COMMITTEE OF EUROPEAN SECURITIES REGULATORS

Date: 6 May 2010
Ref.: CESR/10-589

Questions and answers on MiFID: Common positions agreed by CESR Members of the Investor Protection and Intermediaries Standing Committee

First version – May 2010

INTRODUCTION - The context and status of this 'Q and A':

MiFID overview:

MiFID is a major part of the European Union's Financial Services Action Plan (FSAP), which is designed to help integrate Europe's financial markets and to establish a common regulatory framework for Europe's securities markets. MiFID comprises two levels of European legislation:

- Level 1, the Directive itself (2004/39/EC), was adopted in April 2004. It is a 'framework' Directive and makes provision for its requirements to be supplemented by technical implementing measures, the so-called Level 2 legislation.
- The Level 2 legislation consists of a directive (2006/73/EC) and a regulation (1287/2006). The Level 2 measures were developed on the basis of technical advice provided by CESR and were the subject of negotiation at European level in the European Securities Committee (ESC). They were formally adopted by the Commission and published in the Official Journal of the European Union on 2 September 2006.

MiFID came into effect on 1 November 2007. Its predecessor is the Investment Services Directive (ISD). MiFID allows regulated markets, multilateral trading facilities (MTFs) and investment firms to operate throughout the EU on the basis of authorisation in their home Member State (the "single passport"). MiFID extended the coverage of the ISD and introduced new and more extensive requirements that firms have had to adapt to, in particular for their conduct of business and internal organisation. In general, MiFID covers most, if not all, firms that were subject to the ISD, plus some that were not. This includes investment banks, portfolio managers, stockbrokers and broker-dealers, corporate finance firms, many futures and options firms and some commodities firms. One of the main purposes of MiFID is to harmonise investor protection throughout Europe.

The Investor Protection and Intermediaries Standing Committee:

The Investor Protection and Intermediaries Standing Committee (IPISC) undertakes CESR's MiFID work on issues related to the provision of investment services and activities by investment firms and credit institutions, with particular regard to investor protection, including the conduct of business rules, distribution of investment products, investment advice and suitability.

In terms of policy, the IPISC has responsibility for elaborating Level 2 advice and Level 3 measures on the provisions of the MiFID applicable to investment services and activities, including the authorisation of investment firms, conduct of business, organisational arrangements and passporting. Where required, the IPISC also advises the European Commission on the need for possible changes to the MiFID Level 1 Directive. In addition, the Standing Committee fosters supervisory convergence among CESR Members in the area of investment services and activities.

All work carried out on these issues, and in particular work carried out to develop convergence amongst supervisors (undertaken by CESR in a Level 3 capacity) is available at:

http://www.cesr.eu/index.php?page=groups&mac=0&id=53

The Investor Protection and Intermediaries Standing Committee MiFID Q and A publication:

This Investor Protection and Intermediaries Standing Committee Q and A publication follows the model that is used by CESR for the Prospectus Directive. It is intended to provide market participants with responses in a quick and efficient manner to 'everyday' questions which are commonly posed to CESR by market participants, CESR Members, or the public generally in relation to investor protection and intermediaries issues. CESR responses do not constitute standards, guidelines or recommendations. The main purpose of the Investor Protection and Intermediaries Standing Committee MiFID Q&A is to address issues of practical application, for which a formal consultation process is considered to be unnecessary. CESR intends to operate in a way that will enable its Members to react quickly and efficiently if any aspects of the common positions published need to be modified or the responses clarified further.

Answers to the questions submitted are closely coordinated with the European Commission.

If you have any questions to CESR on the practical application of any of the MiFID requirements, please send them to the following email address (**mifid@cesr.eu**).

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1. Article 19(4) of Directive 2004/39/EC - Client profile review *April 2008*

Q) **How can an investment firm continue to ensure that it can rely on information provided by the customer (i.e., that the information is not manifestly out of date, inaccurate or incomplete), particularly where the firm is providing an ongoing advisory or portfolio management service?**

A) An investment firm should take reasonable care to keep the customer profile under review, also taking into consideration the development of the relationship between the investment firm and the customer. For example, the customer could be advised that he should inform the investment firm of any relevant changes affecting his investment objectives, risk profile, financial situation/capacity, trading restrictions, or the identity or capacity of his representative. If the firm becomes aware of a relevant change in the clients' situation, it should request any additional information that appears necessary.

