. A firm will need to consider whether promotional material (in complex or non-complex instruments) is personalised as this may constitute investment advice.

---

[36] Regulation 94(12).
[37] Regulation 78(2).
[38] Regulation 81.
[39] Regulations 82 and 83.
[40] Regulation 84.
[41] See separate Financial Regulator's Client Money Requirements.
[42] Regulation 92.
[43] Regulation 74(2).
[44] Regulation 82(h).
[45] Specific Best Execution obligations vary depending on whether the firm is "executing orders" or "transmitting/placing orders with other entities for execution".

Question 3.11

I provide portfolio management services, managing portfolios in accordance with mandates given by clients on a discretionary and non-discretionary basis. Do the MiFID Regulations make a distinction in respect of the information that I am required to provide the client about the nature of the agreement between us?

Answer 3.11

Unlike the present Codes of Conduct for investment services, the MiFID Regulations do not distinguish between discretionary and non-discretionary clients in relation to the provision of a Terms of Business or Investment Management Agreement document. Rather the requirements under the MiFID Regulations are set out on the basis of whether the client is a retail or professional client and the nature of the service being provided.

Thus, the MiFID Regulations do not expressly require firms to provide client agreements to professional clients. Nor do the MiFID Regulations expressly require an agreement in situations where the firm is only providing investment advice, although in both instances a firm may choose to do so for commercial reasons.

The MiFID Regulations require firms that provide services other than investment advice to retail clients to provide them with a written agreement setting out the essential rights and obligations of the firm and the client. They also include requirements to retain records of documents that set out the terms on which the firm will provide services to its clients for at least the duration of the relationship and in any event for at least five years.

Question 3.12

What should firms do, when providing the service of portfolio management, to establish an appropriate method of evaluation and comparison to enable the client to assess the firm's performance?

Answer 3.12

Where possible, a range of appropriate indices should be used to benchmark portfolios. In the case of complex instruments, an appropriate method of evaluation should be agreed in advance with each individual client.

4. REPORTING TO CLIENTS

Clients have a right to be informed on a regular basis and in sufficient detail of the type of service that is provided to them. There are three main reporting requirements to clients under the MiFID Regulations, namely reporting obligations in the case of portfolio management[46], reporting obligations other than portfolio management[47] and reporting obligations relating to financial instruments or funds belonging to clients[48].

Firms should be advised that the reporting obligations in relation to client funds are outside the scope of this paper. Accordingly, firms should familiarise themselves with the Financial Regulator's Client Money Requirements.

Question 4.1
What ongoing client reporting obligations do I have to my clients under the MiFID Regulations?

Answer 4.1
Reporting obligations are set out in Regulations 96 and 101. The obligations differ according to client categorisation (i.e., whether the client is a retail or professional client) and type of service provided (i.e., whether the service being provided to the client is portfolio management or the service relates to the execution of clients orders other than for portfolio management).

Execution of Orders other than for Portfolio Management
Where the service being provided is the " execution of orders other than for portfolio management", the primary obligation is to provide contract notes in respect of each transaction. If the service is provided to retail clients, the contract notes must contain all of the information specified in Regulation 96(6) [which is set out in Appendix 2] and they must be sent to the client within a specified time period (as soon as possible and no later than the first business day following execution or receipt of the confirmation from a third party). If the service is being provided to professional clients then the firm must provide the client, in a durable medium, with the essential information concerning the execution of the order.

Portfolio Management
If the service being provided to the client is "portfolio management" then the primary obligation is to provide the client with a periodic statement in a durable medium. The content and frequency is not prescriptive in the case of professional clients and industry practice may vary.

In the case of retail clients the periodic statement must include the information listed in Regulation 96(10). If the retail client has elected to receive contract notes containing the information required by Regulation 96(6) on a transaction-by-transaction basis, this information does not have to be provided again in the periodic statement. For example, a firm which currently provides its clients with contract notes may decide to continue providing information about executed transactions to its portfolio managed clients in this way rather than in periodic statements.

Regulation 96(11) requires that periodic statements must be provided to retail clients at a minimum of once every 6 months. However, where requested the periodic statement must be provided once every 3 months[49] and a firm must inform its retail clients that they have the right to make this request.

---

[46] Regulation 96(9) to (17).
[47] Regulation 96(1) to (8).
[48] Regulation 96(18) to (22).
[49] Regulation 96(11)(a).

If the retail client has elected to receive contract notes containing the information required under Regulation 96(6) on a transaction-by-transaction basis and the client does not trade in derivatives, the periodic statement need only be provided once every 12 months. However, if the retail client authorises the firm to manage a leveraged portfolio in its agreement then the periodic statement must be provided once a month.

Question 4.2
I provide a service in respect of the execution of orders other than for portfolio management and I provide my retail clients with contract notes containing the information required under Regulation 96(6). Do I also have an obligation under the MiFID Regulations to send my clients a periodic statement?

Answer 4.2

No. There is no obligation under the MiFID Regulations to send a periodic statement to clients where the service provided is in respect of the carrying out of an order other than for portfolio management. However, where the firm holds client financial instruments or funds there are additional periodic reporting requirements. These are contained in the Financial Regulator's Client Money Requirements.

Question 4.3
My firm provides portfolio management services. Do I have an obligation under the MiFID Regulations to send my clients contract notes?

Answer 4.3

No. However, your clients may elect to be provided with contract notes. If a retail client elects to be provided with contract notes, they must include the information required under Regulation 96(6). The contract notes must be provided within the timescales stipulated in the MiFID Regulations. If a professional client elects to receive contract notes on a transaction-by-transaction basis, they must be provided promptly and contain the essential information concerning the transaction in a durable medium.

Question 4.4
The MiFID Regulations require that information regarding fees and charges must be detailed in the periodic statement, including details in relation to the costs associated with execution. I currently provide my clients with detailed information regarding costs such as ITP levy, stamp duty and commissions in the contract note. Do I need to repeat this information in the periodic statement?

Answer 4.4

No. Where this detailed information has already been provided to the client there is no need to provide it again as this would be a duplication of information already provided. Instead, a firm should detail any costs and charges in the periodic statement not previously provided to the client and include an explanation that a more detailed breakdown of charges had already been provided on the individual contract notes.

Question 4.5
I manage leveraged portfolios on behalf of my retail clients; does this affect the frequency of reporting?

Answer 4.5
Yes. The MiFID Regulations require that where a retail portfolio managed client holds a leveraged portfolio the periodic statement must be provided monthly.

Question 4.6
A number of our retail clients have authorised the firm in their agreements to manage a leveraged portfolio on their behalf. However, while we have the discretion to manage their portfolios on a leveraged basis, we have not as yet availed of this discretion. Do we have to provide these clients with a monthly statement or can we provide a six-monthly statement until such time as we avail of our discretion to use leverage?

Answer 4.6
Where an agreement between a firm and a retail client authorises a leveraged portfolio but the firm has not yet exercised that authorisation, the periodic statement may be provided once every six months provided the firm has strict controls in place and:

- the client is notified in advance that the firm intends to exercise the authorisation, and
- periodic statements are provided monthly once the authorisation has been exercised.

Question 4.7
I currently send my portfolio managed clients contract notes. What additional reporting obligations do I have under the MiFID Regulations?

Answer 4.7
In the case of <u>retail</u> portfolio managed clients you also have an obligation to send the client a periodic statement containing the information required under Regulation 96(10). If the contract notes contain all of the information listed in Regulation 96(6), are provided in accordance with Regulation 96(1)(b), and do not relate to derivatives, then the periodic statement must be provided at least once every 12 months. Otherwise, it must be provided once every six months although the client may request a statement every three months. However, if the portfolio is leveraged, the retail client must be sent a monthly statement irrespective of whether or not he/she has been provided with contract notes on a transaction-by-transaction basis.

If the firm holds financial instruments or funds on behalf of its clients, then the firm has additional reporting obligations under the Financial Regulator's Client Money Requirements. These obligations apply to professional clients as well as retail clients.

Question 4.8
I currently send my execution-only clients contract notes. What additional reporting obligations do I have under the MIFID Regulations?

Answer 4.8
If the firm holds financial instruments or funds on behalf of its clients, the firm has additional reporting obligations under the Financial Regulator's Client Money Requirements. These obligations apply to professional clients as well as retail clients.

Question 4.9
I currently provide my clients with periodic statements/contract notes in electronic form; can I continue to provide the information in electronic form under the MiFID Regulations?

Answer 4.9
Yes. The MiFID Regulations permit the provision of information in a durable medium other than paper where the provision of the information in that medium is appropriate, for example, where the client has an e-mail address and where the client has chosen to receive the information in that medium. If you currently provide your clients with this information electronically then you must be satisfied that the client has already chosen this method of communication.

Question 4.10
If a client advises in writing that he/she does not wish to receive contract notes or wishes to receive them on a periodic basis only, can I disregard the MiFID requirements in respect of contract notes in order to comply with my client's request?

Answer 4.10
Under the MiFID Regulations, where a firm is executing transactions other than for portfolio management, essential information must be provided promptly to professional clients and in the case of retail clients the detailed information listed in Regulation 96(6) must be sent no later than the first business day following execution (if the confirmation is received by the investment firm from a third party, no later than the first business day following receipt of the confirmation from the third party). There is no scope or flexibility to agree a different timescale with your clients.

If your client is a portfolio management client there is no requirement to provide contract notes. However, clients may elect to receive information from a portfolio manager on a transaction-by-transaction basis and if a retail client opts to receive contract notes he/she must be provided with the detail required under Regulation 96(6) within the timeframe set out above.

Question 4.11
I provide services to retail clients in respect of the receipt and transmission of orders in collective investment schemes only. Do I have an obligation under the MiFID Regulations to provide a contract note no later than the first business day following execution?

Answer 4.11
Under the MiFID Regulations retail client orders for units or shares in collective investment schemes which are executed periodically must comply with the detailed information requirements in respect of contract notes either upon every execution or at least once every six months.

5. INVESTMENT RESEARCH

Question 5.1
Investment research and marketing material are subject to certain requirements under the MiFID Regulations. The Market Abuse Regulations (MAD Regulations) also impose certain requirements on investment recommendations. How do the MiFID and MAD Regulations interact with each other?

Answer 5.1

Regulation 155 of the MiFID Regulations applies where a firm produces *investment research*[50] that is intended or is likely to be subsequently disseminated to the public. *Investment research* is a sub-category of *recommendations* as defined in the MAD Regulations. It is intended that the MiFID and MAD Regulations will operate together and therefore both sets of rules must be considered by the firm and applied where relevant. It should be noted that Part 3 of the MAD Regulations applies only to recommendations issued in respect of financial instruments admitted to trading on an EU regulated market (or for which such an admission has been sought) whereas the MiFID Regulations apply to investment research issued in respect of financial instruments (regardless of whether admitted to trading or not). For the purposes of the MiFID Regulations, material will not fall within the scope of *investment research* unless it is clearly labelled as objective and does not constitute investment advice.

Recommendations within the meaning of Part 3 of the MAD Regulations (which do not meet the requirements of *investment research* in the MiFID Regulations) will be treated as marketing material for the purposes of the MiFID Regulations and therefore they must be clearly identifiable as marketing material and contain a clear statement that the material has not been produced in line with the MiFID requirements designed to ensure objectivity. A firm must be aware of its obligations under the MiFID Regulations in respect of the management of conflicts of interest[51] and if the *recommendation* is distributed to retail clients there are specific requirements to ensure that the information is fair, clear and not misleading [52].

Question 5.2
How do I decide whether a piece of written material constitutes investment research, in order to apply the related obligations[53]?

Answer 5.2

The term *investment research* is designed to capture research material that contains a substantive analysis of one or more financial instruments. The publication of general material, for example, the analysis of a sector or commentary on the economy is not likely to fall within the definition of *investment research*. In order to determine whether more generic material falls within the definition of *investment research* a firm should consider whether the material is likely to influence an investor in respect of a particular financial instrument (i.e., is an investor likely to trade on the basis of the material?).

The issuance of sales notes and short term trading ideas internally within a firm and/or expressed to clients, which are not likely to become publicly available, do not fall within the definition of a *recommendation* [54] (and therefore do not constitute *investment research*).

---

[50] Regulation 151.
[51] Regulations 74 and 75.
[52] Regulations 76(2) and 80.
[53] Regulations 154(2)and 155.
[54] Recital 3; Commission Directive 2003/125/EC.

Question 5.3
What are the requirements contained in the MiFID Regulations where a firm produces "investment research"?

Answer 5.3

If your firm produces *objective investment research* publications, there are specific obligations that apply which are outlined in Regulation 155. In addition to these specific obligations, consideration must be given to the firm's general obligations in respect of the management of conflicts of interest[55] and if the *investment research* is available to retail clients there are specific requirements to ensure that the information is fair, clear and not misleading[56]. If your firm produces what is commonly referred to as *non-objective investment research*, this will be treated as a marketing communication for the purposes of the MiFID Regulations.

Question 5.4
The MiFID Regulations state that a financial analyst and other relevant person must not trade in a financial instrument where they have knowledge as to the likely timing or content of investment research[57]. Does this always prevent employees from dealing in financial instruments where they possess such knowledge?

Answer 5.4

The obligation contained in Regulation 155(2)(a) is there to ensure that financial analysts and relevant persons may not trade in financial instruments in the event that they have knowledge as to the **content** or **timing** of research which cannot be readily inferred from publicly available information until the recipients or intended recipients of the research have had a reasonable opportunity to act on the research.

The rule relates to exclusive knowledge and not to market knowledge or general market expectations as to the timing or content of research. For example, when considering whether a relevant person has knowledge as to the timing of research, the market may expect the publication of research in line with broker regular reporting dates or the financial reporting dates of a company. The rule does not prevent relevant persons of the firm from dealing merely because they expect (on the basis of generally available information) a firm's analyst to produce a piece of research which coincides with such dates.

Question 5.5
How will the prohibition on dealing ahead of research impact upon my market-making obligations?

Answer 5.5

The MiFID Regulations provide for the fact that a firm can trade in the ordinary course of its market-making activities. A firm may also trade on behalf of another person where executing an unsolicited client order[58].

---

[55] Regulations 74 and 75.
[56] Regulations 76(2) and 80.
[57] Regulation 155(2)(a).
[58] Regulation 155(2)(a)(ii).

6. BEST EXECUTION

Best execution is one of the most important changes to market practice which has been introduced by MiFID and will have a significant impact on firms which execute client orders.

The best execution obligations are contained in Regulations 97, 98 and 106 of the MiFID Regulations. Regulation 106 requires firms to take all reasonable steps when executing orders to obtain the best possible result for their clients taking into account price, costs, speed, likelihood of execution and settlement, size, nature or other relevant considerations. The obligations on firms that transmit orders to other entities for execution are set out in Regulation 98.

This section is divided into the following sub-sections:

- Application
- Content of policy
- Information to be provided to clients
- Consent
- Review and monitoring
- What should I do now?

Application

Question 6.1
What are the best execution requirements?

Answer 6.1
Best execution means that when an investment firm executes a client order it must take all reasonable steps to deliver the best possible result for its clients. It must take into account a variety of factors, such as the price, costs, speed, likelihood of execution and settlement, size, nature or other relevant considerations.

Firms must carefully consider and determine the relative importance of these factors by taking into account the characteristics of the client, the client order, the financial instruments and the execution venues to which the order can be directed. There is no requirement to quantify these factors. A firm's execution policy should, however, articulate how a firm typically assesses those factors and the circumstances where other factors may be more relevant.

Best execution obligations will vary depending on the nature of the client and his/her requirements. For example, for retail clients, there is an emphasis placed on "total consideration". The best possible result for a retail client will generally mean the most favourable result in terms of the price of the instrument and the costs associated with the execution (including exchange fees).

Firms must establish and implement an order execution policy which will set out the firm's decision-making process, for example, in selecting an appropriate execution venue for each order. Firms should implement procedures and arrangements to ensure client orders are executed promptly, fairly and expeditiously. Firms are advised to ensure that their records are properly maintained. For many firms that previously conducted transactions in-house, they may also have to consider external trading venues if these appear to offer better results for the client.

Question 6.2
Do the best execution obligations apply to all clients under the MiFID Regulations? Is it possible to contract out of MiFID's best execution obligations with specific client types?

Answer 6.2

The requirements will vary depending on the nature and activities of the firm in question. There are different best execution obligations depending on whether a firm executes client orders (i.e., concludes agreements to buy or sell one or more financial instruments on behalf of clients), in which case Regulation 106 applies, or transmits or places orders with other entities for execution, where Regulation 98 contains the relevant provisions.

The range of clients entitled to best execution extends to all retail and professional clients whenever a firm is acting on the client's behalf. The best execution obligations do not apply to certain transactions with eligible counterparties, i.e., executing orders, dealing on own account or receiving and transmitting orders. The obligations may apply to quote-driven business in certain circumstances. The European Commission has issued an opinion on this issue which is attached to the CESR guidance, *Best Execution - Questions and Answers.*

It is not possible to contract out of the duty of best execution.

Question 6.3
In relation to best execution, when does Regulation 106 apply, and when does Regulation 98 apply?

Answer 6.3

Regulation 106 applies to firms that execute orders on behalf of clients. Regulation 98 applies to firms which transmit the orders to other entities for execution.

CESR acknowledges that an execution chain frequently exists. It has indicated that the determining factor is whether the relevant firm gives an order directly to an execution venue, in which case Regulation 106 will apply, or whether the firm has the order intermediated in some way, in which case Regulation 98 will apply.

For example, in fixed income markets, when an order is given directly to a counterparty broker or any other executing venue by a firm, where that counterparty has previously provided a quote to the firm, the firm will be deemed to have executed the order as it has dealt directly with the execution venue. The firm will, in relation to this order, be subject to the regulatory provisions set out in Regulation 106.

Question 6.4
What is the difference in practice between Regulation 106 and Regulation 98?

Answer 6.4

The following table summarises the different requirements that apply to firms that execute orders compared with those that transmit orders to other entities for execution.

