EXPLANATORY MEMORANDUM TO THE

THE FINANCIAL SERVICES AND MARKETS ACT 2000 (MARKETS IN FINANCIAL INSTRUMENTS) REGULATIONS 2007
2007 No 126

THE FINANCIAL SERVICES AND MARKETS ACT 2000 (REGULATED ACTIVITIES)(AMENDMENT NO. 3) ORDER 2006
2006 No 3384

THE FINANCIAL SERVICES AND MARKETS ACT 2000 (RECOGNITION REQUIREMENTS FOR INVESTMENT EXCHANGES AND CLEARING HOUSES)(AMENDMENT) REGULATIONS 2006
2006 No 3386

THE FINANCIAL SERVICES AND MARKETS ACT 2000 (EEA PASSPORT RIGHTS) (AMENDMENT) REGULATIONS 2006
2006 No 3385

THE FINANCIAL SERVICES AND MARKETS ACT 2000 (EXEMPTION) (AMENDMENT) ORDER 2007
2007 No 125

THE UNCERTIFICATED SECURITIES (AMENDMENT) REGULATIONS 2007
2007 No 124

1. Introduction

1.1 This explanatory memorandum has been prepared by Her Majesty's Treasury and is laid before Parliament by Command of Her Majesty.

2. Description

2.1 These statutory instruments amend UK financial services legislation contained in the Financial Services and Markets Act 2000 ("FSMA") and its subordinate legislation as part of giving effect in the UK to the EC's Markets in Financial Instruments Directive ("MiFID").[1] They deal with the implementation of a wide variety of provisions in MiFID.

3. Matters of special interest to the Joint Committee on Statutory Instruments

3.1 None.

4. Legislative background

[1] Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments (OJ No. L145, 30.4.2004, page 1).

4.1 MiFID does three main things. It:

- establishes organisational requirements and rules governing behaviour towards investors for firms ("investment firms") who wish to be authorised to undertake activities linked to the buying and selling of financial instruments such as shares, bonds and derivatives;

- sets a regulatory framework for stock and derivative exchanges and other markets where the organised trading of financial instruments takes place;

- facilitates the carrying on of business by investment firms and stock and derivative exchanges and other organised financial markets across national borders in Europe.

4.2 MiFID replaces the Investment Services Directive[2] ("the ISD"). Under new arrangements for financial services legislation in the EU, additional detailed provisions were passed under powers in MiFID ("the implementing directive"[3] and "the implementing regulation"[4]). The UK is required to give effect to the directives in its national law by 31 January 2007 and the measures must come into force on 1 November 2007. The implementing regulation has direct effect and so does not require transposition.

4.3 Some provisions of MiFID (the UK is also required to transpose the implementing directive, although this falls almost exclusively to FSA rules) are already given effect in the UK by existing legislation and Financial Services Authority's ("FSA") rules, but changes are needed to give full effect to the directives. In addition to these statutory instruments, further statutory instruments will follow by early 2007 and an earlier statutory instrument implementing MiFID has come into force:

- The Financial Services and Markets Act 2000 (Markets in Financial Instruments) (Modification of Powers) Regulations 2006.[5] The Regulations extended the Treasury's and FSA's powers in certain respects.

4.4 A transposition note setting out how the main elements of MiFID, and the Community legislation adopted under it, will be given effect in UK law is attached at Annex A.

4.5 The directives are transposed using a number of instruments because we have several different enabling powers with different Parliamentary procedures. The use of different types of Parliamentary procedure (two types of affirmative as well as negative) precludes us from combining all the amendments.

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[2] Council Directive 93/22/EEC of 10 May 19993 on investment services in the securities field (OJ No. L141, 11.6.93, page 27).
[3] Commission Directive 2006/73/EC of 10 August 2006 implementing Directive 2004/39/EC (OJ No. L241, 2.9.2006, page 26).
[4] Commission Regulation (EC) 1281/2006 of 10 August 2006 implementing Directive 2004/39/EC (OJ No. L241, 2.9.2006, page 1).
[5] Statutory Instrument 2006/ 2975.

4.6 One of the instruments which transposes the directives involves a set of amendments to an Order that has already been subject to several amendments (the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001[6] ("RAO")). H.M. Treasury has committed to consult on, and undertake a review of, the RAO within the life of this Parliament to see if the RAO can be rationalised. Consolidation was therefore not considered appropriate.