2. Article 19(5) of Directive 2004/39/EC - Appropriateness *April 2008*

Q) **According to article 19 (5) of MiFID when an investment firm ascertains that a product or investment service is not appropriate to a client or potential client, it must warn the client or potential client. In such cases, may the investment firm proceed to the provision of the service right after the receipt of the warning by the client?**

A) If a client wishes to proceed with a transaction after the client has been given a warning, it is for the investment firm to decide whether to do so, having regard to the circumstances of the case. But in such cases it may be prudent for the investment firm to ask the client or potential client to confirm in a durable medium his intention to proceed with the service.

3. Articles 48 and 49 of Directive 2006/73/EC – Aggregated orders and trade allocations *April 2008*

Q) **(a) Does Article 48 apply to investment firms when providing the service of portfolio management? In particular, does it apply to decisions to deal giving rise to a single order that may affect two or more client accounts? Or should the expressions "aggregation" and "aggregated orders" be understood as meaning that this Article applies only to cases where there are two or more orders received from clients?**

(b) Does c) of Article 48(1) only require a general order allocation policy at the level of the investment firm? Or does this provision imply that firms should define, prior to transmitting an aggregated order, the way in which the resulting trade (or trades) will be allocated to the relevant accounts? Can firms comply with the requirement to establish and implement an allocation policy that is fair without defining, order by order, how the trade(s) will be allocated, at least in "sufficiently precise terms" to limit the risk of post-trade abuse?

(c) Do Articles 48(2) and 49(3), which require firms to allocate trades in accordance with their order allocation policy and to put in place procedures designed to

prevent reallocations detrimental to clients, require allocations to be done promptly?

A) (a) The expression "carry out a client order" is used in the implementing directive in order to cover both the reception/transmission of client orders and the transmission of decisions to deal on behalf of a client when providing the service of portfolio management, as well as the execution of client orders. Therefore, Article 48 applies to investment firms when they provide portfolio management services. The references to "client orders" in Article 49 should also be understood as encompassing decisions to deal by a portfolio manager, including a single order that may affect two or more client accounts, or one client account and the own account of the firm.

(b) This provision requires firms to establish an order execution policy "in sufficiently precise terms for the fair allocation of aggregated orders and transactions", which means that a general order allocation policy will not suffice to be compliant. A fair allocation policy should state that the intended basis of allocation for each order that may affect more than one account is to be defined prior to execution of the order or transmission of the order for execution, as the case may be. This interpretation is consistent with CESR's recommendations on the list of minimum records that investment firms must keep (CESR/06-552-c).

(c) A fair allocation policy should provide for the prompt allocation of trades, and prompt allocation furthers the objective of preventing reallocations. In addition, Article 47(1) of the implementing directive requires investment firms to ensure, when "carrying out client orders" (see above), that "orders executed on behalf of clients are promptly and accurately recorded and allocated".

4. Article 32(2) of Directive 2004/39/EC – Tied agents ***December 2008***

Q) **Question for CESR concerning the Recommendations for implementation of Directive 2004/39/EC (CESR/07-337b, Chapter C, paragraph no. 30 - 32) undertaken by the MiFID Level 3 Expert Group through the MiFID Level 3 Intermediaries Sub-group.**

If an investment firm located in a Member State intends to provide investment services through a tied agent established in a country where the investment firm has no existing branch, which notification procedure should the home authority use - notification procedure under Art. 31(2)(1) MiFID or under Art. 32(2)(2) MiFID?

According to the paragraph no. 30 of the Recommendations the investment firm can have recourse to a tied agent to exercise either its right to provide services or its right to free establishment. In both cases, the home authority informs the host authority of the firm's intention to use tied agents, and if available at the time of notification, the identity of prospective tied agents according to the standard notification procedure. This implies that both notification procedures (either under Art. 31(2) MiFID or under Art. 32(2) MiFID) are possible.