Execute orders or decisions to deal (Regulation 106)	Transmit or place orders with other entities for execution (Regulation 98)
Take all reasonable steps to obtain best possible result taking account of: • the factors set out in Regulation 106 • the criteria for determining the relative importance of the factors, as set out in Regulation 97, and • total consideration.	Take all reasonable steps to obtain best possible result taking account of: • the factors set out in Regulation 106 • the criteria for determining the relative importance of the factors, as set out in Regulation 97, and • total consideration.
Establish and implement effective arrangements and order execution policy.	Establish and implement policy.
Provide appropriate information to clients.	Provide appropriate information to clients.
• Obtain prior consent to policy. • Obtain prior express consent before executing orders outside a regulated market or MTF	
Monitor effectiveness of arrangements and policy to identify and correct deficiencies, in particular assess venues on a regular basis.	Monitor on a regular basis the effectiveness of the policy and in particular execution quality, and correct deficiencies.
Notify clients of material change to arrangements or policy.	
Be able to demonstrate that the firm has executed orders in accordance with the policy.	
Review policy and arrangements annually and when material change occurs.	Review policy annually and when material change occurs.
Provide retail clients with the following details, in good time: • relative importance of factors • list of execution venues the firm places significant reliance upon • warning regarding specific instructions.	

Question 6.5
In the event that my firm places/transmits orders to another firm, must the receiving firm have a MiFID compliant execution policy? If the firm has a MiFID compliant execution policy what does this mean for my firm?

Answer 6.5

A firm that transmits orders to another entity must ensure that the entity used has execution arrangements in place to enable the firm to comply with its obligation to obtain the best possible result for its client. It is not always essential that the entity to which an order is passed has a MiFID compliant execution policy in all aspects (e.g., where passed to a non-EEA firm). Additionally, where an entity has a MiFID compliant execution policy it is not intended that the firm transmitting the order duplicates the efforts of the executing firm. To this end, the firm must review the order execution arrangements of the entities it wishes to use to establish whether these will enable the firm to meet its obligations.

A firm would be able to place a high degree of reliance on an entity in the following circumstances:

- the entity is subject to Regulation 106 of the MiFID Regulations or undertakes by contract to comply with Regulation 106, and
- the firm merely transmits or places orders with the entity for execution, taking few steps itself that affect execution quality, and
- the firm has determined that the entity has arrangements that will enable the firm to comply with its obligations under Regulation 98 of the MiFID Regulations.

The firm would still be subject to the other requirements of Regulation 98 of the MiFID Regulations, in particular the requirements to implement an appropriate policy and to monitor and review its effectiveness. The firm could not continue to rely on the entity if its monitoring or review indicated that the entity was not, in fact, enabling it to obtain the best possible result for the execution of its client orders.

Question 6.6
Must an investment firm always achieve best execution for its clients for each and every transaction?

Answer 6.6

The MiFID Regulations do not require a firm to achieve best execution for each transaction for each individual client. Investment firms are required to take "all reasonable steps" to obtain best possible results for clients when executing orders[59]. This recognises that it is impractical for firms to guarantee the best possible result for each and every client order. Investment firms will have met the obligation when they have designed and implemented effective arrangements and an execution policy to allow them to deliver best execution and that overall, client orders benefit from the arrangements which the investment firm has in place.

However, investment firms should be satisfied that their execution arrangements are sufficient or satisfactory to achieve or deliver best execution on a consistent basis if such policies are properly applied and adhered to. Where there are a number of markets involved, a firm's execution policy should take into account the differing characteristics of the relevant markets. A firm should monitor its execution policy on a regular basis.

[59] Regulation 106(1).

Question 6.7
Does a firm have to demonstrate trade-by-trade that it has followed its execution policy?

Answer 6.7
Firms that execute orders must be able to demonstrate, at the client's request, that they have executed their orders in accordance with the firm's execution policy. The best execution obligation requires firms to obtain on a consistent basis the best possible result for the execution of client orders, but not on an order-by-order basis. CESR provides guidance as follows: "Firms ... are not under an obligation to obtain the best possible result for each individual order; rather they should apply their (execution) policies to each order with a view to obtaining the best possible result in accordance with the (execution) policy"[60]. In this regard, a firm will be considered to have met its best execution obligations in respect of trades once it can show that it followed its execution policy in respect of those trades and that its execution policy meets MiFID standards.

Question 6.8
What if a client complains that a firm did not achieve best execution for his/her order?

Answer 6.8
An investment firm should follow its complaints procedure with a view to resolving the issue.

Firms that execute orders are required to demonstrate to clients, on request, that they have executed the client's orders in accordance with the firm's order execution policy[61]. The MiFID Regulations recognise that such a policy cannot guarantee the best possible result for each and every client order. The client's complaint should also be considered as part of the firm's ongoing monitoring and periodic review of its order execution arrangements[62].

Question 6.9
What should a firm do if, in acting on a client's instructions, it fails to achieve best execution?

Answer 6.9
On occasion, firms will receive specific instructions from clients, for example, to execute only at a single venue of their choice or instruction relating to price limits. If an investment firm receives specific instructions from the client it must execute the order in accordance with that instruction. Client instructions will always prevail over a firm's best execution policy. In this case, a firm may be deemed to satisfy its best execution obligations where it acts on its client's specific instructions even where such instructions deviate from or conflict with a firm's existing best execution policies and procedures[63]. Firms are advised to keep appropriate records and to warn their clients that their instructions may deviate from the firm's best execution practices and arrangements.

[60] CESR/07-320 Q3.3
[61] Regulation 106(6)
[62] Regulation 106(5)(a) and 106(7)
[63] Regulation 97(3)

Question 6.10
What is the best execution requirement for customised OTC treasury instruments, such as currency options or swaps?

Answer 6.10

As with all instruments, you must take all reasonable steps to obtain the best possible result for your clients. You are obliged to provide appropriate information to your clients on your order execution policy and obtain their consent to the policy. For these instruments, express consent is not required[64].

Question 6.11
Do the best execution requirements apply to OTC derivatives? What factors should a firm bear in mind when endeavouring to obtain best execution on an OTC derivative structure?

Answer 6.11

The MiFID Regulations state that best execution applies to all financial instruments covered by the MiFID Regulations. This means that investment firms will need to have an execution policy in relation to such instruments. Best execution also applies in certain circumstances to quote-based business[65].

It is not expected that best execution obligations will be applied in the same manner in relation to different instruments. Recital 70 of the MiFID implementing Directive clarifies this by stating that, for example, transactions involving customised OTC financial instruments may not be comparable for best execution purposes with transactions involving shares traded on centralised execution venues.

CESR provides guidance on how an execution policy should be established. However, CESR has not provided any specific guidance in relation to best execution on OTC derivatives.

CONTENT OF POLICY

CESR provides detailed guidance in relation to the development of a firm's execution arrangements and policy. For further information please refer to Questions 4 to 13 of *Best Execution under MiFID - Questions and Answers.*

Question 6.12
Do all execution venues have to be listed in the firm's execution policy?

Answer 6.12

The execution policy should include information on the different venues used by the investment firm to execute its orders. It should include at least those venues that enable the firm to obtain on a consistent basis the best possible result for the execution of orders.

In the case of a firm that transmits or places orders with another entity for execution, the policy should identify the entities to which the firm transmits orders for execution.

In exceptional circumstances, a firm may use venues/entities not listed in its policy.

[64] CESR/07-320, Q21.2
[65] ESC-07-2007, 1-9

INFORMATION TO BE PROVIDED TO CLIENTS

CESR provides detailed guidance in relation to the information to be provided to clients. For further information please refer to Questions 14 to 19 of *Best Execution under MiFID - Questions and Answers.*

Question 6.13
Do firms have to notify clients of every change of execution venue?

Answer 6.13
Regulation 106 requires firms that execute orders to notify clients of any material changes to their execution arrangements or execution policy. The MiFID Regulations do not define material and therefore a firm must use its judgement to decide whether a change in venue is sufficiently significant, in terms of their execution arrangements and execution policy, to warrant notifying clients.

There is no requirement on firms that transmit orders to other entities for execution to notify clients of changes to their policy.

Question 6.14
What level of information must be provided to clients?

Answer 6.14
Appropriate information must be provided to clients. Firms do not need to provide clients with the full detail contained in their arrangements/policy. They must provide sufficient information to enable the client to make an informed decision about whether to utilise the services offered by the firm. Firms that execute orders (i.e., subject to Regulation 106) must provide retail clients with the following information prior to the provision of the service:

- the relative importance of the best execution factors, or the process for determining the relative importance;
- a list of venues the firm places significant reliance upon; and
- a warning regarding specific instructions.

CONSENT

CESR provides guidance in relation to the interpretation of consent and prior express consent. For further information please refer to Questions 20 and 21 of *Best Execution under MiFID - Questions and Answers.*

Question 6.15
The MiFID Regulations require prior express consent where a firm executes a client order outside a regulated market. In determining whether the order is executed outside a regulated market, what criteria should a firm consider?

Answer 6.15
A firm is required to obtain prior express consent from a client where:

- the firm is interacting directly with an execution venue in a MiFID financial instrument, and
- it is possible to execute the order in the financial instrument in question on a regulated market or MTF, and
- the firm proceeds to execute the order *outside* a regulated market or MTF.

Question 6.16
What is meant by the term "outside a regulated market or multilateral trading facility (MTF)"?

Answer 6.16

The European Commission has clarified in its Questions and Answers on MiFID[66] that what matters in determining whether an order was executed <u>on</u> a regulated market/MTF is whether the order was concluded on the regulated market/MTF **<u>or</u>** under the rules of the regulated market/MTF. This means that in practice there may be very few circumstances where a firm is considered to have executed an order outside a regulated market or MTF.

The following provides some useful examples of order execution within a regulated market or MTF:

- A firm executes an order with a market maker (and the market maker is a member firm of a regulated market). However, the firm should satisfy itself that the order is executed subject to the rules of the regulated market in question.
- A member firm executes an order against its proprietary trading book in accordance with the rules of the regulated market or MTF in question.
- A member firm of a regulated market undertakes an agency cross which means that it acts as agent for both the selling and the buying counterparties. In this case, if the order is undertaken in accordance with the rules of the regulated market (or MTF), the order is executed within the regulated market/MTF.

An order may be executed outside a regulated market as follows:

- A firm executes orders in UCITS and the only venue available in line with its execution policy is the UCITS manager (i.e., this is the venue that offers the best possible result or is the only possible venue available). In this case the firm does not need to obtain prior express consent on the basis that the instrument is not admitted to trading on a regulated market/MTF.
- A firm executes orders in bonds by requesting a number of quotes from OTC dealers. If all of the dealers in question are dealing only on an OTC basis (i.e., the bond cannot be traded on a regulated market/MTF) then prior express consent is not needed.
- A broker passes an order in a listed share to a systematic internaliser for execution. In this case given that the systematic internaliser executes orders outside a regulated market/MTF and is considered to be an execution venue, prior express consent is needed.
- An investment manager executes an order in a financial instrument that is capable of being traded on a regulated market/MTF as an internal trade (i.e., client A buys, client B sells) or on its own book (i.e., investment manager is selling, and client A is buying). Prior express consent is needed in both cases.

[66] http://ec.europa.eu/internal_market/securities/docs/isd/questions/questions_en.pdf

Question 6.17
What should we do if we are unable to obtain express consent from a client to deal off-regulated market, having made efforts to obtain consent?

Answer 6.17

As the MiFID Regulations allow for consent to be provided in a general agreement, firms could obtain the express consent at the outset of the relationship. If a client refuses to provide his/her express consent to this policy, then it is in the firm's own interest to inform the client that in these circumstances the firm may not be able to execute a transaction unless *and until* this express consent is forthcoming. The impact of not consenting should be made clear to a client.

Question 6.18
My firm very occasionally may execute an order outside a regulated market. In the case where my firm has executed an order outside a regulated market/MTF for an existing client prior to MiFID and therefore the client has traded on this basis previously, do I need prior express consent from my existing client post 1 November in order to continue to trade on this basis?

Answer 6.18

The obligation to obtain prior express consent before executing orders outside a regulated market or MTF applies to existing clients as well as new clients. CESR has clarified that prior express consent entails an actual demonstration of consent by means of a signature in writing or an electronic signature, by a click on a web page or orally, with appropriate record keeping. The firm cannot assume consent based on the previous transactions carried out on behalf of the client.

REVIEW AND MONITORING

CESR provides detailed guidance in relation to the requirement to review and monitor a firm's arrangements and policy. For further information please refer to Questions 23 to 25 of *Best Execution under MiFID - Questions and Answers.*

Question 6.19
Is there a prescribed approach for monitoring the effectiveness of a firm's execution arrangements?

Answer 6.19

An investment firm is obliged to monitor the effectiveness of its execution policy and arrangements and correct any deficiencies. On a regular basis, it must:

- assess whether its chosen execution venues in fact provide for best possible results;
- assess particular transactions, to determine whether the firm has complied with its policy/arrangements and delivered the best possible result.

Firms that execute orders must inform clients of material revisions. The monitoring methodology is at the discretion of the firm. Monitoring should be proportionate to the firm's business model and structure consistent with the requirement contained in Regulations 98 and 106 that firms should take all reasonable steps to obtain the best possible result in terms of execution for clients. Monitoring may include comparing similar transactions:

- on the same venue/entity;
- on different venues/entities.

Monitoring techniques currently in use vary and include transaction cost analysis, benchmarking and sampling. There is no prescribed approach and the firm must consider what method is appropriate to monitor the effectiveness of its execution policy/arrangements, taking account of the requirements set out in the MiFID Regulations and in the CESR guidance. It must ensure that the method chosen can determine whether the firm has complied with its policy/arrangements and whether it has delivered the best possible result for the client.

Question 6.20
How frequently should a firm review its execution policy?

Answer 6.20

An investment firm must review its policy at least annually and when a material change occurs. Review is an overall assessment of whether the policy and/or arrangements include all reasonable steps to obtain best possible result. A firm should consider whether it could obtain better execution results if it were to:

- include additional or different venues or entities;
- assign a different relative importance to the best execution factors;
- modify any other aspects of the policy/arrangements.

In light of the Commission's call for evidence on transparency for classes of instruments other than shares, it is recognised that firms may be faced with difficulties when obtaining data in respect of less liquid or less transparent markets. It may be difficult in such circumstances to find reliable data to facilitate the comparison of different venues. Firms will be expected to take all reasonable steps in reviewing and monitoring their execution policy.

WHAT SHOULD I DO NOW?

Question 6.21
What should I do now to ensure our firm is ready for MiFID's extensive best execution requirements?

Answer 6.21

Investment firms are advised to devote time to conduct an analysis of their business and be familiar with the MiFID Regulations and the CESR guidance to ensure that their best execution business model complies with the requirements by the deadline of 1 November 2007. A useful checklist is set out below which may assist investment firms in this process but all suggestions are not necessarily applicable to every type of firm. This list is for guidance only and is not exhaustive. Firms should:

- Review their client categorisations.
- Consider whether the investment firm:
  - executes client orders, where Regulation 106 applies, or
  - transmits or places orders with other entities for execution, in which circumstances Regulation 98 will be relevant.
- Establish execution arrangements/policy and select execution venues.
- Incorporate the execution policy/arrangements into existing procedures.
- Ensure adequate records are kept (to properly document that your execution policy is followed).

7. CLIENT ORDER HANDLING

Question 7.1
The MiFID Regulations require firms to publish limit orders in shares admitted to trading on a regulated market where not immediately executed unless otherwise instructed by the client. There is an option to waive the obligation in respect of large limit orders. Does the Financial Regulator intend to exercise this option?

Answer 7.1
The Financial Regulator intends to exercise this option and will not require the publication of a limit order that is large in scale compared with normal market size. Information as to what constitutes a large order is available in the Implementing Regulation (Table 2, Annex II).

This requirement applies to firms that execute orders (not to those that transmit orders to another entity). You should note that there is no obligation to publish a limit order that is not immediately executed where the client confirms that they do not wish such orders to be published.

8. CONFLICTS OF INTEREST

A conflict of interest may arise when a person is in a position of trust which requires him/her to exercise judgment on behalf of others and where he/she has interests or obligations that may influence the exercise of his/her judgment.

Firms are required to identify, manage and disclose conflicts of interest. They are required to maintain a conflicts of interest policy and ensure compliance with their own policy. Under the MiFID Regulations, there is a strong emphasis on client protection. Firms are required to ensure they have adequate conflict management procedures in place so that "risks of damage to client interests" are eliminated. Where this is not possible, there is a requirement to notify or disclose the conflict to clients.

Firms should be aware that the conflict of interest requirements may overlap with other areas such as inducements.

Question 8.1
What are the main conflict of interest obligations which a firm has under the MiFID Regulations?

Answer 8.1
The MiFID Regulations impose four main conflict of interest obligations on firms which can be summarised as follows:
1. Identify Conflicts of Interest

- Firms are required to take all reasonable steps to identify conflicts of interest within the firm, between the firm and third parties, between the client and the firm or between one client and another[67].

2. Establish Conflicts of Interest Policy

- Firms are required to maintain and operate effective organisational and administrative arrangements with a view to taking all reasonable steps designed to prevent conflicts of interest adversely affecting the interests of clients[68]. Thus effective systems, controls and procedures should be put in place to manage conflicts of interest.
- Firms should establish, implement and maintain an effective written conflicts of interest policy[69]. The policy should identify circumstances which give rise to a conflict of interest and specify procedures to be followed and measures to be adopted in order to manage such conflicts.
- Firms should also ensure that any conflict of interest is properly controlled. The procedures to be followed and the measures to be adopted should include the following:
  - effective procedures to prevent or control the exchange of information where there may be a risk of a conflict of interest;
  - separate supervision of persons dealing with clients whose interests may conflict;
  - removal of any direct link between the remuneration of persons where a conflict of interest may arise;
  - measures to prevent or limit any person from exercising inappropriate influence;
  - measures to prevent or control the simultaneous or sequential involvement of persons where such involvement may impair the proper management of conflicts of interest.

---

[67] Regulation 74
[68] Regulation 33(1)(b)
[69] Regulation 75

3. Disclosure

- When organisational or administrative arrangements to manage conflicts of interest are not sufficient to ensure, with reasonable confidence, that risks of damage to client interests will be prevented, firms are required to disclose to clients the general nature and sources of the conflicts of interest before undertaking business on their behalf[70].