4.7 An Explanatory Memorandum on the Commission's proposal for a directive was approved by the Scrutiny Committee in the House of Lords on 27 January 2004 and the Scrutiny Committee in the House of Commons on 22 January 2003.

5. Extent

5.1 These Regulations apply to all of the United Kingdom.

6. European Convention on Human Rights

6.1 The Economic Secretary to the Treasury has made the following statement regarding Human Rights: "In my view the provisions of:

- The Financial Services and Markets Act 2000 (Markets in Financial Instruments) Regulations 2007 (S.I. 2007/126)
- The Financial Services and Markets Act 2000 (Exemption)(Amendment) Order 2007 (S.I. 2007/125)
- The Financial Services and Markets Act 2000 (Regulated Activities) (Amendment No. 3) Order 2006 (S.I. 2006/3384)
- The Uncertificated Securities (Amendment) Regulations 2007 (S.I. 2007/124)

are compatible with the Convention rights."

6.2 As the Financial Services and Markets Act 2000 (Recognition Requirements for Investment Exchanges and Clearing Houses) (Amendment) Regulations 2006 and the Financial Services and Markets Act 2000 (EEA Passport Rights) (Amendment) Regulations 2006 are both subject to the negative resolution procedure and do not amend primary legislation, no statement is required.

7. Policy Background

7.1 The intention of MiFID is to encourage the creation of deep and liquid capital markets in the EU and to ensure investors are adequately protected so that they can invest with confidence. As such, MiFID was a key element in the EU's Financial Services Action Plan ("the FSAP"), a legislative programme which was designed to make a significant step forward towards establishing a single market in financial services in Europe. The government endorsed the FSAP.

[6] Statutory Instrument 2001/ 544.

7.2 The European Commission decided that MiFID's predecessor, the ISD, needed to be replaced for two main reasons. Firstly, because it had been ineffective in promoting business across national borders in the single market. Second, because it did not cover important financial services activities such as investment advice and the trading of commodity derivatives.

7.3 In changing legislation to give effect to MiFID in the UK, the Treasury has tried to use, as much as possible, language from MiFID itself to avoid adding additional obligations on UK businesses. Where the words from MiFID have not been copied out this has largely been to ensure a coherent fit with existing provisions.

7.4 An explanation of the key changes to legislation in the statutory instruments covered by this explanatory memorandum is set out below. This is done on a thematic basis as often more than one statutory instrument deals with the same issue. It explains how the final legislation takes account of public consultation. The Treasury ran a public consultation on the legislative changes necessary to implement MiFID between the middle of December 2005 and the end of March 2006. A copy of a feedback statement on the consultation is available on the EU financial services section of the Treasury's website (www.hm-treasury.gov.uk).

7.5 **Scope: the FSMA (Regulated Activities) (Amendment No. 3) Order 2006.** Relative to its predecessor, the ISD, MiFID covers a wider range of investment services and activities and financial instruments. MiFID includes two new main investment services and activities and two new main sets of financial instruments. The services and activities are investment advice and the operation of a multilateral trading facility ("MTF" - an organised market for the trading of financial instruments). The financial instruments are non-financial derivatives and credit derivatives.

7.6 The extension in scope in MiFID goes beyond the current scope of the RAO and so requires amendments to the RAO. The implementing legislation amends:

- the list of exclusions from the RAO which potentially conflict with MiFID;
- the list of activities covered by the RAO;
- the list of investments covered by the RAO.

7.7 Article 2 of MiFID lists a set of exemptions for firms from the requirement to be authorised. To ensure MiFID is implemented properly we need to ensure that none of the exclusions in the RAO would take a firm outside UK regulation where it would be required to be regulated under MiFID. This is done in the RAO by specifying that certain exclusions do not apply where they are not consistent with the exemptions in MiFID (this is sometimes called "the override"). Where the override is applied to an exclusion, firms need to check that they fall inside both the exemption in MiFID and the exclusion in the RAO to determine whether or not they need to be regulated in the UK.

7.8 There is one exclusion in the RAO which was not subject to the override under the ISD which is being subjected to the override under MiFID. That is article 67, which

covers activities carried on in the course of a profession or non-investment business. This is being overridden as the UK exclusion, unlike the similar exemption in MiFID, does not require a person undertaking such business to be subject to a code of ethics.

