



LATEST NEWS – The Markets and Financial Instruments Directive:

Introduction

The Markets and Financial Instruments Directive ('Mifid') is the biggest regulatory challenge the UK financial services industry has faced since the Financial Services and Markets Act ('FSMA') 2000 and the Financial Services Authority were implemented in December 2001.

Mifid's implementation date is 1 November 2007 and the FSA has to transpose rules into the FSA rulebook by 31 January 2007. However, firms need to be working on Mifid now to understand how this directive will impact on their organisation's activities and employees.

Mifid amendments will affect most authorised firms (especially those holding client money), including investment advisers, banks, building societies, insurers and investment managers.

Summary of impact

Mifid is an EU directive, replacing in the main the previous Investment Services Directive ('ISD'). Its main areas of focus are:

- Compliance arrangements
- Internal systems and controls
- Outsourcing
- Record keeping
- Conflict management
- Safeguarding of client money and assets
- New FSA Conduct of Business rules, including increased obligations to institutional clients, and new client categorisations.

As it is an EU directive, Mifid has not been specifically drafted with the UK financial services industry in mind. Although the directive allows the FSA to transpose the rules by 'intelligent copy out' of appropriate sections of the directive, the fact remains that it has not been written specifically for the UK industry and this in itself may cause difficulties.

Interaction of Mifid with the Capital Requirements Directive

Linked to Mifid is also the Capital Requirements Directive ('CRD'). This directive consolidates or 'recasts' the requirements from two previous directives, the Capital Adequacy Directive ('CAD') and the Banking Consolidation Directive ('BCD'). Its focus is on prudential requirements and capital standards for firms. It mainly impacts on banks, building societies and investment firms. Therefore many firms have to deal with both Mifid and CRD. The CRD has a much earlier implementation date (1 January 2007) and whilst so much focus has been put on Mifid, some firms may be hit sooner by the provisions of the CRD.



The FSA will issue perimeter guidance in the Perimeter Guidance Manual ('PERG') to give guidance on the scope of impact of these directives. This is currently in draft form. Gem Compliance will cover this topic in a separate article to be issued shortly.

Overlap of Mifid and CRD

There are overlaps on the impact of Mifid and CRD, specifically on changes to organisation's systems and controls. So in many provisions, the FSA has decided to implement a 'common' platform of changes so that, according to the regulator, firms impacted by both Mifid and CRD, have greater certainty and only need to implement a revised compliance regime once.

However this is not as straightforward as it seems. One key difference between Mifid and CRD is that some changes in the CRD apply to a firm as a whole and so 'common platform' aspects will therefore have to cover non-Mifid related activities. It means that, in some cases, there may be 'super equivalence' with the rules. So higher CRD requirements may apply to all firms, even if they are not directly impacted by CRD itself. In addition, this common platform will not apply to all new provisions. There are a small number of CRD or Mifid specific changes that will only be applied to those firms directly covered by the specific directive.

1 January 2007 is not that far away. This only leaves six months to interpret and implement many major changes.

Transition rules for systems and controls

CRD systems and controls requirements will be in place and must be adhered to by CRD impacted firms by 1 January 2007. In addition, Mifid rules must be transposed to FSA rules by 31 January 2007 (they will only be mandatory for Mifid impacted firms from 1 November 2007). Mifid impacted firms will have the option to opt into revised systems and controls rules early, before 1 November. But they can only opt in 'en masse'. Firms cannot select some rules to opt into early and delay opting into others.

The consultation paper on revised Systems and Controls ('SYSC'), CP06/9 was issued in May 2006. Consultation ends on 19 August. However the feedback statement will only be issued in December 2006. This doesn't leave a lot of time to comply with revised rules by 1 January. Therefore, the current consultation document on systems and controls is key to understanding the changes that will be required.

Summary of impact on systems and controls

A revised SYSC handbook will be issued by 1/1/07. For firms not impacted by either CRD or Mifid (or for Mifid only firms until 1 November 2007 if they so choose), current Chapter 3 of SYSC will continue to apply. However for all other firms, SYSC Chapter 3 will no longer apply, and will be replaced by the following new SYSC Chapters:



- SYSC 4 – General organisational requirements (including business continuity).
- SYSC 5 – Employees, agents and other relevant persons (includes senior management requirements).
- SYSC 6 – Compliance (including internal audit)
- SYSC 7 – Risk Controls
- SYSC 8 – Outsourcing
- SYSC 9 – Record keeping (although many of the specific rule changes in this chapter will be issued under separate consultation on revised Conduct of Business rules).
- SYSC 10 – Conflicts of interest.

In addition, some existing related requirements specified elsewhere in the current rulebook e.g. SYSC 3A and certain prudential supervision rules, will be consolidated into further new SYSC Chapters, SYSC 11 to 18.

Gem Compliance will cover the detail of the specific rule requirements in each of the new SYSC Chapters in a separate article to be issued shortly.

Timetable of Consultation

The consultation paper on systems and controls is one of four major consultation papers on Mifid. However, the feedback statement will only be issued in December 2006. In addition to this consultation paper, there are currently three other key papers to be considered:

- (i) Best Execution (CP06/3). The consultation paper was issued in May 2006 with a deadline for comments by 17 August. Concerns have already been raised following the issue of this paper of the future definition of 'execution only' business.
- (ii) All other non-Conduct of Business changes – the consultation paper is due during July 2006.
- (iii) Consultation on Conduct of Business changes. The consultation paper is due in the fourth quarter of 2006.

Next steps.

Firms need to be actioning Mifid developments now. Firms who wish to influence the FSA in their decision-making process need to ensure they provide comments on the consultation papers. But also, plans need to be drawn up now to implement Mifid requirements as effectively as possible by required deadlines. Firms who are concerned that they may also be impacted by CRD need to ensure that they are able to implement CRD specific changes at the very least by 1 January 2007. However for a smooth integration, Mifid changes could also be introduced by that date also – but only if firms plan for this now.

Initial steps include:

Review your regulated activities and the scope of both the CRD and Mifid to identify whether you are impacted by these directives and if so, which one and which activities will be covered.

If your firm is impacted by both, decide whether to implement rule changes in one stage by 1 January 2007 or whether to have a phased integration.



If a staged implementation is considered, there should be analysis on the practical issues such as the costs and risks of staging two related major changes within 12 months. This may require discussions with key stakeholders in your organisation before a final decision can be taken.

Ensure that senior management in your organisation have an awareness of the forthcoming developments and their potential impact on not just regulated activities but the firm as a whole. Gem Compliance can assist you in designing/preparing and delivering an initial briefing to senior management, highlighting key areas of impact and timescales.

Carry out a gap analysis to review the existing arrangements, and the revised requirements. This will in turn enable firms to identify the changes required, and start to form an implementation plan. This plan should identify key milestones in the implementation, appropriate deadlines and also resourcing issues. Gem Compliance can assist you to carry out this gap analysis and to put in place an appropriate implementation plan. We can also assist in the overall implementation process.