4. Record of Conflicts

- Firms are required to keep and regularly update a record of the kinds of investment activity or ancillary service carried out by the firm where a conflict of interest has arisen or may arise[71].

Question 8.2
What factors should be taken into account in order to identify potential conflicts of interest?

Answer 8.2

A firm is required to take "all reasonable steps" to identify and manage conflicts of interest. It is the responsibility of individual firms to ensure that their policy and procedures are appropriate. In practice, each firm will have its own particular set of conflicts relevant to its specific business and activities. In some cases, a firm's obligations in relation to the management of conflicts may overlap with non-MiFID areas such as, for example, consumer credit.

The firm should consider whether a conflict of interest arises in the course of carrying out investment services or ancillary services under the MiFID Regulations and whether such a conflict could have a detrimental effect on clients to whom it provides investment or ancillary services.

In order to identify the types of conflicts of interest that may damage the interests of a client, a firm must take into account whether the firm or a relevant person or a person directly or indirectly linked by control to the firm is in any of the following situations[72]:

- likely to make a financial gain, or avoid a financial loss, which is at variance with the client's interests;
- has an interest in the outcome of a service or transaction which is at variance with the client's interests;
- has a financial or other incentive to favour the interest of another client(s);
- carries on the same business as the client;
- receives or will receive an inducement other than the standard commission or fee.

This list is not exhaustive, and firms will need to take a principles-based approach to this issue, the final features of which will vary depending on the nature of the firm, its business and its clients.

Firms must maintain and operate effective organisational and administrative arrangements with a view to taking all reasonable steps to prevent conflicts of interest from adversely affecting the interests of clients.

[70] Regulation 74(2)
[71] Regulation 75(8)
[72] Regulation 75(1)

Question 8.3
What information should be included in the firm's formal conflicts of interest policy?

Answer 8.3

The firm's policy should be formalised. It must be in writing and should be appropriate to the size and organisation of the firm and the nature, scale and complexity of the firm's business[73]. Where a firm is a member of a group, the policy should take into account any circumstances, of which the firm is or should be aware, which may give rise to a conflict of interest arising as a result of the structure and business activities of other members of the group. It should identify with reference to the firm's business the circumstances which constitute or may give rise to a conflict of interest entailing a material risk of damage to the interests of one or more clients. It should specify procedures to be followed, and measures to be adopted, in order to manage such conflicts.

Question 8.4
As a large investment firm, we act for several clients, such as institutional investors, who may be competitors. Must we disclose to a potential client that we act for its competitors?

Answer 8.4

Firms should draw up a comprehensive policy incorporating procedures for identifying and managing conflicts of interests that may damage a client's interests. Normally, it would be expected that these procedures are reliable and effective, and as such no disclosure is required.

In the event that these measures cannot ensure with reasonable confidence or certainty that the risk of damage to any client's interests is prevented, the general nature and sources of such conflicts should be disclosed to the client in question[74].

Clients should be given sufficient information to enable them to make an informed decision as to whether or not to proceed with the transaction.

Disclosure of a conflict of interest is not an alternative to maintaining effective policies and controls. Instead, it should be used where the arrangements are not sufficient to ensure, with reasonable confidence, that risks of damage to clients' interests will be prevented.

Question 8.5
Are investment research and marketing material subject to the conflicts of interest requirements in the MiFID Regulations?

Answer 8.5

The conflicts of interest requirements are organisational requirements that apply to firms subject to the MiFID Regulations. The MiFID Regulations also contain specific rules relating to investment research[75] and marketing material[76]. These issues are dealt with separately in the Investment Research and Information to Clients sections of this document.

---

[73] Regulation 75(2)(a)
[74] Regulation 74(2)
[75] Regulation 155
[76] Regulations 76(2) and 80

Question 8.6
Should the client's category under the MiFID Regulations have an impact on the firm's conflicts of interest policy?

Answer 8.6

No. Each firm is obliged to manage conflicts of interest under the MiFID Regulations regardless of the status of the client. However, retail clients are required to be given a brief description of the firm's conflicts of interest policy in summary form in accordance with Regulation 82(h).

Professional clients may request a summary of the firm's conflicts of interest policy.

Question 8.7
How often should I review my conflicts of interest policy?

Answer 8.7

The conflicts of interest policy will need to be flexible. It should be reviewed periodically to ensure that it remains up to date and properly reflects ongoing changes in the firm's circumstances.

Question 8.8
What should my firm do now to ensure it complies with the conflicts of interest requirements in the MiFID Regulations by 1 November 2007?

Answer 8.8

Firms are advised to familiarise themselves with the conflicts of interest requirements in the MiFID Regulations and conduct an appropriate analysis of their business to ensure compliance by the deadline of 1 November 2007. Firms should ensure that they have an appropriately documented policy for managing conflicts of interest.

A useful checklist is set out below which may assist investment firms in this process. This list is for guidance only and is neither mandatory nor exhaustive.

1. Review the existing business model to identify any conflict of interest (for example, some firms may have to consider new measures such as segregating particular areas of its business to ensure independence).
2. Identify procedures and measures to manage any conflict of interest identified.
3. Draft a conflicts of interest policy.
4. Revise existing policies and procedures to take into account the conflicts of interest policy.
5. Provide retail clients or potential retail clients with a summary of the policy.
6. Train staff in conflicts of interest policy.
7. Consider whether additional measures are necessary.

9. INDUCEMENTS

CESR provides detailed guidance in relation to inducements. For further information please refer to *Inducements under MiFID - Recommendations*. As the Financial Regulator intends to follow CESR guidance on inducements, firms should ensure they are familiar with that guidance, which is included in this document.

The main objective behind the inducements rules in MiFID is investor protection. In the context of a strong focus on the need for investment firms to act in the best interests of clients, the MiFID Regulations[77] impose obligations on firms in this regard.

Following the terminology used in the European MiFID Directives, the MiFID Regulations use the term "inducements" to include all fees, commissions and other non-monetary benefits; the word "inducements" is not intended to convey any negative connotation but merely to refer to remuneration arrangements.

The MiFID Regulations bring transparency to the measures that firms have in place for such fees, commissions and other non-monetary benefits, enabling firms and their clients to agree the specific terms between them. The MiFID Regulations address these arrangements in a number of categories.

Fees/Commissions/Benefits paid to or by the client or a person on behalf of the client
Any remunerative arrangement involving payment directly by a client, where the client is aware of that arrangement, carries no further obligation under Regulation 78 on behalf of the investment firm. This applies both to the payment of fees/commissions, etc. and to any agreement that requires third party costs (e.g., broker fees, custody fees) to be rebilled to the client.

Proper Fees
The MiFID Regulations identify a category of fees, which even if not specifically paid or agreed by the client, may be charged. Such fees:
(a) must enable or be necessary for the provision of the service;
(b) must not, <u>by their nature</u>, give rise to conflicts with a firm's duty to act honestly, fairly and professionally in accordance with the best interests of the client.
Such fees could include, but are not limited to, custody costs, settlement fees, exchange fees, regulatory levies and legal fees, and other similar costs. Investment firms should give a general disclosure of the possibility of such costs.

Third Party Receipts and Payments
Other arrangements which involve payments or benefits made to, or received from, third parties are permissible under the MiFID Regulations provided they pass specific tests.

Investment firms must satisfy themselves that any arrangement with a third party:
(a) must be designed to enhance the quality of the relevant service to the client and it must not impair compliance with the firm's duty to act in the best interest of the client;
AND
(b) there must be clear, prior disclosure to the firm's client, detailing the existence, nature and amount of the fee, commission or benefit or, where the amount cannot be ascertained, the method of calculation. This disclosure may be provided in summary form provided the firm undertakes to disclose further details at the client's request.

---

[77] Regulation 78. The "Conflicts of Interest" Regulations 74 and 75 are also relevant to this section.

Where it is not possible to quantify the fee, commission or benefit associated with an arrangement in advance, firms should still be able to determine whether it meets the criteria above.

The MiFID Regulations apply the same standards to fees exchanged between investment firms that are part of larger groups as to third party arrangements.

Question 9.1

CESR Recommendations indicate that it is possible that some compensation structures in general use could potentially create a conflict of interest, and if this conflict crystallises, could then be considered improper inducements. How can my firm assess whether the arrangements we have in place give rise to any improper situation?

Answer 9.1

"Improper inducements" may arise where a firm receives or pays a fee, commission or non-monetary benefit that could lead the firm to act other than in the client's best interest[78].

The MiFID Regulations require firms to consider the agreements in place for fees, commissions and non-monetary benefits, including disclosures, and to judge whether the arrangements do or do not represent improper inducements. The CESR Recommendations illustrate the type of consideration firms should give and suggest outcomes in certain examples, but also emphasise the need for firms to perform their own analysis, based on their own context, and not extrapolate from the conclusions reached in the examples without proper consideration[79].

Consequently, compliance is achieved through clear and documented consideration of the arrangements in use, not through adoption of one structure or another.

[78] Regulation 78(1)
[79] CESR/07 - 228b Recommendations on Inducements - Paragraph 28

10. INTERACTION BETWEEN THE MIFID REGULATIONS AND THE CONSUMER PROTECTION CODE

The Consumer Protection Code (the Code) and the MiFID Regulations both aim to ensure that products are appropriately matched to the needs of consumers/clients. Firms dealing in MiFID and non-MiFID investment products will encounter situations with their clients where investment products falling within the scope of the MiFID Regulations, as well as products that do not fall within the scope of the MiFID Regulations, address similar client needs.

The MiFID Regulations set out the information that must be obtained in relation to the client and specify the criteria that must be satisfied in order to establish suitability. The Code requires firms to obtain information and to assess suitability but does not specify the type of information or how firms should satisfy themselves that a product or service is suitable. There are some requirements set out in the Code that are not present in the MiFID Regulations, such as the provision of a reason-why letter and the requirement to endeavour to have the client certify the accuracy of the information it has provided.

The table below summarises the requirements in the MiFID Regulations and the Code.

Code	MiFID Regulations
Know your client	**Know your client**
Firms must gather and record sufficient information to enable them to provide a recommendation or a product or service appropriate to that consumer. The level of information should be appropriate to the nature and complexity of the product or service, but must be to a level that allows the firm to provide a professional service.	Firms must obtain the necessary information about the client's knowledge and experience, financial situation and investment objectives to enable them to recommend the investment services or financial instruments that are suitable.
Firms must endeavour to have the consumer certify the accuracy of the information it has provided.	Firms can rely on information provided by the client, or by a third party on behalf of the client.
Firms must ensure that, where a consumer refuses to provide information, the refusal is noted on that consumer's records.	Where a client does not provide the required information the investment firm should not recommend investment services or products to the potential client.

Suitability	Suitability
Firms must ensure that, having regard to the facts disclosed by the consumer and other relevant facts about the consumer of which the firm is aware: • any product or service offered is suitable • options offered in a selection represent the most suitable from the range available to the firm • a recommended product is the most suitable product for the consumer.	Firms must obtain such information as is necessary to understand the essential facts about the client and to have a reasonable basis for believing, giving due consideration to the nature and extent of the service provided, that the recommendation satisfies the following criteria: • meets the investment objectives • client is able financially to bear any related risks • client has knowledge and experience to understand the risks.
Before providing a product or service, a firm must prepare a written statement setting out the reasons why: • a product or service is considered suitable • each of a selection of options is considered suitable • a recommended product is considered to be the most suitable. Firms must give a copy of the statement to the client and retain a copy.	Firms providing investment advice to retail clients must retain a record of: • the fact that investment advice was rendered • the financial instrument that was recommended.

Question 10.1
When I am having a general discussion with a client (for example, investment strategies) the discussion will move from general advice to advice on specific products as more information on the client's requirements becomes available. Do the MiFID Regulations or the Code govern any investment advice provided?

Answer 10.1

The MiFID Regulations provide a detailed definition of investment advice summarised as a personal recommendation in respect of (MiFID) financial instruments[80]. The Code similarly describes the outcome of the advice process in terms of suitability of products or services recommended. Consequently, both the MiFID Regulations and the Code apply the relevant obligations from the point where a specific product is recommended, and the regime that applies is the regime applicable to that product. Where multiple products are involved (including where these are alternatives), the relevant regime should be followed for each product recommendation.

[80] Regulations 3(1) and 3(4)

Question 10.2
When I refer my clients to firms with non-MiFID authorisations (e.g., a Multi-Agency Intermediary) to receive financial advice, which might include investment advice, am I responsible for the advice they receive?

Answer 10.2
No. When your client becomes a client of another regulated entity, the other entity has responsibility for the advice it provides to that person as its own client, regardless of the referral from you.

Question 10.3
When providing portfolio management services to MiFID clients, I will invest in MiFID and non-MiFID products. How should these investments be treated?

Answer 10.3
Industry in Ireland and elsewhere distinguishes between:

- discretionary portfolio management, in which the investment manager makes investment decisions for its client under a mandate, and
- non-discretionary portfolio management, in which investment decisions are made by the client (sometimes after receiving advice) and administered by the investment firm.

The MiFID Regulations use the term "portfolio management" to refer to discretionary portfolio management only[81].

Discretionary portfolio management
The service of discretionary portfolio management is subject to the requirements contained in the MiFID Regulations and is specifically excluded from the Code. The MiFID Regulations contain suitability requirements in relation to the service of portfolio management and to the transactions in MiFID financial instruments entered into in the course of providing a portfolio management service.

While the Code does not apply to the service of portfolio management, it would apply to any transactions in non-MiFID instruments to be included in the portfolio. Notwithstanding this, if the requirements of the MiFID Regulations are complied with in respect of financial instruments that are subject to the MiFID Regulations or the Code, the obligations under the Code will be deemed to be complied with.

Non-discretionary portfolio management
As the term 'portfolio management' in the MiFID Regulations refers to discretionary portfolio management only, non-discretionary portfolio management is not considered a MiFID service. The service provided is investment advice and/or reception and transmission of orders and/or execution of orders. Where such a service relates to MiFID instruments the MiFID Regulations apply and in the case of non-MiFID instruments, the requirements of the Code apply.

[81] Regulation 3(1)

Question 10.4
Do I have to prepare separate sets of documentation for MiFID and non-MiFID business - for example, fact-finds or terms of business?

Answer 10.4
If you wish, you may use one set of documents to cover MiFID and non-MiFID activities and services provided the documents cover the obligations of both the MiFID Regulations and the Code for your business.

Question 10.5
It is common for clients to borrow for the purpose of investing in a financial instrument. The loan may be arranged with, for example, a branch of the credit institution providing the investment services, or with the investment firm acting as a credit intermediary. Is this loan subject to the requirements of the MiFID Regulations or the Code?

Answer 10.5
Where the firm granting a loan for the purpose of investing in a financial instrument is also involved in the investment transaction, the loan is provided as an ancillary service[82] and the MiFID Regulations apply. While firms should confirm their own arrangements are compliant, it would normally be expected that:

- standard information to clients[83] would already be addressed during provision of the investment service to which the loan is ancillary;
- specific information on the client's loan may be addressed using formats designed to meet the provisions of the Code[84]. However, firms must ensure that all relevant requirements under the MiFID Regulations are met, e.g., requirements regarding inducements.

If the loan is granted by a separate legal entity that is not involved in the investment transaction, the requirements of the Code apply.

Firms authorised as credit intermediaries are not regulated by the Financial Regulator for their credit intermediary business and, therefore, are not subject to the Code for that business.

Both the Code and the MiFID Regulations oblige investment firms to act honestly, fairly and professionally in the best interests of their clients[85].