Furthermore, according paragraph no. 31 of the Recommendations, when making use of the right to free establishment to provide investment services through a tied agent established in a country where the investment firm has no existing branch, the tied agent will be treated as a branch presence in that country. In this case,

where the investment firm exercises only its right to provide services in the host Member State and wants to use just a tied agent there without a branch establishment, we are not sure about the notification procedure.

In the above mentioned case we should according to our opinion use Annex 1 – standard notification form for cross-border services - mentioned in the Protocol on MiFID Passport Notifications (CESR/07-317b) and after this notification this tied agent shall be assimilated to the branch and shall be subject to the provisions of MiFID relating to branches (Art. 32(2) MiFID). The use of Annex 2 – standard notification form for branch establishment mentioned in the Protocol on MiFID Passport Notifications (CESR/07-317b) would in our opinion deprive Art. 31(2)(1) MiFID of its purpose.

Moreover, if we should use Art. 32(2) MiFID, how is the investment firm supposed to fill out the Annex 2 (Program of operations - corporate strategy, commercial strategy, organizational structure) in case of legal entities and in case of natural persons as an established tied agent? Should we then verify the tied agent like a person responsible for the management of the branch or is it enough that the tied agent is verified by the authorisation as a tied agent?

In conclusion, we would like to make the right to free establishment clear. We suppose that this right after MiFID application lies in possibility to provide investment services and/or activities as well as ancillary services either through the establishment of a branch in the host Member State or through the establishment of a tied agent there as well. In this case, would it be possible.

1) **to establish tied agents in the host Member State and notify them according to Art. 31(2) MiFID; and**
2) **to use cross-border tied agents established and also registered in the home Member State or in other Member States (other than the host Member State where tied agents are active under the full responsibility of the investment firm) and notify them according to Art. 31(2) MiFID?**

A) The notification of the appointment of a tied agent established in a Member State where the investment firm does not have any branch should be made under MiFID Article 32(2) which states that:
"...In cases where an investment firm uses a tied agent established in a Member State outside its home Member State, such tied agent shall be assimilated to the branch and shall be subject to the provisions of this Directive relating to branches."

According to the prevailing opinion[1], where a branch does not currently exist, the branch notification provisions in the CESR Protocol on MiFID Passport Notifications (CESR/07-317b) should be effective, as if the firm was notifying its intention to establish a branch for the first time. The home Member State authority should be satisfied that the investment firm has sufficient systems and controls over the tied agent's activities in the host Member State.

Notification under article 31(2) would be appropriate, for example, where the tied agent is established in the home Member State and not the host Member State and intends to provide investment services in the host Member State on a cross-border services basis.

5. Article 41(3)(c) of Directive 2006/73/EC – Leveraged portfolio ***May 2009***

[1] BaFin and the Czech National Bank infer from the wording and context of Art. 32(2) subparagprah 2 MiFID that an investment firm that wants to use tied agents in a country where it is not established through a regular branch, must file a notification according to the rules on the cross-border provision of services (Art. 31 (2) MiFID).

Q) **According to Article 41(3)(c) of the MiFID L2 Directive, "In the case of retail clients, the periodic statement referred to in paragraph 1 shall be provided once every six months, except in the following cases: (c) 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".**

What should be taken into account to determine if the reporting must be provided once a month:

- **the exposure of the portfolio (due to leverage)?; or**
- **the risk incurred by the portfolio (due to leverage)?**

In other words, the concern here is to know if the monthly reporting requirement applies:

- **as soon as the portfolio allows leverage (exposure - for example, if the portfolio manager has bought a call option, the portfolio will be "exposed" to the underlying asset and there should be a monthly reporting) (option 1); or,**
- **only when the portfolio incurs a potential risk of loss due to leverage (for example, if the portfolio manager has sold naked call options, the portfolio may be at risk depending on the value of the underlying asset and there should be a monthly reporting) (option 2).**

A) According to Article 41(3)(c) of Directive 2006/73/EC, the periodic statement of the portfolio management activities must be provided at least once a month where the agreement between an investment firm and a retail client for a portfolio management service authorises a leveraged portfolio. There are two questions to discern: (a) what is meant by "leveraged portfolio"?; and (b) must such a monthly reporting be done as soon as the portfolio management agreement authorises a leveraged portfolio or only when the portfolio incurs a potential risk of loss due to leverage transactions authorised by the agreement?