7.9 All the services and activities required to be regulated by MiFID fit within the activities covered by the RAO. However, the language in the RAO articles that relate to the provision of a service akin to operation of a multilateral trading facility is not very close to that in MiFID, and part of the Commission's purpose in creating this new activity was to provide clarity around its regulatory status (Member States disagree over whether or not it is covered by the ISD). It was therefore decided for the sake of clarity to create a new activity in the RAO, drawing on the language in MiFID.

7.10 The scope of financial instruments in MiFID is wider than the current scope of investments in the RAO. There are three main differences.

- **Options:** Options are products where someone is granted the right to buy or sell something at a specified date in the future at a price fixed today**.** Article 83 of the RAO currently covers options on certain financial instruments, such as shares and bonds, currencies and precious metals. MiFID requires an extension to options on all commodities and various other non-financial products.

- **Futures:** Futures are products where someone agrees to buy or sell a product at a specified date in the future at a price fixed today. Article 84 of the RAO covers futures where they are made for investment rather than commercial purposes. A range of indicative and determinative factors are used to make the distinction. For commodity futures and certain other non-financial futures, MiFID has its own determinative criteria for identifying when a contract falls within regulation. It is necessary to ensure that these take precedence over the current criteria in the RAO.

- **Credit derivatives.** Credit derivatives are products designed to transfer the risk of a credit event such as a default or bankruptcy. They are covered by Article 85 of the RAO to the extent that they take the form of agreements where the parties can make a profit or loss depending on fluctuations in the value of a product. However, some credit derivatives are more in the nature of a bet whereby a payout is made when for example, an event such as a default occurs. MiFID requires that such credit derivatives are brought inside regulation.

7.11 The responses to the consultation in respect of the scope of MiFID touched on several points:

- Many respondents wanted as much clarity as possible on the face of the RAO about which additional financial instruments were being brought into the scope of regulation by MiFID. The final Order tries to spell out more clearly where the scope of coverage is being increased.

- Most respondents welcomed the inclusion of a new activity of operating an MTF as providing welcome clarity. However, some respondents thought it would cause confusion rather than create clarity.

- Most respondents wanted the definition of “investment firm” to include UK branches of firms based outside the European Economic Area ("the EEA"). The final order includes UK branches of firms based outside the EEA. This ensures such branches are treated no more favourably in the UK than branches of investment firms based in the EEA.

7.12 **Recognised investment exchanges and clearing houses: amendments to Part 18 of FSMA in Schedule 2 to the FSMA (Markets in Financial Instruments) Regulations 2007, the FSMA (Recognition Requirements for Investment Exchanges and Clearing Houses)(Amendment) Regulations 2007 and the Uncertificated Securities (Amendment) Regulations 2007.** MiFID includes provisions dealing with the organisation and operation of stock and derivative exchanges. These are akin to existing provisions in UK legislation covering recognised investment exchanges, such as the London Stock Exchange.

7.13 There are three main substantive changes which MiFID brings for recognised investment exchanges. These are requirements that:

- the FSA be notified when someone plans to acquire a controlling stake in a recognised investment exchange and the FSA be able to veto a change of control where this would threaten the proper running of an exchange;

- certain specified information be made publicly available about trading in shares admitted to those markets with the most detailed regulatory standards ("regulated markets");

- detailed rules apply to which instruments can be admitted to trading on regulated markets.

7.14 MiFID also seeks to ensure that access to clearing and settlement infrastructure is opened up for stock and derivative exchanges and their users. Clearing and settlement are the so-called "plumbing" of the financial system, processes which happen after a transaction has been agreed and before it is finalised. In the United Kingdom such services are supplied by recognised investment exchanges and recognised clearing houses, and approved operators of securities settlement systems. There are few specific restrictions on the use of such infrastructure currently in the UK but amendments are being made to enshrine the positive rights granted under MiFID.

7.15 Respondents to the public consultation on the implementation of MiFID were broadly content with the suggested implementing proposals. Some points of detail were raised, such as ensuring that certain standards MiFID only requires to be imposed on regulated markets were not also imposed on less highly regulated markets ("multilateral trading facilities") run by exchanges. Some amendments to the consultation draft were made in response.

7.16 **Tied Agents: paragraphs 2, 3 and 12 of Schedule 5 to the FSMA (Markets in Financial Instruments) Regulations 2007 and the FSMA (Appointed Representatives) (Amendment) Regulations 2006[7].** Under MiFID Member States can allow firms to appoint so-called "tied agents". Tied agents are firms who are not regulated under MiFID but carry out activities on behalf of firms who are regulated under MiFID. This is a similar concept to that already used in existing UK legislation of an "appointed representative". The UK will therefore allow firms it regulates under MiFID to use tied agents.