[82] Schedule 1, Part 2(2)
[83] For example, general information to clients as described in Regulations 80 and 82 or disclosure of conflicts of interest according to Regulation 74(2)
[84] For example, indication of a repayment schedule would address the requirements of Regulation 92, Regulation 76(2)(c)(iv) and Regulation 78(1)(b)(i) and 78(2).
[85] Regulation 76(1)(a) and the Code's General Principle 1

Appendix 1

INFORMATION TO BE PROVIDED TO CLIENTS PRIOR TO PROVISION OF SERVICE		
Written Agreement	**Retail**	**Professional**
A firm that provides an investment service other than investment advice shall enter into a written basic agreement in a durable medium with the client setting out the rights and obligations of the firm and the client. *Regulation 94(12)*	✔	N/A
Inducements		
When applicable, firms must disclose in summary form the essential terms of the arrangements it has in place regarding a fee, commission or non-monetary benefit. The firm must provide further details on request. *Regulation 78(2)*	✔	✔
Client Categorisation		
▸ Firms must notify new clients, and existing clients that the firm has newly categorised under the MiFID Regulations, of their categorisations as a retail client, professional client or eligible counterparty. ▸ Firms must inform clients in a durable medium about any right that client has to request a different categorisation and about any limitations to the level of client protection that would entail. *Regulation 81*	✔	✔
Information about the firm and services to be provided		
Firms must provide retail clients or potential retail clients with the information listed in Regulation 82, including: ▸ General information about the firm (name, address, method of communication, authorisation, etc). ▸ Nature and frequency of reports on performance of service. ▸ Details of any relevant investor compensation scheme. *Regulation 82*	✔	N/A
When providing the service of portfolio management, a firm must provide retail clients or potential retail clients with the information listed in Regulation 83(2) including details of any delegation of the discretionary management of all or part of the portfolio and a specification of any benchmark against which the performance of the portfolio will be compared. *Regulation 83*	✔	N/A

INFORMATION TO BE PROVIDED TO CLIENTS PRIOR TO PROVISION OF SERVICE		
Information about Financial Instruments	**Retail**	**Professional**
Description of the nature and risks of financial instruments taking into account the client's categorisation as either retail or professional. *Regulation 84*	✔	✔
Safeguarding of Client Financial Instruments		
Where an investment firm holds financial instruments or funds belonging to a retail client, or potential retail client, the firm shall provide the client with certain information regarding the safeguarding of client instruments (refer also to the Financial Regulator's Client Money Requirements for the relevant requirements). *Regulations 88 to 91*	✔	N/A
Professional clients must receive in good time certain specific information related to the safeguarding of client financial instruments or client funds (refer also to the Financial Regulator's Client Money Requirements for the relevant requirements). *Regulations 89 and 90*	N/A	✔
Conflicts of Interest		
Where there is a potential risk of damage to client interests, the firm must disclose the general nature and/or sources of conflicts of interest to a client before undertaking business on the client's behalf. *Regulation 74(2)*	✔	✔
In the case of retail clients a description of the conflicts of interest policy must be provided which may be in summary form. *Regulation 82(h)*	✔	N/A
Costs and Associated Charges		
Detailed information in respect of the costs and associated charges of MiFID services provided by the firm. *Regulation 92*	✔	N/A

INFORMATION TO BE PROVIDED TO CLIENTS PRIOR TO PROVISION OF SERVICE		
Best Execution	**Retail**	**Professional**
Appropriate information on the firm's execution policy must be provided to clients. The nature of the information to be provided will vary depending on whether the firm is deemed to be executing orders or simply receiving and transmitting orders for execution by another entity. *Regulations 98(3)(d) and 106(3)*	✔	✔
Where the firm is providing portfolio management services and/or receiving and transmitting orders, retail clients must be provided with the information listed in Regulation 98(6) in good time prior to the provision of services. *Regulation 98(6)*	✔	N/A
Firms that execute client orders must obtain prior consent from clients to their order execution policy and must obtain prior express consent if an order is executed outside a regulated market or MTF. *Regulations 106(3)(c) and 106(4)*	✔	✔

Appendix 2

CONTRACT NOTES		
Orders Other Than for Portfolio Management	**Retail**	**Professional**
An investment firm must promptly provide the client, in a durable medium, with the essential information concerning the execution of that order.	✔	✔
In the case of a retail client, the firm must send the client a notice in a durable medium confirming execution of the order (i) as soon as possible and no later than the first business day following execution, or (ii) if the confirmation is received by the investment firm from a third party, no later than the first business day following receipt of the confirmation from the third party.	✔	N/A
Contract notes for retail clients must contain[86]: (a) the reporting firm identification; (b) the name or other designation of the client; (c) the trading day; (d) the trading time; (e) the type of the order; (f) the venue identification; (g) the instrument identification; (h) the buy/sell indicator; (i) the nature of the order if other than buy/sell; (j) the quantity; (k) the unit price; (l) the total consideration; (m) a total sum of the commissions and expenses charged and, where the retail client so requests, an itemised breakdown; (n) the client's responsibilities in relation to the settlement of the transaction, including the time limit for payment or delivery as well as the appropriate account details where these details and responsibilities have not previously been notified to the client; (o) if the client's counterparty was the investment firm itself or any person in the investment firm's group or another client of the investment firm, the fact that this was the case unless the order was executed through a trading system that facilitates anonymous trading.	✔	N/A
Portfolio Management		
If a client elects to receive contract notes on a transaction-by-transaction basis, they must comply with requirements set out above including in the case of retail clients the timescales for remitting the contract note and contents requirements set out in Regulation 96(6).	✔	✔

[86] Regulation 96(6).

Appendix 3

PERIODIC STATEMENTS		
Portfolio Management Services Only	**Retail**	**Professional**
An investment firm which provides the service of portfolio management to clients shall provide each of them with a periodic statement in a durable medium of the portfolio management activities carried out on behalf of that client, unless such a statement is provided by another person.	✔	✔
Periodic reports for retail clients must contain certain specified information contained in Regulation 96(10).	✔	N/A
In the case of retail clients, the periodic statement must be provided once every 6 months, except in the following cases: ▸ where the client so requests, the periodic statement must be provided every 3 months (firms must inform retail clients that they have the right to make requests for reports to be provided every 3 months); ▸ where the client has elected to receive contract notes containing all of the information listed in 96(6), the periodic statement can be provided on a 12 monthly basis. **N.B.** This exception does not apply in the case of transactions in complex instruments. ▸ where the agreement between an investment firm and a retail client for a portfolio management service authorises a leveraged portfolio, the periodic statement must be provided at least once a month.	✔	N/A
All Services		
Where an investment firm - (a) provides portfolio management transactions for retail clients, or (b) operates retail client accounts that include an uncovered open position in a contingent liability transaction, the firm shall report to the retail client any losses exceeding any predetermined threshold, agreed between the firm and the client, no later than (i) the end of the business day in which the threshold is exceeded, or (ii) in a case where the threshold is exceeded on a non-business day, the close of the next business day.	✔	N/A
Where an investment firm holds client financial instruments or client funds there are specific reporting requirements including a list of items that must be included in such reports. Firms should refer to the Financial Regulator's Client Money Requirements for details.	✔	✔

CESR The Committee of European Securities Regulators

Ref: CESR/07-320

Best Execution under MiFID

Questions & Answers

May 2007

11-13 avenue de Friedland - 75008 PARIS - FRANCE - Tel.: 33.(0).1.58.36.43.21 - Fax: 33.(0).1.58.36.43.30

Web site: www.cesr.eu

CONTENTS

Section 1 – Background and Scope

Introduction

MiFID will introduce common standards of investor protection throughout the European Union. MiFID's best execution requirements are an important component of these investor protection standards as they are designed to promote both market efficiency generally and the best possible execution results for investors individually.

Discussions in the CESR Implementation Forum suggested that many Member States and competent authorities will implement MiFID's best execution requirements by introducing the terms of MiFID directly into their legislation or rulebooks. By copying-out, there will be harmonised Level 1 and Level 2 requirements. Beyond this, it is the responsibility of the competent authorities in each Member State to interpret and supervise compliance with these harmonised rules.

As harmonisation of regulation in the area of best execution is a key objective behind MiFID, CESR has an important role to play in promoting supervisory convergence in this area. To this end, CESR members set out their agreed views on a range of issues relating to best execution in Consultation Paper CESR/07-050b which was published in February 2007. CESR has published a separate Feedback Statement CESR/07-321 on the responses received to the Consultation Paper.

Objective of the Q&A

CESR has prepared this paper in order to clarify key aspects of the CP. CESR has chosen a Q&A format in order to present its views in a user-friendly way that facilitates compliance by firms and convergence among competent authorities. This Q&A presents CESR's answers to practical questions raised by firms and competent authorities about how firms should be complying with the MIFID best execution regime. In this Q&A, CESR does not impose requirements on firms or otherwise go beyond what the Directives already require. Rather, the Q&A explains CESR's views on how firms can comply with the Directives in the particular circumstances and situations that stakeholders have raised.

Status of the Q&A

Members of CESR will make use of this Q&A on a voluntary basis in their day-to-day supervisory practices. The Q&A does not constitute European legislation and will not require national legislative action.

The European Commission has participated as an observer in the course of CESR's work on best execution.

This Q&A is only intended to promote supervisory convergence and does not prejudice the role of the Commission as guardian of the Treaties.

Scope

On 15 November 2006 CESR posed three questions to the European Commission in relation to the work it was undertaking on best execution:

1. In what circumstances do the best execution requirements apply to firms who operate by providing quotes and then dealing?
2. What scope may "specific instructions" from a client cover?
3. In what circumstances do portfolio managers and order receivers and transmitters "execute client orders"?

The Commission's response is appended to this Q&A but does not form part of the Q&A itself. CESR has not addressed the scope of best execution under MiFID in this Q&A, nor has it addressed the question of how best execution applies in dealer markets.

The MiFID Level 3 Expert Group has considered the possibility of conducting a further public consultation following the Commission's reply to CESR and consulted the MiFID Consultative Working Group on this question to gain input from a wider group of stakeholders. Following this consultation, CESR considers that the Commission's reply forms a sufficient basis for implementation and that no further work is needed at the present time.

Further work
In devising its future work plan, CESR will consider reviewing how MiFID's best execution requirements are being applied as well as submissions and requests from the Commission, the Consultative Working Group and other stakeholders.

Section 2 – Questions and Answers

Q1 Which provisions in MiFID relate to best execution?

1.1 MiFID's best execution regime is set out as follows in the Directives. Article 21 of Level 1 and Articles 44 and 46 of Level 2 set out the requirements for investment firms that provide the service of executing orders on behalf of clients for MiFID financial instruments and, indirectly via Article 45(7), for investment firms that provide the service of portfolio management, when executing decisions to deal on behalf of client portfolios.

1.2 Article 45 of Level 2 (enacted under Article 19 of Level 1) sets out the requirements for (i) investment firms that provide the service of reception and transmission of orders, when transmitting orders to other entities for execution and (ii) investment firms that provide the service of portfolio management, when placing orders with other entities for execution that result from decisions to deal in financial instruments on behalf of client portfolios. There are associated recitals in both Level 1 and Level 2 (Recital 33 of Level 1, and Recitals 66 to 76 of Level 2.)

1.3 Responses to the CP pointed out that investment firms may provide a combination of investment services to the same clients. For example, an investment firm may have the flexibility either to transmit an order on behalf of a client to another entity for execution or to execute the order itself. Similarly, an investment firm may have the flexibility to place orders resulting from its decisions to deal on behalf of client portfolios with other entities for execution or to execute such decisions to deal itself. To take account of this, the Q&A will refer to firms that "execute orders or decisions to deal" and to firms that "transmit or place orders with other entities for execution" rather than referring to "portfolio managers", "RTOs" and "investment firms that execute orders on behalf of clients." Where the Q&A means to refer only to investment firms when they execute orders on behalf of clients, it will refer to firms that "execute orders." The Q&A refers to all of these firms collectively as "firms that carry out orders."

Q2 What is the overarching best execution requirement?

2. MiFID's best execution regime requires investment firms to take all reasonable steps to obtain the best possible result for their clients, taking into account price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to order execution. CESR considers this requirement to be of a general and overarching nature. See Q3.

Q3 What should firms do to comply with the overarching best execution requirement?

3.1 The overarching best execution requirement sets a high level standard, allowing investment firms a considerable degree of flexibility on how to meet it. However, MiFID does require firms to comply with a number of specific provisions.

3.2 Firms that execute orders or decisions to deal should establish "execution arrangements" and an "execution policy" (Article 21) for complying with the overarching best execution requirement. In a similar way, firms that transmit or place orders with other entities for execution should establish a "policy" (Article 45) for complying with the overarching best execution requirement. It follows that all of these firms should carry out orders on behalf of clients in accordance with their (execution) policies and/or arrangements.

3.3. In order to comply with the overarching best execution requirement, firms should ensure that appropriate (execution) policies and/or arrangements are effectively implemented for the carrying out of all orders. Firms however are not under an obligation to obtain the best possible result for each individual order; rather they should apply their (execution) policies to each order with a view to obtaining the best possible result in accordance with the (execution) policy.

3.4 All investment firms that carry out orders should also disclose "appropriate information" to clients about their (execution) policies and monitor and review their performance. See Q13 – Q18 and Q22-24.

Q4 What is the content of the execution policy of a firm that executes orders on behalf of clients or decisions to deal on behalf client portfolios?

4.1 An execution policy should set out the investment firm's strategy for obtaining the best possible result for the execution of its client orders, including the key steps the firm is taking to comply with the overarching best execution requirement and how those steps enable the firm to obtain the best possible result.

4.2 The execution policy should also include an account of the relative importance, or the process for determining the relative importance, the firm places on the best execution factors when executing client orders or decisions to deal, as well as information on how those factors affect the firm's choice of execution venues for inclusion in the execution policy.

4.3 The execution policy should also set out the execution venues the firm uses. Article 21(3) states that the execution policy "…shall at least include those venues that enable the investment firm to obtain on a consistent basis the best possible result for the execution of client orders". CESR understands this provision to mean that firms should include certain venues in their policy, not that the policy can omit other venues used by the firm. A firm may however in exceptional circumstances use venues not listed in its policy, for example on a provisional basis or to accommodate a client request to trade in an unusual instrument, with a view to satisfying the overarching best execution requirement. See Q13 through Q15 on disclosure about the execution policy.

Q5 What are execution arrangements and how do they differ from the execution policy?

5. The "execution arrangements" are the means that an investment firm employs to obtain the best possible result when executing orders or decisions to deal, while the "execution policy" may be understood as a document that describes the most important and/or relevant elements of those execution arrangements. See [Q7].

Q6 What is the content of a policy for a firm that transmits or places orders with other entities for execution?

6.1 The "policy" is the means that the investment firm employs to obtain the best possible result for its clients when it transmits or places orders with other entities for execution.

CESR

6.2 In particular, the policy should set out the strategy of the firm, the key steps the firm is taking to comply with the overarching best execution requirement and how those steps enable the firm to obtain the best possible result.

6.3 The policy should also include an account of the relative importance, or the process for determining the relative importance, the firm places on the best execution factors when carrying out client orders, as well as information on how those factors affect the firm's choice of entities for inclusion in the policy.

6.4 The policy should also set out the entities the firm uses. In exceptional circumstances, however, a firm may use entities not listed in its policy (See Q4). See Q13 and Q16 on disclosure about the policy.

Q7 How differentiated should the content of an (execution) policy be?

7.1 The investment firm should differentiate its (execution) policy to the extent necessary to comply with the overarching best execution requirement.

7.2 The number of subsets in the (execution) policy will depend *inter alia* on the types of clients a firm serves, the types of financial instruments for which it accepts orders, and the relevant execution venues and entities available for those instruments.

7.3 A firm's (execution) policy will need at least to address the different classes of instrument for which it carries out orders. Examples of such classes are equities, debt instruments, units of collective investment schemes and derivatives (which would need to be further distinguished between exchange-traded derivatives and OTC products, if appropriate). The (execution) policy will also need to address the distinction between retail and professional clients to the extent that the firm treats each such category of clients differently. In addition to differentiating by class of instrument and client categorisation, an investment firm may wish to distinguish its policy further, for example by order type.

Q8 Can a firm that executes orders or decisions to deal include only one venue in its execution policy?

8.1 CESR considers that whenever there is more than one execution venue that would enable the investment firm to obtain the best possible result on a consistent basis, the firm should consider the respective merits of such venues. The firm should at least include those venues that enable it to obtain on a consistent basis the best possible result for the execution of its client orders or decisions to deal.

8.2 However, MiFID does not prohibit firms from selecting only one execution venue if the firm can show that by doing so it is able to obtain the best possible result on a consistent basis. For example, there may be circumstances where a particular execution venue will deliver the best possible result on a consistent basis for a given subset of the execution policy, or where the costs of including more than one venue in the execution policy (to the extent that such costs would be passed on to clients) would outweigh any price improvement to be gained by doing so (considered over a reasonable time frame). In such circumstances, it may be reasonable for the firm to include only one venue in its execution policy.

8.3 In order to comply with the requirement under Article 19(1) to act in the best interests of its clients, a firm should consider transmitting client orders instead of executing them itself where that would deliver a better result for clients, provided the firm is authorised for reception and transmission of such orders.

Q9 Can a firm that transmits or places orders with other entities for execution include only one entity in its policy?

9. An investment firm that transmits or places orders with other entities for execution can include a single entity in its policy if is able to show that this allows it to satisfy the overarching best execution requirement. That is, where a firm transmits or places orders with a single entity for execution, the firm should determine that selecting only one entity complies with the overarching best execution requirement. In addition, the firm should reasonably expect that the entity it selects will enable it to obtain results for its clients that are at least as good as the results that it reasonably could expect from using alternative entities.

Q10 How does a firm assess the relative importance of the best execution factors?

10.1 Responsibility for assessing the relative importance of the best execution factors lies with the investment firm. A firm should take into account the following criteria when determining the relative importance of the best execution factors:

- the characteristics of the client, including the categorisation of the client as retail or professional;
- the characteristics of the client order;
- the characteristics of the financial instrument that is the subject of the order;
- the characteristics of the execution venues or entities to which that order can be directed.

10.2 For retail clients, the best possible result is determined in terms of the total consideration. See Q11.

Q11 What is "total consideration"?

11.1 Total consideration is the price of the financial instrument and the costs related to execution, including all expenses incurred by the client which are directly related to the execution of the order such as execution venue fees, clearing and settlement fees, and any other fees paid to third parties involved in the execution of the order.

11.2 For example, an investment firm that provides a service to retail clients with respect to shares admitted to trading on a regulated market will focus on the net cost (or net proceeds in the case of a sale) of executing the order on the venues available, and will direct the order to the execution venue or entity providing the best possible result in terms of total consideration. The firm may consider speed, likelihood of execution and settlement, the size and nature of the order, market impact and any other implicit transaction costs and give them precedence over the immediate price and cost factors if they are instrumental in delivering the best possible result in terms of the total consideration to the retail client. Such implicit costs may be relevant for retail clients with respect to a large order in a relatively illiquid share, for example.

11.3 CESR considers that the concept of total consideration is relevant for the assessment of best execution for professional client orders too, because in practice a firm is unlikely to be acting reasonably if it gives a low relative importance to the net cost of a purchase or the net proceeds of a sale. There may be circumstances, however, where other factors will be more important for professional clients and MiFID clearly allows firms flexibility in this regard.

Q12 Can a firm take its fees and commissions into account when deciding between execution venues?

12.1 With respect to investment firms that execute orders on behalf of clients, MiFID draws a distinction between the selection of venues to be included in the firm's execution policy and the choice between two or more venues contained in the execution policy for the execution of a particular transaction.

12.2 When selecting venues to be included in its execution policy, a firm should not take into account the fees and commissions that it will charge its clients. At this stage, the firm should focus on the potential of the venues to enable the firm to obtain on a consistent basis the best possible result for the execution of its client orders. In other words, it should focus on the quality of execution available on the various venues.

12.3 When choosing a venue for the execution of a particular client order (from among the venues included in the firm's execution policy that are capable of executing such an order), the firm should take into account the effect of its own fees and commissions on the total consideration to the client.

12.4 For example, if a firm has included a regulated market and a systematic internaliser in its execution policy (or is itself a systematic internaliser) because both those venues enable the firm to obtain on a consistent basis the best possible result for the execution of its client orders, the firm will need to take into account not only the prices displayed by those two venues, but also any difference in fees or commission it charges the client for executing on one venue rather than the other (as well as any other costs or other relevant factors). See Q13.