CESR considers that regarding the notion of "leveraged portfolio", reference should be made to question n° 116 of the European Commission's (EC) Q&A on MiFID which defines this notion. In its MiFID Q&A, the EC has defined 'leveraged portfolio' as follows: "'Leveraged portfolio' is a term that can designate two situations. The first one is the case where the portfolio manager has borrowed in order to finance investment. The term is also used for portfolios containing derivatives or structured products that create investment which is leveraged." (see question n° 116, page 82). CESR understands the second part of the EC definition as meaning that as soon as there is one transaction that creates leverage, there is a leveraged portfolio. A portfolio containing leveraged transactions which are perfectly hedged (i.e. 100% inverse correlation to the initial position) would not amount to a leveraged portfolio for the purposes of this answer. A portfolio containing leveraged transactions which are imperfectly hedged (i.e. less than 100% inverse correlation to the initial position) would amount to a leveraged portfolio for the purposes of this answer.

CESR considers that the wording of Article 41(3)(c) of Directive 2006/73/EC is not ambiguous; as soon as the agreement between an investment firm and a retail client for a portfolio management service authorises any type of leveraged transaction(s), monthly reporting should be conducted. This is irrespective of whether there is a potential risk of loss due to leverage.

6. Articles 17(1) and 18(3) of Directive 2006/73/EC - Due diligence on sub-custodians

March 2010

Q) **When depositing client financial instruments into an account opened with a third party or client funds into an account opened with a credit institution, a bank or a**

qualifying money market fund, should the investment firm exercise a legal due diligence concerning the legal or regulatory framework applying to that third party with regard to the safeguarding of such assets?

A) According to Article 17(1) of Directive 2006/73/EC, investment firms can deposit financial instruments held by them on behalf of their clients into an account opened with a third party provided that the firms exercise all due skill, care and diligence in the selection, appointment and periodic review of the third party and of the arrangements for the holding and safekeeping of those financial instruments. The same provision further specifies that this implies that investment firms shall take into account, amongst other things, any legal requirements or market practices related to the holding of those financial instruments that could adversely affect client's rights. Article 18(3) of Directive 2006/73/EC contains very similar obligations regarding client funds: that Article states that where investment firms do not deposit client funds with a central bank, they exercise all due skill, care and diligence in the selection, appointment and periodic review of the credit institution, bank or money market fund where the funds are placed and the arrangements for the holding of those funds. It also specifies that this implies that investment firms shall take into account, amongst other things, any legal or regulatory requirements or market practices related to the holding of client funds that could adversely affect clients' rights.

CESR considers that the wording of those two Articles implies that the due diligence that investment firms must make when selecting custodians or deposit-taking institutions includes a due diligence of the legal or regulatory framework applicable to such sub-custodians or deposit-taking institutions (a so called "legal due diligence"). This meaning is further confirmed by other Articles of Directive 2006/73/EC, such as Articles 16(2) and (3) or Article 32(2), which contain references to the applicable law. Those Articles do indeed impose additional requirements on investment firms when the applicable law would hinder the protection of the assets of their clients. Firms can organise themselves in the way they find the most appropriate to make such due diligences.

7. Article 23 of Directive 2004/39/EC – Tied Agents *March 2010*

Q) **Can you define the terms broker and an authorised representative? What is the difference?**

Where an individual starts working for a new firm, are there any restrictions preventing him from approaching former clients, from his previous employment, to provide them services offered by his new firm?

Where an individual starts working for a new firm, are there any restrictions preventing him from providing services to former clients from his previous employment when the clients, on their own initiative, approach him?

A) The terms broker and authorised representative are not defined under MiFID.

A broker typically is a person who executes client orders on behalf of a client or receives and transmits orders in relation to one of more financial instruments. A broker can also give investment advice and perform other investment services and activities.

MiFID does not make any reference to authorised representatives. However, under Article 23 of MiFID Level 1, firms are able to appoint Tied Agents. Tied Agents may receive and transmit orders from clients or potential clients.

In relation to the last two questions, MIFID does not contain requirements regarding the solicitation of clients from a former employer.