7.17 But changes to existing legislation are needed to give effect to MiFID's provisions, in particular the requirement that tied agents are entered into a public register held by a regulator. The FSA's register will cover not just tied agents established in the UK, but also tied agents of UK firms who are established in countries which do not permit the firms they regulate under MiFID to use tied agents.

7.18 Respondents to the public consultation on MiFID indicated that they believed it was correct, alongside additions to the FSA's rules, to amend the existing provisions dealing with appointed representatives to help to give effect to MiFID's provisions dealing with tied agents.

7.19 **Passporting: new Chapter 3A of Part 18 to FSMA in Schedule 3 to the FSMA (Markets in Financial Instruments) Regulations 2007, amendments to Schedule 3 to FSMA in Schedule 4 to those Regulations, the FSMA (EEA Passport Rights) (Amendment) Regulations 2006, and the FSMA (Exemption) (Amendment) Order 2007.** MiFID provides a so-called "passport" for firms. If they are authorised under MiFID in one Member State, they can perform activities or provide services in another Member State without requiring an additional authorisation. Firms are, however, required to make notifications to their regulator when they intend to provide services outside the Member State in which they are authorised. These notifications are then passed on to the regulatory authorities in the Member State or Member States in which the firm intends to operate.

7.20 Similar passporting provisions were included in the ISD and are given effect to in existing legislation. However, changes to legislation are needed to reflect minor changes in passporting procedure and some changes in substance between the two directives. Changes of substance include changes related to firms doing business through tied agents. Changes are also required to give effect to the new passporting right for market operators. A new section 312A of FSMA inserted by paragraph 15 of Schedule 2 to the FSMA (Markets in Financial Instruments) Regulations 2006 replaces current provision in the FSMA (Exemption) Order 2001[8] and allows EEA market operators to make arrangements in the UK for access to their systems.

7.21 **Trade matching and reporting systems: new section 412A and 412B of FSMA inserted by paragraph 18 of Schedule 5 to the FSMA (Markets in Financial Instruments) Regulations 2007.** MiFID imposes a requirement that investment firms report certain of the transactions they complete to regulators. Amongst other things this helps regulators to monitor for possible signs of market

[7] The Statutory Instrument in relation to Appointed Representatives will follow separately.
[8] Statutory Instrument 2001/1201.

abuse. MiFID allows firms to make the transactions reports through several different channels, including trade matching and reporting systems approved by a regulator.

7.22 Whilst there are currently transaction reporting obligations in the UK, we do not have arrangements covering transaction reporting through approved trade-matching and reporting systems. The FSA is therefore given a new power to approve such transaction reporting entities, which includes the power to obtain information to ensure that they meet the requirements for approval on an ongoing basis.

7.23 **FSA's powers: amendments to Part 13 of FSMA in Schedule 1, amendments to Part 18 of FSMA in Schedule 2, new Part 18A inserted by Schedule 3 and other amendments to FSMA in Schedule 5 to the FSMA (Markets in Financial Instruments) Regulations 2007 and the Financial Services and Markets Act 2000 (Disclosure of Confidential Information) (Amendment) Regulations 2006[9].** MiFID requires that regulators have wide-ranging powers to enforce MiFID and to co-operate with each other so that cross-border business is effectively regulated. This builds on similar provisions in the ISD however in some places existing powers are required to be used in accordance with different procedures. As a result it is necessary to make changes to legislation.

7.24 Some of the key changes to legislation include:

- ensuring the FSA can take action against firms for breaches of the implementing regulation which has direct effect in the UK (ie it does not need to be turned into domestic legislation or FSA rules);

- the ability for the FSA to require firms to suspend or prohibit trading in instruments admitted to trading on regulated markets where there is a threat to the interests of investors or market stability.

- The grounds on which the FSA may exercise its "power of intervention" are extended in relation to UK branches of EEA firms who have breached any requirements which implement MiFID under FSMA or EC regulations, and EEA firms who have breached any requirements which implement MiFID under their home state's legislation or EC regulations. Subject to notice requirements, the FSA can require or prohibit any action of the firm (eg initiating new business in the UK).