Q13 Does MiFID regulate the fees and commissions a firm charges for the execution of client orders?

13.1 Investment firms are free to set their fees or commissions at the level they choose, provided that no venue is unfairly discriminated against. A firm may not charge a different commission (or spread) for execution on different venues unless the difference reflects a difference in the cost to the firm. For example, a firm may not direct all its orders to another firm within its corporate group on the basis that it charges its clients a higher fee for access to other venues that is unwarranted by higher access costs.

13.2 MiFID contains specific disclosure requirements for retail clients regarding a firm's fees and commissions to ensure that these investors are able to compare the fee structures of different firms[1]. See Q14.

Q14 What information about its (execution) policy should a firm disclose to its clients?

14.1 An investment firm should provide appropriate information about its (execution) policy to its clients, rather than the full detail of its execution arrangements and/or policy. In this way, MiFID strikes a balance between requiring firms to disclose a lengthy trading manual which would be of limited utility to clients and information that is too high level to enable an adequate understanding of a firm's (execution) policy by clients.

14.2 CESR considers that firms should disclose sufficient information, reflecting any relevant differentiation of the firm’s (execution) policy (see Q7), to enable clients to make a properly informed decision about whether to utilise the services offered by the firm.

---

[1] See Article 19(3) of Level 1 and Articles 33 and 40(4) of Level 2.

Q15 Is there additional information about its execution policy which a firm that executes orders or decisions to deal should disclose to its retail *clients?*

15.1 An investment firm executing orders or decisions to deal on behalf of retail clients should disclose the following in good time prior to the provision of the service:

- the relative importance the firm assigns to the best execution factors, or the process by which it determines their relative importance,
- a list of the execution venues on which the firm places significant reliance in meeting the overarching execution requirement,
- a warning to the client regarding the use of specific instructions.

15.2 CESR considers that where a retail client requests additional information about a firm's execution policy and such a request is reasonable and proportionate, the firm, by virtue of its duty to act fairly and professionally[1], should consider honouring such a request, especially where such information is needed to enable the client to make a properly informed decision about whether to utilise, or continue utilising, the services of the firm.

Q16 Is there additional information about its execution policy which a firm that executes orders or decisions to deal should disclose to its professional *clients?*

16.1 An investment firm should provide appropriate information about its execution policy to its professional clients. There are no provisions within MiFID that detail what constitutes "appropriate information" for professional clients.

16.2 Firms should supply information to professional clients upon request provided the request is reasonable and proportionate. What is reasonable and proportionate will depend on the facts and circumstances of each particular situation.

Q17 Is there additional information about its policy which a firm that transmits or places orders with other entities for execution should provide to its clients?

17.1 A firm that transmits or places orders with other entities for execution should provide "appropriate information" on its policy to its clients.

17.2 This information should enable the client to understand the key aspects of the firm's policy. Depending on the circumstances, it may be appropriate to mention the relative importance of the factors or to describe the process used to select the entities. It will also be appropriate to mention the entities used, depending on the circumstances. For example, where an investment firm includes only a small number of entities in its policy, it may be appropriate to disclose them to clients.

[1] See Article 19(1) of Level 1.

Q18 What should a firm do if it amends its execution policy?

18.1 An investment firm that executes orders or decisions to deal should notify its clients of any material changes to its execution arrangements or execution policy. A change is material where its disclosure is necessary to enable the client to make a properly informed decision about whether to continue utilising the services of the firm. In particular, a firm should consider the materiality of any changes it makes to the relative importance of the best execution factors or to the venues on which it places significant reliance in meeting the overarching best execution requirement.

18.2 There is no comparable requirement for firms that only transmit or place orders with other entities for execution but do not execute orders or decisions to deal.

Q19 How should disclosure on the (execution) policy be presented?

19.1 Investment firms should provide their clients with appropriate information in a comprehensible form.

19.2 A firm executing orders or decisions to deal on behalf of retail clients should provide the required information about its execution policy either in a durable medium or by means of a website under certain conditions[1]. Any such disclosure could be incorporated into the client agreement.

Q20 How do clients consent to the execution policy?

20.1 An investment firm that executes orders or decisions to deal should obtain the prior consent of its clients to its execution policy. CESR observes that for consent to be valid, the legal provisions of the relevant Member State relating to the giving of consent must be satisfied, without prejudice to what is said in Q14 through Q16 about the information that the firm should provide to clients.

20.2 A firm should obtain the prior express consent of its clients before executing their orders outside a regulated market or MTF.

20.3 There are no comparable requirements for firms when they transmit or place orders with other entities for execution but do not execute orders or decisions to deal themselves.

Q21 What is the difference between "consent" and "express consent"?

21.1 Where MiFID requires "prior express consent", CESR considers that this entails an actual demonstration of consent by the client which may be provided by signature in writing or an equivalent means (electronic signature), by a click on a web page or orally by telephone or in person, with appropriate record keeping in each case.

21.2 CESR considers that on a purposive reading of the "express consent" requirement, an investment firm does not have to obtain express consent from its clients where the relevant instruments are not admitted to trading on a regulated market or MTF.

---

[1] See Articles 3(1) and 3(2) of Level 2.

21.3 CESR understands that "prior consent" may, at least in some jurisdictions, be tacit and result from the behaviour of the client such as the sending of an order to the firm after having received information on the firm's execution policy.

21.4 Competent authorities are empowered to require evidence from firms that tacit consent has been given by clients and may have access to any document and demand information from firms in this regard[1]. In particular, a firm may be asked to show that it has supplied clients with the appropriate information on its execution policy.

Q22 In what respects and under what circumstances can a firm that transmits or places orders with other entities for execution rely on those entities to help it satisfy the overarching best execution requirement?

22.1 MiFID clarifies that its best execution provisions are not intended to require a firm that transmits or places orders with other entities for execution to duplicate the efforts of its execution entities. Rather, a firm should determine that the entities it uses will enable it to comply with the overarching best execution requirement when placing an order with, or transmitting an order to, another entity for execution.

22.2 To this end, a firm should review the execution arrangements of the entities it wishes to use to determine whether they will allow the firm to comply with all its best execution requirements.

22.3 In determining whether an entity is likely to enable the firm to obtain the best possible result for its clients, a firm also may need to consider:

- o whether the entity itself is subject to Article 21 for the relevant business, that is, whether the entity is an investment firm executing or receiving and transmitting orders on behalf of the firm and the entity has agreed to treat the firm as a retail or professional client;
- o whether the entity will undertake by contract to comply with any or all of the MiFID best execution requirements in relation to the relevant business (with the result that it has contractual but not regulatory responsibilities for best execution); and
- o whether the entity can demonstrate that it delivers a high level of execution quality for the kind of orders that the investment firm is likely to place with or transmit to it.

Furthermore, with respect to the relevant business, if an entity is subject to Article 21 or undertakes by contract to comply with Article 21, and the firm merely transmits or places orders with the entity for execution, taking few steps itself that affect execution quality, and the firm has determined that the entity has arrangements that will enable the firm to comply with its obligations under Article 45, then CESR considers that the firm will be able to place a high degree of reliance on that entity in order to comply with its own overarching best execution requirement. That is, in these circumstances, CESR considers that a firm would be complying with the overarching best execution requirement with respect to particular orders simply by placing them with or transmitting them to such entities. Of course, the firm would still be subject to the other requirements of Article 45, in particular the requirements to implement an appropriate policy and to monitor and review its effectiveness, including the execution quality actually delivered by such entities. And the firm could not continue to rely on an entity if its monitoring or review indicated that the entity was not, in fact, enabling it to obtain the best possible result for the execution of its client orders.

[1] See Articles 50(1)(a) and (b) of Level 1.

22.4 In addition, when devising its policy, a firm should consider whether it is reasonable simply to transmit or place orders with another entity for execution or whether it is necessary to exercise some additional control over how its orders are executed, in order to meet the overarching best execution requirement. Similarly, any actions the firm takes that may affect the quality of execution of the order should be consistent with the overarching best execution requirement. For example, where a firm gives specific instructions to an execution entity about how or where a particular transaction is to be executed, those instructions should comply with the overarching best execution requirement.

22.5 Firms are not restricted to using entities subject to MIFID for carrying out their orders. In order to be able to use an entity that is not subject to the MiFID best execution regime, in particular a non-EEA service provider, firms should ensure that the execution arrangements of such an entity allow them to comply with the overarching best execution requirement. Where the firm cannot satisfy itself that this is the case, it should not use such entities.

Q23 What is the requirement to review?

23.1 Review is an overall assessment of whether the (execution) policy and/or arrangements include all reasonable steps that the investment firm could be taking to obtain the best possible result for the execution of its client orders. Specifically, the firm should consider whether it could consistently obtain better execution results if it were to:

- include additional or different execution venues or entities;
- assign a different relative importance to the best execution factors; or
- modify any other aspects of its (execution) policy and/or arrangements.

23.2 All investment firms should carry out reviews at least annually. A firm should also review its (execution) policy and/or arrangements whenever a material change occurs that could affect its ability to obtain the best possible result for the execution of its clients' orders. What is material will depend on the nature and scope of any change.

Q24 What is the requirement to monitor?

24.1 Monitoring is the assessment, on a regular basis, of particular transactions in order to determine whether the investment firm has complied with its (execution) policy and/or arrangements, and whether the resulting transaction has delivered the best possible result for the client.

Monitoring may include comparing similar transactions:

(i) on the same execution venue or with the same entity, in order to test whether a firm's judgement about how orders are executed is correct, or

(ii) on different execution venues or entities chosen from among those in the firm’s (execution) policy, in order to test whether the 'best' execution venue or entity is being chosen for a given type of transaction.

24.2 Where monitoring reveals that a firm has fallen short of obtaining the best possible result, the firm should consider whether this is because the firm has failed to follow its (execution) policy and/or arrangements or because of a deficiency in such policy and/or arrangements, and make appropriate amendments.

24.3 All investment firms should undertake monitoring, but the monitoring methodology is at the discretion of the firm. Where monitoring every transaction would be disproportionate, other approaches, such as appropriate methodologies for sampling, may suffice.

Q25 Will the precise nature of review and monitoring vary depending on where a firm sits in a chain of execution?

25.1 Investment firms that execute orders or decisions to deal will need to monitor and review the steps they are taking to deliver the best possible result, as well as the performance of the execution venues they are using.

25.2 Investment firms that transmit or place orders with other entities for execution may need to take different approaches to their review and monitoring requirements, depending on how much control they exercise over the way their orders are executed. A firm may merely send orders received or decisions to deal to an entity for execution, taking few steps itself that affect execution quality and therefore relying to a high degree on the entity with respect to how orders are to be executed; alternatively, it may provide that entity with more or less extensive instructions about how the order should be executed or take steps to manage the execution of the order itself before sending the order to an entity. In the second case, the firm should monitor and review its own actions and their impact on the execution quality it is obtaining.

25.3 In any event, firms that transmit or place orders with other entities for execution should review and monitor the execution quality of the entities they use.

25.4 In addition, if a portfolio manager is empowered to either execute its decisions to deal itself or to place orders with other entities for execution, then, as part of the review process, it should compare the performance of the entities it uses with its own performance in executing its decisions to deal.

Q26 Is CESR currently undertaking any work on execution quality data?

26.1 No. CESR will consider any request from the Commission to examine execution quality data or any other aspect of best execution and will report such requests as and when they are received. CESR will consider whether further work is needed in relation to best execution as part of the assessment of the MiFID work programme starting in November 2007.

Q27 What is the outcome of CESR's call for evidence on article 21(5) of the Level 1 'demonstration of compliance'?

27.1 An investment firm that executes orders or decisions to deal should be able to demonstrate to its clients on request that such executions have been carried out in accordance with its execution policy. After November 2008, with one year of practical experience of the MiFID rules, CESR will consider whether there is a need to do further work to align the practices in this respect.

CESR

Section 3 – Definitions

In the interests of clarity and simplicity, CESR has kept to the terminology used in MiFID and its implementing directive wherever possible. However CESR considers it useful to abbreviate certain of these terms and concepts in order to keep the length of this paper to a minimum and to make its contents as user friendly as possible. Non-MiFID terms have only been used where CESR considers such concepts useful aids to understanding the directive. These terms are defined here but CESR does not intend for these terms to supersede or add to the terms of the directives in any way.

Level 1	Directive 2004/39/EC of 21 April 2004
Level 2	Directive 2006/73/EC of 10 August 2006
MiFID	Collectively Directive 2004/39/EC of 21 April 2004 and Directive 2006/73/EC of 10 August 2006
Article 21	Article 21 of Directive 2004/39/EC of 21 April 2004 (Level 1)
Articles 44, 45 and 46	Articles 44, 45 and 46 of Directive 2006/73/EC of 10 August 2006 (Level 2)
(Execution) policy	The "execution policy" under Article 21 and the "policy" under Article 45.
Execute orders or decisions to deal	Execute orders on behalf of clients, or execute decisions to deal on behalf of client portfolios when providing the service of portfolio management.
Carrying out	(i) Executing an order on behalf of a client (ii) When providing the service of portfolio management, placing an order with an entity for execution that results from a decision to deal in financial instruments on behalf of a portfolio or executing a decision to deal in financial instruments on behalf of a client (iii) When providing the service of reception and transmission of client orders, transmitting client orders to other entities for execution The European Commission has confirmed its intention to give the term this meaning as used in the context of client order handling in Articles 47, 48 and 49 of Level 2
Execution venues	Regulated markets, MTFs, systematic internalisers, market makers or other liquidity providers or entities that perform a similar function in third countries to the function performed by any of the foregoing (last paragraph of Article 44(1) of Level 2)

Entities	Natural or legal persons or other entities that either transmit or execute orders in financial instruments
Best execution factors	The factors listed in Article 21(1) of Level 1. These factors are also referred to in Article 45(4) of Level 2.
Overarching best execution requirement	The requirement under Article 21(1) and Article 45(4) to take all reasonable steps to obtain the best possible result for the execution of client orders, taking into account the best execution factors
Transmit or place orders with other entities for execution	Transmit client orders to other entities for execution when providing the service of reception and transmission of orders, or place orders with other entities for execution that result from decisions to deal in financial instruments on behalf of client portfolios when providing the service of portfolio management.

Appendix – European Commission response to CESR questions on scope

CESR

EUROPEAN COMMISSION
Internal Market and Services DG

FINANCIAL SERVICES POLICY AND FINANCIAL MARKETS
Director

23.03.07 1179

Brussels, 19 March 2007
G3 D(2007)

Mr. Eddy Wymeersch
Chairman
CESR
Avenue de Friedland 11-13
75008 Paris
FRANCE

Subject : **Best execution – scope issues under Mifid and the implementing directive**

Dear Eddy,

Following Arthur Philippe's request of 15 November 2006 please find the Commission services' opinion on the three issues related to best execution for which CESR asked for clarification.

Yours sincerely

David WRIGHT

J:\A FS 80 SECURITIES\FS 80.30 ISD - MIFID\30.1 MIFID\30.1.8 Implementation\30.1.8.1Best execution

Commission européenne, B-1049 Bruxelles / Europese Commissie, B-1049 Brussel - Belgium. Telephone: (32-2) 299 11 11.

http://ec.europa.eu/internal_market/

CESR

WORKING DOCUMENT ESC-07-2007

Commission answers to CESR scope issues under MiFID and the implementing directive

Issue 1 - Dealing on quotes

In what circumstances do the best execution requirements apply to firms who operate by providing quotes and then dealing?

In many markets in financial instruments firms operate by providing 'quotes' (that is, prices at which they may be willing to buy or sell:
- continuously, such as for example, on a web-page or some limited access bulletin board; or
- to a particular person, such as, for example, in response to a 'request for quote' from that person, which is communicated electronically or over the phone,

and then dealing with a person to whom they have made a quote.

In its consultation paper published on 31 October 2006, the UK FSA has suggested that best execution requirements do not necessarily apply to firms who operate in this way for either or both of the following reasons:

(i) A firm operating in this way may not be providing an investment service, only performing an investment activity. That is, there is no client;

(ii) A firm operating in this way does not receive a client order, because there can only be an order where the firm commits to do something on behalf of the client and the presumption is that there is no such commitment in this type of dealing. (An order would be, for example, where the firm commits to obtaining the best price.)

Other CESR members believe that the above-mentioned interpretation is not consistent with Art. 21 of MiFID and Art. 44 of the implementing directive because the "dealing on quotes" meets the criteria of dealing on own account. Dealing on own account with clients by investment firms should be considered as the execution of client orders and therefore is subject to the best execution requirements (Recital 69 of the implementing directive).

The interpretation according to which "dealing on quotes" does not amount to "dealing on own account" was expressly rejected in the negotiation of level 2 measures. The rationale behind was that such an interpretation runs against the approach adopted in the Level 1 regulatory framework.

According to MiFID, only eligible counterparties may be allowed to enter into transactions without benefiting of the best execution requirements. Apart from such an exception, whenever an investment firm executes an order, it provides an investment service to a client, therefore best execution requirements apply.

Moreover, Art. 44(3) of the implementing directive expressly refers to the need of taking into account the client's nature (retail/professional) in order to achieve the best possible result.

The motive for not having exempted professional clients may be that the best execution rules not only serve the purpose of investor protection but also to foster the competition between execution venues and overall market efficiency. This is expressed in Art. 21(6) of MiFID ("fair and orderly functioning of markets") and Art. 44(4) of the implementing directive ("discriminate unfairly between execution venues").

Commission services' response

1. We do not consider it fruitful to distinguish between, on the one hand, cases where a service is being provided to a client and, on the other hand, those where an activity is simply being carried on *with* a person who is not a client. The Level 1 Directive provides no clear criterion for distinguishing between these two situations. It is clearly the case, for example, that carrying on the activity of dealing on own account can also involve the provision of a service to a client in some cases. This much is implicit in Recital 69 of the Level 2 Directive. Therefore, we do not believe this distinction should determine whether or not best execution is required in a particular case. Similarly, we do not believe it is useful to focus on the question of when an *order* arises. Again, this is consistent with Recital 69, which clarifies that whenever a firm deals on own account with a client there should be considered to be an order.

