

The impact of MiFID on the retail customer

We now have a good idea of the impact of MiFID on the governance and systems and controls that firms have in place. On the whole, these are not considered far reaching for those firms who comply with the exiting SYSC requirements.

The organisational implications for MiFID firms dealing with retail investors

For firms who comply with the current SYSC Sourcebook the changes here should be at the margin and some of the more detailed requirements of MiFID will usefully expand upon the very brief statements in SYSC Chapter 3. Many of the issues picked up in MiFID reflect the level of detail seen in SYSC3A (Operational Risk)

The FSA have published the degree to which firms consider they will need to make changes and the statistics quoted come from CP06/9.

New SYSC Chapter	Likely gaps to be filled over and above current Handbook
(4) General organisational requirements	Change will be unlikely unless firms are not operating good governance practices now. The FSA's survey to establish a cost/benefit analysis indicated that for more than 80% of firms there would be no material impact.
(5) Employees, agents and other relevant persons	SYSC equivalent Guidance in SYSC3A.6 People. Most firms 87% reported no material impact from the proposals. Firms will need to review structures to establish where staff could be performing multiple functions that create conflicts.
(6) Compliance (including internal audit);	MiFID requires monitoring of the effectiveness of the systems, internal controls, and arrangements to meet the Common Platform requirements. Together with the need for an independent function, these requirements remove the flexibility that SYSC guidance provides and the need to evidence compliance with these rules will have a high cost impact. The same issues apply to the requirement for an Internal Audit function.
(7) Risk controls	Most firms should have well developed risk management systems although the research suggested that this varied considerable across the population with high costs expected by some firms to comply
(8) Outsourcing;	SYSC equivalent Guidance in SYSC3.2.4 and SYSC3A.9. No material impact expected
(9) Record keeping	Awaiting COB consultation although the draft provisions indicate that all customer records should generally be retained for 5 years.
(10) Conflicts of interest.	Most firms in the survey did not anticipate a material impact although this is one where greater clarity on the options available and understanding of how the FSA will apply the rules in practice is needed.

The greatest impacts will come from the changes required to the long standing content of COB. Before dissecting the drafting of the COB MiFID rules from a technical point of view it is worth considering the benefits this initiative is intended to bring to investors in the UK and in the rest of Europe.

Many of us may be reeling at the implications for our business as we look forward to 2007 but we are at least starting from a position where we stand to lose some of the prescription we have for a more flexible regime. Some countries are starting from scratch to meet these requirements.

Given the speed between the issue of the COB consultation and response (30 days) it is worth reviewing the content of the Conduct of Business elements of MiFID and the main benefits that are expected to arise for retail investors

Benefit 1: A bigger choice of investment service providers

In the UK there is a considerable range of choice for retail investors, indeed, some would say too much. By eliminating barriers to entry across member states and imposing a set of standard Conduct of Business Rules the market for retail investors business should become more competitive. As well as new entrants to the UK we should see UK firms expanding into new territories.

Benefit 2: Consistent high standards of behaviour

All firms will need to meet high standard of management and control as well as delivering a customer service with safeguards, hardly distinguishable from those we have in place now. For example, suitable advice standards, detailed information about the product recommended and disclosure of remuneration. Sounds familiar?

Benefit 3: Communications must be “fair clear and not misleading”

This standard applies to all communications whether individual or through advertising and marketing. The Directive indicates that these communications must be made in a durable medium and that investors should have time to read and understand the information. If the information is published on the web then the web page must be available for a sufficient time for customers to refer to it. The devil is in the detail.

Benefit 4: Better execution

Those customers who deal in investments are intended to benefit from the requirements. A key element of the MiFID Level 1 requirements, that the FSA consulted on in CP06/14, requires that firms check prices and costs across traditional exchanges and new “venues” such as multilateral trading facilities (MTFs), broadly speaking these are non-exchange trading platforms and ‘systematic internalisers’, i.e. banks or investment firms who systematically execute client orders internally on own account (rather than sending them to exchanges).

There are some different terms that apply in the area of execution which will hopefully become clearer. First, there is “Best execution” which requires firms to take all reasonable steps to deliver the best possible result for their clients, taking into account a variety of factors, such as price, speed of execution and cost. Second, “best possible” for retail investors means the most favourable result in terms of the price of the instrument and the costs associated with the execution. No mention is made of other factors when dealing on “best possible terms”.

Benefit 5: Protection against unsuitable generic advice

Advice given when no specific product recommendation is made would currently fall outside of the rules and therefore the protections afforded to retail investors. Under MiFID firms will need to think carefully about this area as it is the intention of the rules that they would be liable for unsuitable generic advice because the high level principle to “act in the best interests of its retail investors” would apply. Conversely, firms not subject to MiFID could give generic advice with not penalty under the rules but be able to sue through the courts, as ever.

Benefit 6: Assurance that the firm will ensure that your instructions are “appropriate”

MiFID blurs the line between “execution only” where an instruction is taken and acted upon with responsibility taken by the customer for the suitability of his/her actions and advice. The measure requires an assessment of “appropriateness” to be made. Retail investors will be able to rely upon firms to assess whether, in giving an instruction in relation to a particular type of product of service, they have the knowledge and experience necessary to understand the risks. To Assess the impact, if any, of this protection we need to wait for the COB Consultation Paper.

Achieving the benefits

Apart from the benefits to retail investors, which seem limited in the UK environment, there are some far-reaching changes in terms of the changes that firms will need to make to the small print. There is also the risk of creep into ICOB and MCOB as COB was the root for the drafting of these rules. As ever, when examining the detail of the changes, the work need to implement the changes will be extensive and costly. The following is a “starter for ten” list of actions that will be necessary to comply with the new COB MiFID rules. -

1. Gap analysis between your compliance requirements and the new rules
2. Reviewing the independence and resorting of the Compliance function
3. A review of services, particularly the provision of advice and categorisation or re structuring to fit the MiFID approach
4. Categorisation of clients into retail investors, professional investors and eligible counterparties
5. Agreeing with retail investors (individuals) whether they wish to be regarded as Professional Investors and have less protection as a result.
6. Writing to retail investors advising them of the categorisation they have been allocated and explaining what that means.
7. Review and revision of dealing practices and methods of evidencing best execution across new trading platforms
8. Changes to procedures and Compliance Manuals
9. Re-training of staff in new practices
10. Setting new Compliance monitoring criteria

Each of the subjects discussed in this article will be developed as not just the FSA’s rules become known, but also as firms look at their particular range of activities and types of retail investors and consider the impact.

The upside is that much of the detail, which exists in the FSA COB Sourcebook, should disappear and the goal of principles based regulation will allow flexibility in the way business is done.

Let’s see!

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