- Alongside changes for information exchange amongst competent authorities required by MiFID, we have taken the opportunity to introduce information gateways to allow information to be shared with the Gambling Commission and the Financial Reporting Council (FRC) and its operating bodies[10].

7.25 In implementing MiFID we have sought to ensure a smooth transition between the new MiFID and the current ISD regimes. The transitional and saving provisions in

[9] The Statutory Instrument in relation to Disclosure of Confidential Information will follow separately.
[10] HMT ran a separate consultation on the introduction of information gateways. The consultation ran between 7th June 2006 and 29th August 2006 and is available on the HMT website.

the main regulations[11] provide transitional provisions in relation to the exercise of passport rights by investment exchanges, investment firms and the registration of tied agents.

7.26 Guidance on various aspects of provisions made under MiFID are being provided in the FSA's Handbook. When the FSA has revised its Handbook to implement MiFID, a copy will be available on the FSA's website (www.fsa.gov.uk).

8. Impact

8.1 A regulatory impact assessment is attached as Annex B to this memorandum.

8.2 As now, the FSA will be responsible for enforcement of FSMA. MiFID should not significantly impact on the size of their task. Public sector organisations will, as they do at the moment, ensure that if their activities require them to be regulated by the FSA they abide by FSA rules.

9. Contact

9.1 Sarah Parkinson at HM Treasury: Tel 020 7270 5912 or e-mail: sarah.parkinson@hm-treasury.x.gsi.gov.uk can answer any queries regarding the regulations.

[11] Part 4 and Schedule 7 of the FSMA (Markets in Financial Instruments) Regulations 2006.

Annex A - Transposition Note for Directive 2004/39/EC – The Markets in Financial Instruments Directive (MiFID)

The attached table sets out the main elements of the UK's implementation of the Markets in Financial Instruments Directive (MiFID). The directive was passed under the "Lamfalussy" process for EU financial services legislation. Under this process, MiFID is a framework directive designed to provide a high-level approach to the matters it covers and to provide the power for more detailed implementing measures to be included in secondary legislation. The relevant secondary legislation, a directive and a regulation[12], was adopted by the Commission based on advice from the Committee of European Securities Regulators.

MiFID covers the buying and selling and organised trading of shares, bonds, money market instruments, units in collective investment undertakings and derivatives. It aims to create deep and liquid capital markets in the EU and to protect investors using those markets.

Some provisions of MiFID are already given effect in the UK by existing legislation and FSA rules. But changes are needed to give full effect to the directive. Some of the changes go beyond those required under a strict interpretation of the directive. The directive is being implemented through about twelve statutory instruments and changes to the Financial Services Authority's Handbook of rules and guidance. The nine statutory instruments covered in this transposition table are as follows:

Financial Services and Markets Act 2000 (Modifications of Powers Regulations) 2006 (SI 2006/2975)
Financial Services and Markets Act 2000 (Markets in Financial Instruments) Regulations 2007
Financial Services and Markets Act 2000 (Regulated Activities)(Amendment No. 3) Order 2006
Financial Services and Markets Act 2000 (EEA Passport Rights)(Amendment) Regulations 2006
Financial Services and Markets Act 2000 (Appointed Representatives) (Amendment) Regulations 2006
Financial Services and Markets Act 2000 (Recognition Requirements for Investment Exchanges and Clearing Houses) (Amendment) Regulations 2006
Financial Services and Markets Act 2000 (Disclosure of Confidential Information) (Amendment) Regulations 2006
Financial Services and Markets Act 2000 (Exemption) (Amendment) Order 2007
Uncertificated Securities (Amendment) Regulations 2007

Because Commission Directive 2006/73/EC is based on powers set out in the framework directive, it is covered in the table below under the articles of MiFID to which it relates, rather than as separate pieces of legislation. Commission Regulation 1287/2006 is directly applicable and the only provisions mentioned in the table are those that require additional implementing measures in the UK.

[12] Directive 2006/73/EC and Regulation No 1281/2006.