2. As a corollary, we believe that whenever a person or entity enters into a transaction with an investment firm, it will do so in the capacity either of an eligible counterparty, or as a retail or professional client.

3. As regards eligible counterparties, Article 24 of MiFID provides that best execution obligations under Article 21, together with conduct of business obligations under Article 19 and client order handling obligations under 22(1), do not apply. At the same time, as indicated by Recital 40 of MiFID, eligible counterparties should be considered to be acting as clients. One consequence of this is that the protections of Articles 13 and 18, relating *inter alia* to conflicts of interest and client assets, will continue to apply. As regards retail or professional clients, Articles 13, 18 and 19 of MiFID will always apply whilst the application of Article 21 will depend on what is said below.

4. In our view, the key concept to focus on in interpreting Article 21 is the execution of orders *on behalf of clients*. This is consistent with the definition in Article 4(1)(5) of MiFID, which refers specifically to a firm acting to conclude agreements to buy or sell financial instruments *on behalf of clients*, and the description of the relevant investment service in Annex I to MiFID as the "execution of orders on behalf of clients". Both provisions support the idea that the requirement that an order is being executed on behalf of a client is integral to the concept of best execution.

5. Recital 33 of MiFID provides some explanation of the concept of execution of orders *on behalf of clients*, by indicating that it will typically be present in a range of circumstances which are broadly referred to in that Recital as situations where 'contractual or agency obligations' are owed by the firm to the client[1]. It is also important to note that Recital 33 of MiFID circumscribes the scope of Recital 69 of the level 2 Directive, so that the scope of best execution requirements in relation to dealing on own account is limited to circumstances covered by Recital 33 where the firm is acting on behalf of the client (and is thereby in a position to make decisions that will affect the interests of the client).

[1] However, the reference to 'agency' in Recital 33 is not intended to equate the application of best execution obligations with the existence of an agency relationship under the applicable national law.

Indicative examples of cases where a firm executes an order on behalf of a client and therefore best execution applies

6. Applying the principles set out above, transactions based on a client's request to the investment firm to buy or sell a financial instrument for him will *always* fall within the concept of execution of an order on behalf of a client. This will include the following types:

o Executing a client order by dealing as agent for a client. In this situation, the intermediary takes a customer order and places the order, on behalf of the client, with an execution venue (such as an exchange, a systematic internaliser or another liquidity provider) for execution. For example, client A instructs investment firm B to buy 100 shares of X. The firm must then seek the execution venue that offers the best conditions for buying X shares at the time that the order is to be executed.

o Executing a client order against the firm's own proprietary position (including as a systematic internaliser), where the firm is making decisions as to how the order is executed: e.g. where it is 'working the order' on the client's behalf. For example, client A gives the same instruction as in the preceding example, but investment firm B sells 100 shares in X to client A from its own portfolio. In this case, B puts itself in competition with other relevant execution venues and can execute the client instructions by selling the shares from its portfolio, provided that in doing so it obtains the best result for the client as compared with the other execution venues surveyed.

o Executing a client order by dealing as a riskless principal on behalf of the client, including cases where the client is charged a spread on the transaction. In this type of transaction, the investment firm will typically deal as principal with its client at the same time, and on the same terms (as to instrument, time and price (allowing for any spread)), as it enters a transaction as principal with a counterparty.

Indicative examples of transactions where a firm generally does not execute an order on behalf of a client and therefore does not owe an obligation of best execution to its client

7. Transactions based on a specific request by the client to buy or sell a financial instrument from the investment firm, or on the acceptance by the client of an offer made by the firm to buy or sell a financial instrument from the firm, will typically not fall within the concept of execution of an order on behalf of a client unless in all the circumstances, taking into account the considerations set out in paragraph 8 below, the firm should properly be regarded as acting on behalf of the client. This class of transactions will include the following type:

o Executing a client order by entering a proprietary trade with the client in those cases not covered by paragraph 6 above. This includes the case where the firm engages in proprietary trading by quoting on a 'request for quote' basis. For example, client A requests a quote from investment firm B for 100 shares of X. The firm provides a quote which the client accepts and asks to buy 100 shares at the price quoted by B. By way of further example, B is a market maker that displays its quotes and Client A "hits" the quote displayed by B.

8. However, in some cases, proprietary trades will attract the best execution obligation. The application or otherwise of best execution will depend on whether the execution of the client's order can be seen as truly done *on behalf of* the client. This is a question of fact in each case which ultimately depends on **whether the client legitimately relies on the firm to protect his or her interests in relation to the pricing and other elements of the transaction - such as speed or likelihood of execution and settlement -that may be affected by the choices made by the firm when executing the order**. The following considerations, taken together, will help to determine the answer to this question:

- o whether the firm approaches (initiates the transaction with) the client or the client instigates the transaction by making an approach to the firm. In those cases where the firm approaches a retail client and suggests him to enter into a specific transaction it is more probable that the client will be relying on the firm, to protect his or her interests in relation to the pricing and other elements of the transaction.

- o questions of market practice will help to determine whether it is legitimate for clients to rely on the firm. For example, in the wholesale OTC derivatives and bond markets buyers conventionally 'shop around' by approaching several dealers for a quote, and in these circumstances there is no expectation between the parties that the dealer chosen by the client will owe best execution.

- o the relative levels of transparency within a market will also be relevant. For markets where clients do not have ready access to prices while investment firms do, the conclusion will be much more readily reached that they rely on the firm in relation to the pricing of the transaction.

- o the information provided by the firm about its services and the terms of any agreement between the client and the investment firm will also be relevant, but not determinative of the question. The use of standard term agreements to characterise commercial relationships otherwise than in accordance with economic reality should be avoided.

9. These factors are likely to support the presumption that, in ordinary circumstances, a retail client legitimately relies on the firm to protect his or her interests in relation to the pricing and other parameters of the transaction. Similarly, *prima facie* application of these factors is likely to lead to the presumption that in the wholesale markets clients do not rely on the firm in the same way.

Issue 2 - Use of Specific Instructions

What scope may "specific instructions" from a client cover?

Investment firms are considered to meet their best-execution obligation in respect of specific client instructions for an order or an aspect of an order.

Recital 68 clarifies that when an investment firm executes an order following specific instructions from the client, it should be treated as having satisfied its best execution obligations only in respect of the part or aspect of the order to which the client instructions relate. This provision should not be used by firms to avoid their duty of best execution. In particular, firms should not "suggest" instructions from their clients and thus avoid complying with their obligation.

Commission services' response

10. Recital 68 of the Level 2 Directive must be read in its entirety. In particular, the clarification that a firm should not solicit a specific instruction by expressly indicating or implicitly suggesting the content of an instruction to a client is limited to those circumstances "when the firm ought reasonably to know that an instruction to that effect is likely to prevent it from obtaining the best possible result for that client". So, a firm that 'suggests' instructions to a client should not be considered as avoiding best execution in all cases.

11. For example, a client chooses to use a Direct Market Access system, such that he himself selects parameters of the trade (such as the price, the counterparty, the venue, the timing and the size of trade). In such a case the dealer, while acting on the client's behalf in providing the DMA service, will be treated as having satisfied its duty of best execution to the extent that the client has given specific instructions by means of the DMA system.

The scope for specific instructions deserves legal clarifications as regards, at least, its application in customised products.

Regarding application of the best-execution to customised products (e.g. an Over-The-Counter product), where the client indicates the particular characteristics of the product that he/she wants, can this specification of the characteristics be considered "specific instructions"? Or, as recital 70 of the implementing directive already provides for a differentiated approach to best execution, should this be dealt with not as a scope issue but as an issue of the relevant standard of best execution? Or, in case of complex products, should we consider that the best execution requirement applies to each of the single components of the product?

Commission services' response

12. Best execution applies to OTC customised instruments in those cases when the firm is considered to be acting on behalf of the client. This will depend on the factors set out in our answer to issue 1. A customised instrument should be understood as that instrument which is tailored to specific needs of a client and for which there is practically no liquidity. On the contrary, an OTC plain vanilla option on a single liquid share with a maturity of one month should not be considered as a customised instrument.

13. The fact that the client specifies what he needs in terms of exposure and protection does not necessarily exclude the application of best execution. In the first stage where an investment firm proposes to a client the elements of an OTC derivatives contract that would respond the client's needs, it is more appropriate to speak of investment advice rather than best execution. For example, a client may ask an investment firm to design an instrument that will protect him against a collapse in gas prices and a spike in the price of electricity. The investment firm may propose a number of alternatives with different pay-off structures and advise the client to select one particular design meaning the suitability obligations apply. Best execution obligations could apply depending on the considerations set out in our answer to issue 1.

14. Ordinarily, in those circumstances where best execution applies, the identity of the instruments sought will be a matter of the information contained in the order rather than a question of specific instructions. Nevertheless there may be a level of discretion as to exactly which instruments to obtain on behalf of a client in the order.

15. In the case of complex products[2], the best execution requirement (when applicable) applies to the product as a whole. Best execution for the product as a whole may conceivably be obtained even if best execution for each component, when considered in isolation, is not obtained.

[2] We understand complex products as those that are composed of or represent the performance of more than one product.

.

CESR

Issue 3 - Obligations on portfolio managers and order receivers and transmitters

In what circumstances do portfolio managers and order receivers and transmitters "execute client orders"?

Some take the view that portfolio managers execute client orders when they deal directly with execution venues, including direct access to regulated markets as well as use of MTFs, investment firms that deal on own account and other liquidity providers and counterparties.

Others take the view that portfolio managers never execute client orders, except possibly where they arrange transactions between their clients ("agency cross transactions"). For transactions in quote driven markets, some argue that portfolio managers are price takers, not makers, and that, for this reason, they are not 'executing client orders'. Rather, it is the dealer who executes.

In addition, some investment firms that provide retail brokerage services suggest that they themselves only receive client orders and transmit them to other investment firms, it is these other firms that take responsibility for executing these orders. Is there any clear line that can be drawn between reception and transmission of client orders for execution and execution of client orders? Is it possible for two firms in a chain of execution both to be viewed as executing those orders?

These questions are particularly relevant for the operation of Article 45(7) of the Implementing Directive and Article 66 of the Level 1 Directive. Article 45(7) provides that Article 21 (not Article 45) applies to portfolio managers and order receivers and transmitters when they execute client orders.

The requirements under Article 45 are not as extensive as those under Article 21. Therefore, brokerage firms and portfolio managers have an incentive to characterise their business models as something other than execution of client orders.

If portfolio managers do execute client orders when they deal on quote driven markets or deal "direct" via regulated markets or MTFs, then there is a question about what Article 45(7) means for portfolio managers authorised under the UCITS Directive. This is because MiFID Article 66 only applies MiFID Articles 2(2), 12, 13 and 19 to UCITS portfolio managers but not Article 21. Does MiFID apply to transactions by UCITS portfolio managers when they execute client orders?

Commission services' response

16. Since the "execution of orders on behalf of clients" is a distinct investment service, it could be argued that only those entities licensed to provide this particular service can execute orders or decisions to deal on behalf of clients. This would mean that investment firms authorised to provide portfolio management services[3] may transact directly with execution venues (i.e. execute decisions to deal) only if they are authorised to provide the service of execution of orders on behalf of clients.

17. The consequence of this reading would be to prevent UCITS management companies from transacting directly with execution venues when providing the investment service of individual portfolio management under Article 5 of the UCITS directive.

18. In accordance with this reading, in such cases Article 45(7) of the implementing Directive will simply not apply because those entities cannot provide the service of execution of orders, and the question as to whether Article 21 applies to UCITS management entities providing the service of portfolio management would be irrelevant.

[3] Thus bringing them within the scope of MiFID. Collective investment undertakings that do not carry on individual portfolio management (or any other investment service of activity regulated under MiFID) are excluded from the scope of MiFID (Article 2(1)(h)).

19. However, the MiFID implementing Directive supports a different interpretation of the relevant provisions which is more consistent with current business practices and also ensures the level of investor protection and gains in market efficiency which the best execution obligations are designed to secure. Under this interpretation, an authorisation to provide the service of portfolio management under Article 5(3) of the UCITS Directive is treated as entitling portfolio managers to execute their own decisions to deal. However, if , when executing the decisions to deal, those persons should be required to comply with the same obligations as those under Article 21 of the MiFID. Any other outcome would compromise investor protection.

20. Article 45(7) of the Level 2 Directive implies that persons who are authorised to carry out portfolio management are not considered to provide the MiFID service of executing orders on behalf of clients when executing decisions to deal in the course of the activity of portfolio management, because there may not necessarily be any client orders when the portfolio manager decides to initiate a transaction on behalf of a client's portfolio.

21. However, the Level Directive 2 recognises that the same policy concerns arise in situations when a portfolio manager executes a decision to deal as are present when an investment firm executes an order on behalf of a client. Indeed, in both cases, transactions are executed on behalf of clients, be they clients under management or clients placing orders. In fact, there seems to be little or no difference, in so far as the interests of the client are at stake, between a situation where a client receives advice from an investment firm and acts on this advice by issuing an order to an investment firm for execution and a situation where a portfolio manager executes a decision to deal directly with an execution venue. In both cases the client needs to be able to rely on the firm's expertise to deliver the best possible result for the transaction.

22. This is why Article 45(7) of the Level 2 Directive provides that when an investment firm that provides the service of portfolio management transacts or deals directly with an execution venue (i.e. executes a decision to deal), it should comply with the obligations under Article 21 of MiFID.

23. This means that UCITS asset managers and investment firms, when executing orders directly (rather than transmitting them to an intermediary who would execute them on their behalf) in the course of providing the service of individual portfolio management, will have to comply with the obligations under Article 21. This is necessary in order to ensure adequate investor protection.

Reception and transmission

24. There should be a clear regulatory distinction between a firm that is authorised both to receive and transmit orders and to execute them and a firm that may only receive and transmit client orders for execution to another investment firm. The latter firm may not in any way alter client instructions as it transmits them to another firm for execution or further transmission.

25. Execution of a client order or a decision to deal is always carried out when an investment firm is the last link in the chain of intermediaries between the client order and an execution venue. Clearly, an investment firm may be the first and the last link in the chain: for example, when a client order is executed by an investment firm in its capacity as systematic internaliser.

26. A firm which is authorised both to receive and transmit orders and to execute orders on behalf of clients will need to comply either with Article 21 of MiFID or with the requirements under Article 45 of the MiFID implementing Directive, depending on whether the investment firm transacts directly with the execution venue or transmits the order to another firm for execution. In cases where the investment firm transacts directly with the execution venue, Article 21 of MiFID always applies.

27. Sometimes an investment firm that is authorised to execute orders but acting in its capacity as a receiver and transmitter of orders, issues instructions to another executing firm which are not client instructions and which may affect the quality of execution of the order. In such cases, the instructing firm must comply with Article 45 of the implementing Directive. Execution of the order is carried out by the last firm in the chain.

28. The firm which receives instructions (which are not client instructions) from another investment firm should comply with any instructions passed on to it, treating them as if they were client instructions for the purposes of Article 21(1). However, it must deliver best execution in respect of any part of the order which is not covered by an instruction.

CESR THE COMMITTEE OF EUROPEAN SECURITIES REGULATORS

Ref: CESR/07-228b

Inducements under MiFID

Recommendations

May 2007

11-13 avenue de Friedland - 75008 PARIS - FRANCE - Tel.: 33.(0).1.58.36.43.21 - Fax: 33.(0).1.58.36.43.30

Web site: www.cesr.eu

Contents

1. Introduction

Article 19(1) of the Level 1 Markets in Financial Instruments Directive 2004/39/EC ("MiFID") provides that when providing investment services and/or, where appropriate, ancillary services to clients an investment firm must act honestly, fairly and professionally in accordance with the best interests of its clients. Article 26 of the MiFID implementing Directive 2006/73/EC ("Level 2 Directive"), entitled "Inducements", sets further requirements in relation to the receipt or payment by an investment firm of a fee, commission or non-monetary benefit that could, in certain circumstances, place the firm in a situation where it would not be acting in compliance with the principle stated in MiFID Article 19(1).

In its consultation papers (CESR/06-687 published in December 2006 and CESR/07-228 published in April 2007)) CESR explained that it was considering issuing a recommendation setting out a common supervisory approach to the operation of Article 26 of the Level 2 Directive.

Objective of the recommendations

The public consultation has allowed CESR to understand and to take into account the views of market participants (both investment firms and consumers). Following consultation CESR is providing recommendations that are intended to facilitate a consistent implementation of Article 26 of the Level 2 Directive without imposing further obligations on investment firms. This will help investment firms to assess the way in which the provisions will be interpreted.

It is important to note that the main objective behind the inducements rules in MiFID is investor protection. In elaborating these Level 3 recommendations, CESR's intention has been to implement this principle by taking into account valid considerations such as level playing field between the treatment of financial instruments and business models that are within the scope of application of the inducements rules under MiFID.

The recommendations are, therefore, designed to foster supervisory convergence across the EU and to ensure consistent implementation and application of the Level 2 Directive.

Status of the recommendations

The outcome of CESR’s work is reflected in the recommendations set out in this paper which are addressed to CESR members, which are provided with explanatory text. These do not constitute European Union legislation and will not require national legislative action. CESR Members will apply the recommendations in their day-to-day supervisory practices on a voluntary basis. The recommendations below are not stand-alone obligations or new requirements.

The European Commission has participated as an observer in the course of CESR's elaboration of the recommendations. In particular, CESR has discussed with the Commission the interpretation of the legal obligations under MiFID and its Level 2 Directive on inducements; the Commission agrees with the legal interpretation given by CESR. Furthermore the Commission considers that the contents of this paper do not go beyond the MiFID legal texts and that the approach taken in this paper comes from the normal, natural reading of MiFID and the Level 2 Directive.

CESR recommendations for the consistent implementation of MiFID and of the Level 2 Directive will not prejudice, in any case, the role of the Commission as guardian of the Treaties.

