



## LEARNING CURVE®

### MiFID: The Implications For Derivatives & Structured Products

The Markets in Financial Instruments Directive came into force across the European

Economic Area on Nov. 1. Although most member states have taken many of the steps necessary for implementation of MiFID, further work needs to be done before all relevant legislation and rules are in place. Understandably, therefore, firms are still getting to grips with the new rules and how they will impact their business.

Two aspects of the rules that could have a particular significance for firms providing investment services in relation to derivatives or structured securities embedding derivatives are the new appropriateness obligation and the best execution rules. Both are considered in turn in this Learning Curve.

#### Appropriateness

Under MiFID, there are two separate standards relating to the degree of due diligence a firm needs to carry out on client before providing investment services. These are the suitability regime and the appropriateness obligation. The more extensive suitability regime applies only where a firm provides portfolio management services or investment advice to its client. The new appropriateness obligation applies where a firm provides any other investment service, including the sale of financial products, to customers without providing advice, subject to certain exemptions.

Where the appropriateness obligation applies, Article 19(5) of MiFID requires a firm to obtain information regarding the knowledge and experience of the client in the relevant investment field to enable the firm to assess whether the proposed investment service or product is appropriate for that client. This obligation is likely to be of most concern to firms which deal with retail clients. This is because under Article 36 of the implementing directive (2004/39/EC), firms are entitled to assume that a professional client has the necessary experience and knowledge to understand the services or products for which it is classified as a professional.

An exemption to the appropriateness obligation applies where a firm provides execution-only services to its client. This

exemption applies solely to services that consist of execution and/or the reception and transmission of client orders where each of the following four conditions are satisfied:

- the service relates to shares admitted to trading in a regulated market, money market instruments, UCITS and other non-complex financial instruments;
- the service is provided at the initiative of the client;
- an appropriate warning is given to the client, which may be in a prescribed format; and
- the firm has complied with its conflicts of interest obligations under MiFID.

The definition of non-complex financial instruments for this purpose expressly excludes derivatives and bonds or securitized debt that embeds a derivative. The execution-only exemption will therefore not be available in relation to these types of products and the appropriateness obligation will apply.

The definition of non-complex product has been the subject of some debate. There is not necessarily a correlation between risk and complexity. An investment in a share trading on a regulated exchange may represent a much greater risk to a client than a principal protected equity-linked bond (where the client is guaranteed to receive its principal back, subject to the credit worthiness of the principal provider). The share can, however, fall within the best execution exemption whilst the equity linked bond cannot.

A wide range of products currently distributed to retail investors including convertible bonds, index tracker products and guaranteed equity bonds will not fall within the definition of non-complex product for this purpose. This may have an impact upon how products are structured. As UCITS compliant products are governed by the UCITS III Directive and can fall within the execution-only exemption in MiFID, this may encourage firms to structure their products under this regime.

It should, however, be noted that the appropriateness obligation is not necessarily a particularly onerous one. Unlike the suitability obligation, it is principally concerned with the level of understanding of the client and whether it

has the knowledge and experience to understand the investment it is acquiring. The obligation does not require a firm to consider the client's investment objectives or whether the client can financially bear the related investment risks. It may, however, require information to be obtained as to the type of transactions the client has previously invested in, the volume and frequency of such transactions and the level of education and professional experience to assess its financial sophistication. The obligation may therefore require additional due diligence which would not be necessary if the execution-only exemption could be relied upon. In relation to existing clients, however, it should be possible for a firm to presume that clients engaged in dealing with such instruments prior to the implementation of MiFID have the necessary experience and knowledge to understand the risks involved in relation to that specific type of instrument.

## Best Execution

The best execution obligation is not a new concept for financial services firms. The formulation in MiFID is, however, likely to require a material change in many firms' procedures to ensure their best execution obligations to clients are satisfied.

The general principle is set out in Article 21 of MiFID, which provides that investment firms should "take all reasonable steps to obtain, when executing orders, 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 the execution of the order."

It is important to note that best execution does not necessarily equate to best price. Firms are required to maintain an order execution policy establishing the relative importance of the factors specified in Article 21 and including information on different venues where the firm executes its client orders. Where a firm executes an order on behalf of a retail client, however, it is necessary that the best possible result be determined in terms of the total consideration including associated costs such as execution venue, clearing and settlement fees. Statements by the **Committee of European Securities Regulators** and national regulators such as the U.K. **Financial Services Authority** make it clear that even with professional clients, price is likely to merit a high level of importance in obtaining the best possible result.

The nature of the best execution duty may, however, be difficult to establish in relation to certain structured products transactions embedding derivatives which are tailored to meet a client's particular needs. Best execution obligations will need to be applied in a manner that takes into account the different circumstances associated with the execution of

orders related to particular types of financial instruments. Recital 70 of the implementing directive states, by way of example, that "transactions involving a customized OTC financial instrument that involve a unique contractual relationship tailored to the circumstances of the client and the investment firm may not be comparable for best execution purposes with transactions involving shares on centralized execution venues".

The background note to the implementing directive states, however, that where there is a tailored contract or instrument, the lack of a precise or reliable benchmark comparison does not relieve a firm of its best execution obligations. The pricing of the instruments should take into account, as far as possible, the market values of the variables that enter into the pricing process or, where possible, use available comparisons and realistic assessment of risk.

In certain cases it may be that, in relation to an entirely bespoke transaction structured with the particular needs of the client in mind, the best execution obligation will be satisfied by the execution of the customized contract where only one execution venue is available. However, if the contract has features which make it similar to products for which there is an available secondary market or market prices can be obtained for the different elements of the product, it is unlikely the product would be regarded as an incomparable customized product for best execution purposes. The best execution obligation does not apply to the extent the product and the price comply with specific instructions from the client.

## Impact Of MiFID On Derivatives And Structured Products

The implementation of MiFID is likely to have an impact on the way in which firms deal with their clients in respect of derivative transactions and transactions embedding derivatives. The new appropriateness obligation and the exclusion of derivatives and products including derivatives from the execution-only exemption may result in certain firms ceasing to sell such products to retail clients or repackaging them in other ways, such as UCITS III compliant products. Firms will also need to consider carefully the impact of the new best execution rules. In particular, in the context of tailored customized products, firms should not assume that the customized nature of the product makes it incomparable with other products for best execution purposes. In such cases the ability to obtain comparisons to ensure best execution should be considered on a case by case basis.

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