Glossary

ARR – Financial Services and Markets Act 2000 (Appointed Representatives) Regulations 2001 (SI 2001/1217)
ARR(A) - Financial Services and Markets Act 2000 (Appointed Representatives) (Amendment) Regulations 2006
Business Order - Financial Services and Markets Act 2000 (Carrying on Regulated Activities by Way of Business) Order 2001 (SI 2001/1177)
Credit institution – a credit institution authorised under the banking consolidation directive (2006/48/EC) or an institution which would satisfy the conditions for authorisation under that directive if it had its registered office in an EEA State
DCI – Financial Services and Markets Act 2000 (Disclosure of Confidential Information) Regulations 2001 (SI 2001/2188)
DCI(A) – Financial Services and Markets Act 2000 (Disclosure of Confidential Information) (Amendment) Regulations 2006
EO - Financial Services and Markets Act 2000 (Exemption) Order 2001 (SI 2001/1201)
EO(A) - Financial Services and Markets Act 2000 (Exemption) (Amendment) Order 2006
FSA – Financial Services Authority
FSMA – Financial Services and Markets Act 2000
Investment firm – a person whose regular occupation or business is the provision or performance of investment services and activities on a professional basis
ISD – Investment Services Directive (Directive 93/6/EC)
Market Operator – a person or persons who manages and/or operates the business of a regulated market.
MiFI - Financial Services and Markets Act 2000 (Markets in Financial Instruments) Regulations 2006
MiFID – Markets in Financial Instruments Directive (Directive 2004/39/EC)
MPR - Financial Services and Markets Act 2000 (Modifications of Powers) Regulations 2006 (SI 2006/2975)
MTF – defined by MiFID as a multilateral trading facility is a multilateral system, operated by an investment firm or a market operator which brings together multiple third-party buying and selling interests in financial instruments – in the system and in accordance with non-discretionary rules – in a way that results in a contract in accordance with the provisions of Title II of MiFID.
OTC – over the counter.
PRR – Financial Services and Markets Act 2000 (EEA Passport Rights) Regulations 2001 (SI 2001/2511)
PRR(A) - Financial Services and Markets Act 2000 (EEA Passport Rights)(Amendment) Regulations 2006
RAO – Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (SI 2001/544)
RAO(A) - Financial Services and Markets Act 2000 (Regulated Activities)(Amendment) (No. 3) Order 2006
Regulated market – defined by MiFID as a multilateral system operated and/or managed by a market operator which brings together or facilitates the bringing together of multiple third-party buying and selling interests in financial instruments – in the system and in accordance with its non-discretionary rules – in a way which results in a contract, in respect of the financial instruments admitted to trading under its rules and/or systems, and which is authorised and functions regulatory and in accordance with the provisions of Title III of

MiFID. These are the markets with the most detailed regulatory standards operated by stock and derivative exchanges.
RRR – Financial Services and Markets Act 2000 (Recognition Requirements for Recognised Investment Exchanges and Clearing Houses) Regulations 2001 (SI 2001/995)
RRR(A) – Financial Services and Markets Act 2000 (Recognition Requirements for Investment Exchanges and Clearing Houses) (Amendment) Regulations 2006
USR- Uncertificated Securities Regulations 2001 (SI 2001/3755)
USR(A) – Uncertificated Securities (Amendment) Regulations 2006

Transposition note for Directive 2004/39/EC: the Markets in Financial Instruments Directive (MiFID)

Articles of Directive 2004/39/EC	Objectives	Implementation	Body responsible
1 and 4	Application of MiFID and definitions.	Article 1 requires no independent transposition. Article 4 definitions are transposed along with the provisions to which they relate.	HM Treasury and FSA
2 and Annex I and article 52 of Directive 2006/73/EC	These set the scope of the directive, establishing which services and activities and financial instruments the directive requires to be regulated and provide for exemptions.	The services, activities and instruments falling within MiFID's scope are largely transposed by the RAO. The new activity of operating an MTF is added at article 25D by the RAO(A). MiFID requires a wider set of non-financial derivatives and credit derivatives to be brought inside the scope of UK regulation. This is done through changes to articles 83, 84 and 85 of the RAO made by the RAO(A). Exemptions are transposed by the RAO (as amended by the RAO(A)) and the EO (as amended by the EO(A)).	HM Treasury
3	Member States may choose not to apply the directive to firms who cannot hold client funds and securities and who only receive and transmit orders and give investment advice.	Article 3 will be transposed by regulations to be made under section 2(2) of the European Communities Act 1972 by the end of January 2007.	HM Treasury
5-8 (excluding articles 5(2) and 6(3))	Authorisation of investment firms and withdrawal of authorisation.	The authorisation requirement is transposed principally by section 19 of FSMA, the RAO and the Business Order. The remaining provisions are transposed by existing legislation, largely Part 4 of, and Schedule 6 to, FSMA, and FSA directions in the Perimeter Guidance section of the Handbook. The registration requirement is transposed by section 347. Amendments are made to section 45 of,	HM Treasury and FSA