General comments on responses to consultations

In developing its recommendations CESR has carefully considered the responses to its two consultation papers from the industry and from consumer representatives. Many industry respondents suggested that CESR had been in error in determining the scope of Article 26 of the Level 2 Directive. In particular, they suggested that "standard commissions or fees [2]", were outside the scope of Article 26 altogether or, if not, that they were outside the scope of Article 26(b). CESR has considered these comments very carefully as they are fundamental to a proper understanding of the provisions. However, CESR has concluded that the interpretation of Article 26 that it adopted in its consultation papers is correct. Article 26 must be interpreted in the context of Article 19(1) of MiFID; but, although Article 26 is entitled "inducements", its content covers any fee or commission or non-monetary benefit that an investment firm may receive or pay in connection with the provision of investment and ancillary services to clients. It sets the characteristics of these fees and commissions in order for a firm to act honestly, fairly and professionally in accordance with the best interests of its clients. So, "standard commissions and fees" (for example, those that are customary in and at the usual level in a particular market) are of a nature to fall within Article 26. CESR has discussed this with the Commission, which, in relation to this issue of scope, agrees with CESR.

It has been argued that the disclosure element in inducements could favour a system of vertical integration at the disadvantage of the so called 'open architecture'. CESR is clarifying in this document that intra-group inducements are covered by the application of the provisions of the MiFID Level 2 Directive. In this way, payments made between distinct legal entities pertaining to the same group which only offer their own products are treated in the very same way as payments in the context of 'open architecture' firms.

The recommendations provided by CESR do not discriminate between different types of financial instrument and apply to all financial instruments within MiFID scope (see Annex I, section C of MiFID). They apply only to firms within the scope of MiFID. So, for example, they do not apply to the managers of collective investment undertakings where they are acting within the scope of the exemption provided in Article 2(1)(h) of MiFID (unless Member States apply such requirements, in the exercise of discretion outside the scope of MiFID). Where potential regulatory arbitrage cannot be simply addressed and resolved by virtue of application of MiFID (eg for investment products that do not fall under the scope of MiFID), CESR will signal this potential arbitrage to the European Commission for possible European regulatory interventions.

CESR has also taken this opportunity to illustrate a greater degree of flexibility in the interpretation of "designed to enhance the quality of the service and not impair compliance with the firm's duty to act in the best interests" of its clients, in particular, in response to industry concerns about the application to standard commissions and fees.

[2] The term "standard commission or fee" is used in Article 21(e) of the Level 2 Directive in the context of establishing minimum criteria for identifying types of conflict of interest that arise in the course of providing an investment or ancillary service. The term is not used in Article 26.

2. Recommendations

General

1. Article 19(1) of the Level 1 Directive requires investment firms to act honestly, fairly and professionally in accordance with the best interests of their clients when providing investment services and/or, where appropriate, ancillary services. Other provisions of MiFID and of its implementing provisions provide measures relevant to the same objective. The main provisions in this field include those set out in Articles 19(2) to 19(8) of the Level 1 Directive and Articles 26 to 45 of the Level 2 Directive.

2. Article 26 of the Level 2 Directive sets further requirements in respect of the general duty to act in accordance with the best interests of clients. It is intended, in particular, to set standards for the payment and receipt by investment firms of fees, commissions and non-monetary benefits. This is because such benefits, in some circumstances, place the firm in a situation where it would not be in compliance with the general duty to act in accordance with the best interests of clients. In order to do so, the Article applies in relation to the receipt or payment by an investment firm of any fee, commission or non-monetary benefit, but applies in a different way to different types. It does not deal with payments made within the investment firm, such as internal bonus programmes, even though these could give rise to a conflict of interest covered by Article 21[3] of the Level 2 Directive.

3. Inducements are referred to in Article 21 of the Level 2 Directive and in the title of Article 26 of the Level 2 Directive. Article 21 sets out minimum criteria that a firm must take into account in identifying relevant types of conflict of interest. Article 26 sets conditions that must be met in order for a fee, commission or non-monetary benefit to be allowed. In doing so, it applies to all fees, commissions and non-monetary benefits that are paid or provided to or by an investment firm in relation to the provision of an investment or ancillary service to a client. Therefore, Article 26 should not be treated as applying only to payments or receipts that are made with the purpose or intent to influence the actions of a firm. However, regulators and supervisors will, of course, direct their attention to items and situations in which there is a greater possibility of harm to the interests of clients.

4. Article 26 applies only to items received or provided by an investment firm, whereas through the concept of "relevant persons" the rules on conflicts of interest also apply to individuals working for the investment firm. When a relevant person is acting for the firm in relation to the provision of an investment or ancillary service to a client Article 26 also applies to items paid by a third party to that relevant person acting in such a capacity. Small gifts and minor hospitality below a level specified in a firm's conflicts of interest policy are irrelevant for this purpose.

5. The scope of application of Article 26 is the same in relation to payments between firms that are members of the same group as it is to payments between firms that are not members of the same group.

[3] Articles 21 to 23 (Conflicts of interest) of the Level 2 Directive provide elaboration of the principles set out in Articles 13(3) and 18 of the Level 1 Directive.

Recommendation 1: General

BOX 1

CESR considers that:

(a) Article 26 of the MiFID Level 2 Directive applies to fees, commissions and non-monetary benefits paid by an investment firm or received by it in relation to the provision by it of an investment or ancillary service to a client. Such fees, commissions and non-monetary benefits include commissions or fees that may be paid or provided to or by an investment firm and which are standard in the market;

(b) The application of Article 26 is the same in relation to a payment or non-monetary benefit provided to or made by a legal entity within the same group as the investment firm as it is to one provided to or made by any other legal entity.

Article 26 (a) of the Level 2 Directive : items "provided to or by the client"

6. Article 26(a) provides for circumstances in which an investment firm is not prohibited from paying or receiving fees, commissions or non-monetary benefits in relation to an investment or ancillary service provided to a client. The circumstances are where the item is a *"fee, commission or non-monetary benefit paid or provided to or by the client or a person on behalf of the client"*.

7. In CESR's view it is clear that if the client himself negotiates and pays a fee for a service provided by the investment firm then the payment of that fee will be within Article 26(a). Another clear circumstance will be if someone is acting under a general power of attorney on behalf of the client. The effect in such cases of Article 26(a) is that the relevant payments will not be subject to Article 26(b). This will not affect the operation of disclosure under Article 19(3) of MiFID and its implementing provisions.

8. To consider a payment made or received on behalf of the client under Article 26(a), the client needs to be aware that this payment has actually been made or received on his behalf. The client may of course give a specific separate instruction to a person to act on his behalf in making or receiving the payment of a fee or commission. This would generally include circumstances in which there is a clear payment instruction, agency agreement, or the other person is acting as a "mere conduit" for the payment.

Recommendation 2: Article 26(a)

BOX 2

CESR considers that:

Article 26(a) applies when the payment is made/received by the client or by a person on behalf of the client. This includes where the client pays a firm’s invoice directly or it is paid by an independent third party who has no relevant connection with the investment firm regarding the investment service provided to the client, such as an accountant or lawyer, acting on behalf of the client. A separate, specific instruction issued by the client to the investment firm to receive or make a payment on his/her behalf will also be relevant. The fact that the economic cost of a fee, commission or non-monetary benefit is borne by the client is not alone sufficient for it to be considered within Article 26(a).

Article 26 (c) of the Level 2 Directive

9. Article 26(c) defines a category of item ("proper fees") that can be paid to or provided by an investment firm. It contains two tests that the payment must meet in order for the exception to apply. The first one is that the payment must "enable or be necessary" for the provision of the service; the second one is that "by its nature [it] cannot give rise to conflicts with the firm's duty to act honestly, fairly and professionally in accordance with the best interests of the client." Any items that are of a type similar to the proper fees it mentions, that is custody costs, settlement and exchange fees, regulatory levies or legal fees which "enable or are necessary for the provision of investment services" and "which, by their nature, cannot give rise to conflicts with the firm's duties to act honestly, fairly and professionally in accordance with the best interests of its clients" will not be subject to Article 26(b). This will not affect the operation of disclosure under Article 19(3) of MiFID and its implementing provisions.

10. The list of items provided by Article 26(c) cannot be exhaustive. Within Article 26(c) are a number of conditions or factors that must be considered in determining whether an item can be considered to fall within it. Particularly important is whether an item by its nature cannot give rise to conflicts with the firm's duty to act, honestly, fairly and professionally in accordance with the best interests of its clients. This is a test that needs to be considered in the abstract, on the "nature" of the item; that is not on the basis of whether the result of the payment has been to give rise to such a conflict. The possibility of a receipt of a standard commission or fee is of a nature to give rise to conflicts with the duty owed to clients. (For example, it can provide an incentive to act in other than the best interests of the client because it is to the firm's advantage to make recommendations that will maximise the commission the firm will earn).

Recommendation 3: Article 26 (c) of the Level 2 Directive ***BOX 3***

CESR considers that:

The list of items mentioned within Article 26(c) of the Level 2 directive is not exhaustive, but in considering whether items that are not specifically mentioned also fall within Article 26(c) the factors that are mentioned within it need to be considered. Of particular importance is whether an item by its nature cannot give rise to conflicts with the firm's duty to act, honestly, fairly and professionally in accordance with the best interests of its clients.

Article 26(b): conditions on third party receipts and payments

11. In CESR's view, Article 26 (b) performs two functions:

- First, it ensures disclosure of legitimate third party payments and non-monetary benefits that do meet the tests established in Article 26 (b) (ii).
- Second, the article prohibits certain third party payments and non-monetary benefits. That is, those that do not meet the tests set out in Article 26 (b) (ii).

12. Items that are not "proper fees which enable or are necessary for the provision of investment services (…) and by their nature cannot give rise to conflicts with the firm's duties to act honestly, fairly and professionally in accordance with the best interests of its client" and that are paid to the investment firm by a third party (or which the investment firm pays to a third party) and not the client or a person on behalf of the client, are dealt with under Article 26 (b) of the Level 2 Directive.

13. Unlike payments to and receipts from clients these have to meet a number of conditions in order not to be prohibited. These are:

(a) the item must be designed to enhance the quality of the relevant service to the client and it must not impair compliance with the firm's duty to act in the best interests of the client; and,

(b) there must be clear, prior disclosure to the firm's client.

14. These tests appear to be primarily concerned with circumstances in which the client of an investment firm will bear the cost of the payment or receipt of a monetary or non-monetary benefit to or by an investment firm, but which may also result in some benefit to the investment firm. In these circumstances the interests of the investment firm and its client are not necessarily the same or aligned. Article 26(b) puts regulatory controls around payments where there is the possibility of client detriment.

15. Ordinarily, the two legs of the test in (a) in par. 13 would be considered as a whole, but it is worth noting that in relation to "designed to enhance the quality of the relevant service to the client", the use of the word designed makes clear that a judgement about a fee or payment, or arrangements for fees or payments, can be made at the time the arrangement is proposed, rather than only once a payment has been made. Further, CESR considers that such payments may also benefit other clients or groups of clients apart from the particular client that is receiving the investment service; in this case the requirement to enhance the quality of the relevant service to the client is met at the level of the service, provided that the other clients or groups of clients are receiving such a service. For example, a bank will be able to assess the requirement at the level of reception and transmission of orders placed by all its clients and relating to a specific business line towards these clients. However, it will not be able to assess this requirement at the level of the service provided to all its clients over different business lines. The assessment at the level of service should not be interpreted too widely to convert the test into a meaningless exercise. This does not prevent competent authorities from assessing compliance with the requirements on the basis of the effective use that is made of inducements received by a given firm.

16. CESR considers it will be helpful to CESR members to set out factors that could be used in determining whether arrangements that an investment firm has entered into or proposes to do so are consistent with the test in (a) in par. 13 above. Factor (d) will be particularly relevant in some cases, for example, if the investment firm and the third party have a number of joint or common interests. In these cases, firms should assess whether these relations are influencing the firm to act in a way that is not in the best interests of the client. It is important to note that the factor in recommendation 4(d) will not always be relevant; the fact that a group relationship exists is not by itself relevant.

17. On factor (c), conflicts management measures can help to mitigate the effect of incentives that could influence the investment firm to act other than in the best interests of the client. It is important to stress that the conflicts management rules and the inducements rules are complementary and not substitutes or alternatives. Compliance with the conflicts rules does not provide a safe-harbour from the inducements rules. Compliance with the inducements rules does not provide a safe-harbour from the conflicts rules.

18. The factors included in Recommendation 4 must be considered as tools to help investment firms and CESR members to assess whether current and future arrangements investment firms are considering entering into are consistent with Article 26. The factors do not represent a 'one size-fits all approach' and are not intended to apply uniformly to all situations.

19. The factors set out in Recommendation 4 are relevant to both advice-based and non advice-based distribution models, and in general for the provision of all investment and ancillary services. They are indicative criteria only and not strict or exhaustive factors that must be taken into account in all cases. They are not standalone obligations or new requirements.

Recommendation 4: Factors relevant to arrangements within Article 26(b) ***BOX 4***

CESR considers that the following are among the factors that should be considered in determining whether an arrangement may be deemed to be designed to enhance the quality of the service provided to the client and not impair the duty of the firm to act in the best interests of the client:

(a) The type of the investment or ancillary service provided by the investment firm to the client, and any specific duties it owes to the client in addition to those under Article 26, including those under a client agreement, if any;

(b) The expected benefit to the client(s) including the nature and extent of that benefit, and any expected benefit to the investment firm; the analysis about the expected benefit, can be performed at the level of the service to the relevant client or clients;

(c) Whether there will be an incentive for the investment firm to act other than in the best interests of the client and whether the incentive is likely to change the investment firm's behaviour;

(d) The relationship between the investment firm and the entity which is receiving or providing the benefit (although the mere fact that a group relationship exists is not by itself a relevant consideration);

(e) The nature of the item, the circumstances in which it is paid or provided and whether any conditions attach to it.

Recital 39 of the Level 2 Directive

20. In relation to the nature of the investment service, is important to take into account Recital 39 of the Level 2 Directive. This refers to situations where investment firms are paid by commissions received from product providers (such as, by the management company of a collective investment scheme). CESR's view is that recital 39 makes clear that such a type of remuneration can be legitimate, provided that the investment firm's advice or general recommendation to its client is not biased as a result of the receipt of that commission. If this condition is met then the advice or recommendation should be considered as having met the condition of being designed to enhance the quality of the service to the client. The other conditions of Article 26 (b) – disclosure, and, the obligation not to impair compliance with the duty act in the best interest of the client – must also, of course, be met, as must other obligations under MiFID.

21. Recital 39 is limited to an investment firm that is giving unbiased investment advice or general recommendations. However, it does not exclude that other cases may be treated in similar terms. An example is where an issuer or product provider pays an investment firm for distribution where no advice or general recommendation is provided. In such cases the investment firm will be providing an investment service to its end-clients; in the absence of payment by the product provider or issuer these investment services, most likely, would not be provided; therefore, in the distribution of financial instruments the payments could be seen as being designed to enhance the quality of the service to the client by allowing that investment service being performed over a wider range of financial instruments. The other conditions of Article 26 (b) – disclosure, and, the obligation not to impair compliance with the duty act in the best interest of the client – must also, of course, be met, as must other obligations under MiFID.

Recommendation 5: Recital 39 to the Level 2 Directive **BOX 5**

CESR considers that:

(a) Recital 39 makes clear that where an investment firm provides investment advice or general recommendations which are not biased as a result of the receipt of commission then the advice or recommendations should be considered as having met the condition of being designed to enhance the quality of the service to the client. The other conditions of Article 26 (b) – disclosure, and, the obligation not to impair compliance with the duty to act in the best interests of the client – must be met;

(b) Recital 39 is relevant to cases in which an investment firm is giving unbiased investment advice or general recommendations. It is not exhaustive and does not prohibit other distribution arrangements under which an investment firm receives a commission (from, for example, a product provider or issuer) without giving investment advice or general recommendations. For these cases, payments can be seen as being designed to enhance the quality of the service to the client by allowing a given investment service to be performed over a wider range of financial instruments. The other conditions of Article 26 (b) – disclosure, and, the obligation not to impair compliance with the duty act in the best interests of the client – must be met.

Article 26(b) of the Level 2 Directive: Disclosure

22. Article 26 recognises in 26 (b) clear, prior disclosure to the firm's client as one of the conditions for receipts or payments paid or provided to or by a third party to be permitted.

23. As far as the content of the disclosure is concerned, Article 26 (b) (I) is clear in setting out the information that an investment firm should provide, that is: " *the existence, nature and amount of the fee, commission or benefit, or, where the amount cannot be ascertained, the method of calculating that amount*". A generic disclosure which refers merely to the fact that the firm may or will receive inducements is not in CESR's view sufficient to enable the investor to make an informed decision and therefore will not be considered as meeting the requirements of Article 26.

24. The final paragraph of Article 26, however, allows the investment firm to provide a "summary disclosure" (" *the essential terms of the arrangements relating to the fee, commission or non-monetary benefit in summary form*") rather than the full information. CESR considers that means it must contain enough information to enable the client to make an informed decision.

25. There has been some concern about distribution channels where between a product provider and the final client there is at least one further intermediary. Each investment firm that is providing an investment or ancillary service must comply with its obligation of disclosure to its clients in relation to the services that it provides.

<u>Recommendation 6: Disclosure under Article 26(b) of the Level 2 Directive</u> ***BOX 6***

CESR considers that:

(a) in order to contain the "essential terms" a summary disclosure must provide adequate information to enable the investor to relate the disclosure to the particular investment or ancillary service that is provided to him, or, to the products to which it relates, to make an informed decision whether to proceed with the investment or ancillary service and, whether to ask for the full information;

(b) a generic disclosure which explains merely that the firm will or may receive or pay or provide items within Article 26(b) is not sufficient to enable a client to make an informed decision and therefore will not be considered as providing the "essential terms of the arrangements" referred to in Article 26 of the Level 2 Directive;

(c) when a number of entities are involved in the distribution channel, each investment firm that is providing an investment or ancillary service must comply with its obligation of disclosure to its clients.

3. Illustrative examples to show the application of the Recommendations

26. In order to explain how Article 26 operates CESR provides below a number of examples. These illustrate some of the variety of circumstances in which Article 26 of the Level 2 Directive is relevant.

27. The examples deal only with the application of Article 26 of MiFID Level 2 Directive in relation to the circumstances they mention and are presented without prejudice to firms' other obligations under MiFID.

28. The examples are for illustration purposes only; although they are intended to be helpful in assessing cases that arise in practice, each such case must be assessed on its own merits and in accordance with its own circumstances. It is not correct to extrapolate the conclusions reached in these examples without a thorough analysis of the context and specific circumstances of each case.

I. A client of an investment firm agrees a fee of €100 an hour plus disbursements for the service of investment advice. The investment firm provides the advice and issues an invoice for 10 hours work €1000 and an additional €200 for disbursements. The client pays the invoice himself or instructs his accountant to pay the invoice.

The payment is clearly paid by the client or by a person on behalf of the client and as such is within Article 26(a) of the Level 2 Directive. No additional requirements under Article 26 apply to the arrangements.

*****

II. A client of an investment firm that provides portfolio management services agrees a fee of 1% per annum of assets under management charged pro rata to be paid out of assets under management and that dealing costs such as dealing fees charged by brokers will also be paid out of the client's assets.

The payments out of the client's funds for the service of portfolio management are clearly paid by the client or by a person on behalf of the client and as such are within Article 26(a) of the Level 2 Directive. The payment of the dealing fees will amount to payments on behalf of the client within Article 26(a). No additional requirements under Article 26 apply to the arrangements.

*****

III. A client has agreed with investment firm (A) the fee that he will pay to (A). The client could, if he wishes in connection with an investment or ancillary service provided by (A), also provide an explicit instruction to (C) to pay the amounts that the client owes to investment firm (A) out of the client's account with (C). The client is able to instruct (C) to cease to make such payments.

Here it is clear that (C) is acting on behalf of its client and the arrangements are within Article 26 (a), and, that (C) is not a "third party" such as to require the tests of Article 26(b) to be met.

*****

IV. *A client of an investment firm that provides portfolio management services agrees a fee of 1% per annum of assets under management charged pro rata to be paid out of assets under management and that dealing costs such as dealing fees charged by brokers will also be paid out of the client's assets. The portfolio manager agrees with one broker that 20% of the dealing fees above a certain level each year will be repaid. These are paid to the portfolio manager.*

The payments to the investment firm out of the client's assets for the service of portfolio management are clearly paid by the client or by a person on behalf of the client and as such are within Article 26(a) of MiFID Level 2. In this case the portfolio manager has also negotiated a further payment to itself. This receipt by the investment firm from a "third party" (the broker) falls within Article 26(b) and in order for the portfolio manager to retain it and not pay it to the client the tests within Article 26(b) would have to be met. Particularly relevant could be factors 4 (a), (b) and 4(c). The arrangement entered into by the investment firm does not appear to provide any new benefit for the clients of the investment firm. The investment firm itself receives a benefit and therefore has an incentive to use only the broker offering the payments. Any enhancement of the service provided to the investment firm's clients seems unlikely, but the incentive is likely to impair the firm's duty to act in the best interest of its clients (for example, to provide best execution).

*****

V. *An investment firm provides a portfolio management service to a client and charges a fee for that service. The investment firm purchases financial instruments for its client; the provider of those financial instruments pays a commission to the investment firm that is paid out of the product charges made to the client.*

CESR's view is that such arrangements are not altogether prohibited. The receipt of commission in addition to the management fees received for the service of portfolio management is clearly of a nature that could impair the firm's duty to act in the best interests of its client. One clear option for the investment firm is to repay to its client any commissions received. If the investment firm wishes not to do so then special attention has to be paid, since it would be difficult for portfolio managers to meet the other conditions within Article 26, especially the duty to act in the best interests of the client.

*****

VI. *A client (C) of an investment firm (F) wishes to deal in instruments that (F) does not offer. Therefore (F) introduces (C) to another investment firm (A). (C) becomes a client of investment firm (A). (A) provides investment services to (C) and charges transaction fees to (C). (A) then pays a share of those fees to the introducing investment firm (F).*

The arrangements need to be considered from the perspective of both the paying investment firm (A) and the receiving investment firm (F).

CESR's view is that the payment by the investment firm (A) will fall within Article 26(b), and can be considered to be designed to enhance the quality of the service to the client. The payment to the introducing broker must be disclosed and not impair the investment firm's duty to act in the best interest of the client.

CESR's view is that the receipt by the investment firm, where received in connection with an investment or ancillary service provided to (C), will fall within Article 26(b). (F) will need to consider carefully whether the arrangements are permitted under Article 26(b)and for this purpose may find the factors set out in Recommendation 4 useful. Article 26(b) also requires the receipt of the benefit to be disclosed.

*****

VII. *An investment firm provides investment advice or general recommendations to its client, transmits orders to product providers on behalf of the client and it does not charge a fee to its clients but receives commission from the product providers when it arranges such sales.*

If the *investment* advice or general recommendation is not biased as a result of the receipt of commissions the receipt should be considered as designed to enhance the quality of the investment advice to the client. The other conditions of Article 26 (b) will also have to be met, and Recommendation 4 (c) will be particularly relevant.

*****

VIII. *As Example VII above, except that the investment firm receives an additional one-off bonus (or "override") payment once sales of a particular product reach an agreed level.*

Factors 4(b), (c) and (e) are particularly relevant to such an arrangement, and it is doubtful that Article 26(b) can be satisfied. As sales approach the target level it becomes more likely that the firm's advice will become biased towards that particular product, in breach of the duty to act honestly, fairly and professionally in accordance with the best interests of the client.

*****

IX. *An investment firm that is not providing investment advice or general recommendations has a distribution or placing agreement with a product provider or issuer to distribute its products in return for commission paid for by the product provider or a member of its group.*

In such a case the investment firm will be providing an investment service to its end-clients; in the absence of payment by the product provider or issuer these investment services, most likely, would not be provided; therefore, the payments may be seen as being designed to enhance the quality of the service to the client. The other elements of Article 26 (b) must also be met and in considering this, Recommendation 4(c) in particular may be relevant.

*****

X. *An investment firm is providing the ancillary service of corporate finance advice (falling within Section B (3) of Annex I of MiFID). In doing so it incurs its own costs such as fees for legal advice which it does not recharge to its client.*

These costs, *if* they are within Article 26 of the Level 2 Directive at all, are within Article 26(c).

*****

XI. *A product provider provides (without charge) training to the staff of an investment adviser that is an investment firm.*

Such training will be a non-monetary benefit provided to the investment firm and most likely within Article 26(b) of the Level 2 Directive. Within Recommendation 4, factors (b), (c) and (e) will be relevant, for example, the extent to which the training is in relation to services provided to the clients. Training that is provided in an exotic holiday location paid for by the provider is more likely to impair the investment firm's duty to act in the best interests of the client and so not be permitted.

*****

XII. A broker provides to an investment firm general office equipment such as computer equipment.

The office equipment will be a non-monetary benefit provided to the investment firm and most likely within Article 26(b) of the Level 2 Directive. Within Recommendation 4, factors (b), (c) *and* (e) will likely be relevant. Assessment of such items will vary on a case by case basis, depending on all the circumstances. Where equipment provided is closely related to services provided to clients then its provision to an investment firm is more likely to be permitted. Where it is "general" office equipment that can be used for a wide range of purposes within the firm then assessment against the factors in Recommendation 4 is more likely to lead to a conclusion that the item should not be permitted.

Annex A: Extracts from MiFID Implementing Directive 2006/73/EC

Recitals 39 and 40

(39) For the purposes of the provisions of this Directive concerning inducements, the receipt by an investment firm of a commission in connection with investment advice or general recommendations, in circumstances where the advice or recommendations are not biased as a result of the receipt of commission, should be considered as designed to enhance the quality of the investment advice to the client.

(40) This Directive permits investment firms to give or receive certain inducements only subject to specific conditions, and provided they are disclosed to the client, or are given to or by the client or a person on behalf of the client.

Article 21:

Member States shall ensure, for the purposes of identifying the types of conflict of interest that arise in the course of providing investment and ancillary services or a combination thereof and whose existence may damage the interests of a client, investment firms take into account, by way of minimum criteria, the question of whether the investment firm or a relevant person, or a person directly or indirectly linked by control to the firm, is in any of the following situations, whether as a result of providing investment or ancillary services or investment activities or otherwise:
(…)
(e) the firm or that person receives or will receive from a person other than the client an inducement in relation to a service provided to the client, in the form of monies, goods or services, other than the standard commission or fee for that service.

Article 26:

Member States shall ensure that investment firms are not regarded as acting honestly, fairly and professionally in accordance with the best interests of a client if, in relation to the provision of an investment or ancillary service to the client, they pay or are paid any fee or commission, or provide or are provided with any non-monetary benefit other than the following:

(a) a fee, commission or non-monetary benefit paid or provided to or by the client or a person on behalf of the client;

(b) a fee, commission or non-monetary benefit paid or provided to or by a third party or a person acting on behalf of a third party, where the following conditions are satisfied:

(i) the existence, nature and amount of the fee, commission or benefit, or, where the amount cannot be ascertained, the method of calculating that amount, must be clearly disclosed to the client, in a manner that is comprehensive, accurate and understandable, prior to the provision of the relevant investment or ancillary service;

(ii) the payment of the fee or commission, or the provision of the non-monetary benefit must be designed to enhance the quality of the relevant service to the client and not impair compliance with the firm's duty to act in the best interests of the client.

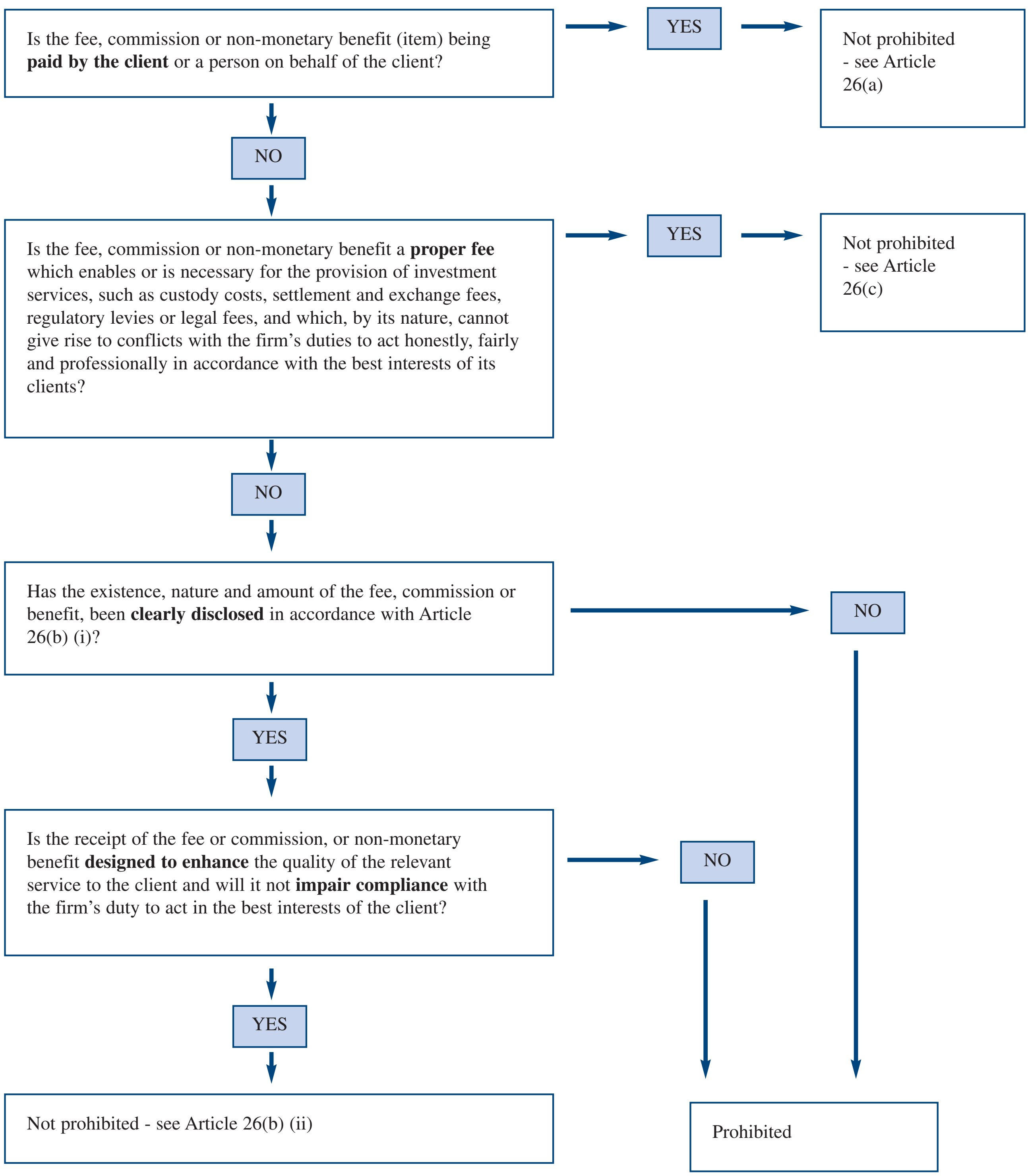
(c) proper fees which enable or are necessary for the provision of investment services, such as custody costs, settlement and exchange fees, regulatory levies or legal fees, and which, by their nature, cannot give rise to conflicts with the firm's duties to act honestly, fairly and professionally in accordance with the best interests of its clients.

Member States shall permit an investment firm, for the purposes of point (b)(i), to disclose the essential terms of the arrangements relating to the fee, commission or non-monetary benefit in summary form, provided that it undertakes to disclose further details at the request of the client and provided that it honours that undertaking.

CESR

Annex B (1)

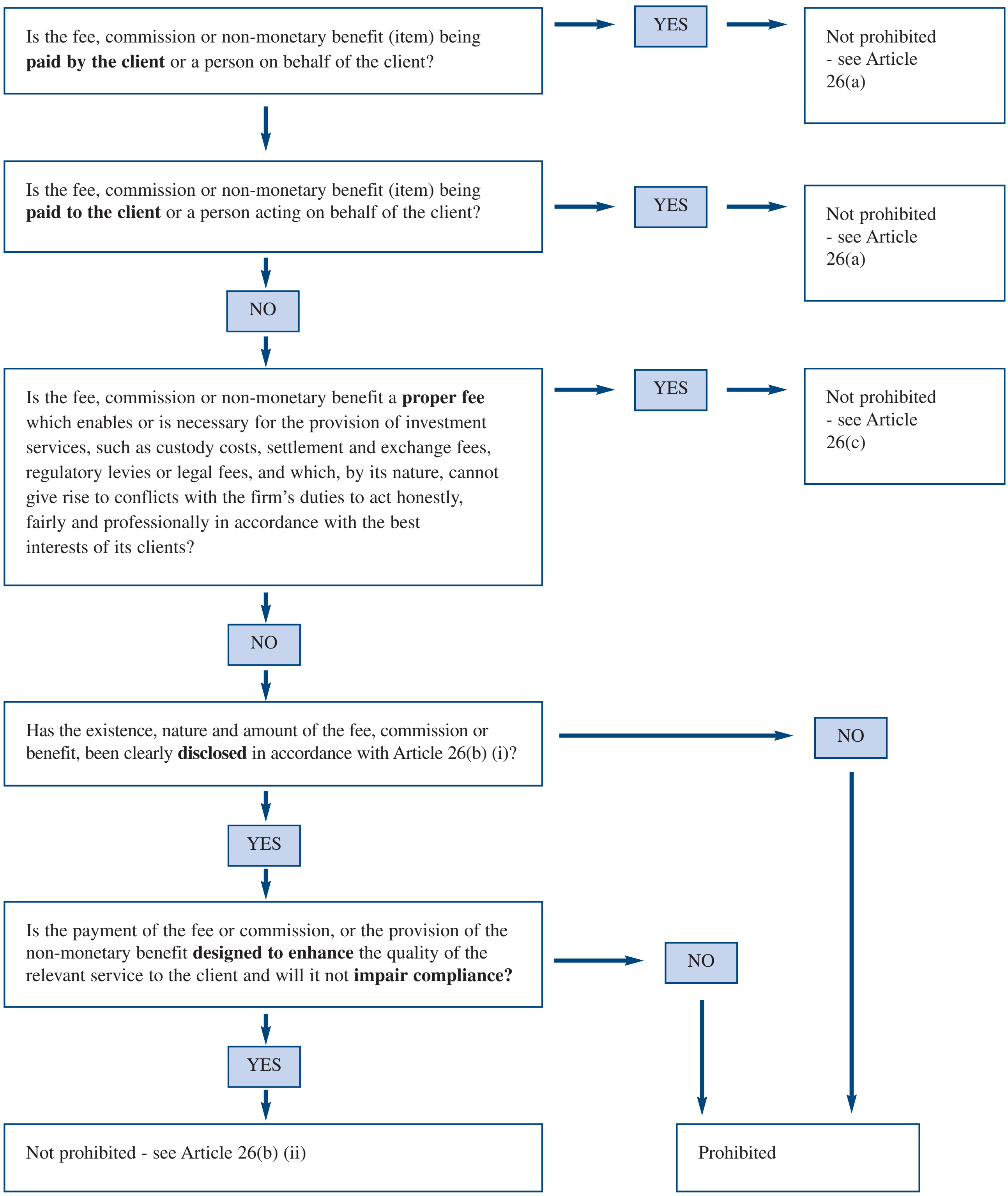
To show the treatment under Article 26 of a fee, commission or non-monetary benefit *received by* a firm in connection with a service provided to its client



CESR

Annex B (2)

To show the treatment under Article 26 of a fee, commission or non-monetary benefit *paid by* a firm in connection with a service provided to its client



FINANCIAL REGULATOR
Rialtóir Airgeadais

PO BOX NO 9138
COLLEGE GREEN,
DUBLIN 2, IRELAND

T +353 1 410 4000
Consumer help-line
lo call 1890 77 77 77
Register of Financial Service Providers help-line
lo call 1890 20 04 69
F +353 1 410 4900
www.financialregulator.ie
www.itsyourmoney.ie
Information Centre: 6-8 College Green, Dublin 2