		paragraph 2 of Schedule 6 to, FSMA (see Schedule 5 to MiFI). Provision transposing article 7(1) is included at regulation 4 of MiFI. Guidance in the FSA's SUP and ENF sections of the handbook are also relevant here.	
9	To ensure that investment firms are run by people of probity and competence.	This is transposed mainly through existing section 41 and Part 5 of, and paragraph 5 of Schedule 6 to, FSMA and the Supervision section of the FSA's Handbook. The legislation is unchanged but some changes are being made to the FSA's Handbook.	HM Treasury and FSA
10	To ensure that investment firms are owned by people of probity.	This is transposed mainly through existing section 41 and Part 12 of, and Schedule 6 to, FSMA. These provisions do not need to be changed to implement this article. FSA rules in the Supervision section of the Handbook are also relevant: SUP 11.4.2R and SUP 16.4.5R.	HM Treasury and FSA
11, 12, 13, 18 (and articles 5 to 23, 25 and 51 of Directive 2006/73/EC)	Investment firms and credit institutions must be members of an investor compensation scheme, and have adequate systems and controls to carry out their business in a way which enables them to discharge their obligations. The systems and controls must include adequate measures to deal with actual and potential conflicts of interest. Investment firms must have adequate capital.	Transposition is mainly through FSA Rules, and see also sections 41 and 213 of, and Schedule 6 to, FSMA. The UK already has a comprehensive set of systems and controls requirements in the Senior Management Arrangements, Systems and Controls Section of the FSA's Handbook. There is substantial overlap between the existing requirements and those in the directive but differences in wording and scope of application. The existing Handbook requirements are being updated to reflect the scope and wording of the directive. The MPR amend section 138 of FSMA to extend FSA's rule-making powers and insert new section 158A of FSMA (guidance on outsourcing by firms).	HM Treasury and FSA
15	Relations with third countries	This is transposed by sections 405 to 408 of FSMA as amended by Schedule 5 to MiFI.	HM Treasury
16 and 17	Ongoing compliance with conditions for authorisation and	These provisions are transposed by Part 4 of, and paragraph 6 of Schedule 1 to, FSMA and FSA rules. Schedule 5 to	HM Treasury and FSA

	monitoring of investment firms and credit institutions	MiFI amends paragraph 6 to secure that FSA's enforcement powers extend to Regulation 1287/2006. FSA rules in SUP 15 and guidance in COND 1.2.2 of the Handbook also transpose these articles.	
5(2), 14 & 26	That MTFs meet certain minimum standards of operation to protect investors.	The UK already has provisions dealing with MTFs, in the RRR for MTFs operated by exchanges, and in the Market Conduct section of the FSA's Handbook for those run by investment firms and credit institutions. MiFID requires these provisions to be updated. For MTFs run by exchanges these articles are transposed by the RRR, as amended by the RRR(A), see in particular new paragraph 9A of the Schedule to the RRR. The provisions dealing with MTFs run by investment firms and credit institutions are being implemented by changes to the FSA's Handbook.	HM Treasury and FSA
19 (and articles 3, 24, 26 to 45 and 47 to 49 of Directive 2006/73/EC)	To ensure that clients are treated honestly, fairly and professionally by investment firms and credit institutions. This includes ensuring that clients get adequate information about the firms and their products and services, and that firms have adequate information about clients when providing investment advice or discretionary portfolio management services, or where the client is buying higher risk investments.	These provisions are transposed mostly by FSA rules. The UK already has extensive obligations in this area in the Conduct of Business section of the FSA's Handbook. The provisions in MiFID are less detailed in some areas and more detailed in others than those in the FSA's current rules and involve some differences of substance. The FSA are revising the relevant conduct of business provisions in their Handbook. The MPR amended section 145 of FSMA to enable FSA's financial promotion rules fully to transpose MiFID.	HM Treasury and FSA
20	Provision of services through medium of	This is transposed by FSA rules in COBS 2.4.4 in the Handbook.	FSA

	another firm.		
21 (and articles 44 and 46 of Directive 2006/73/EC)	To ensure investment firms and credit institutions when buying and selling financial instruments on behalf of clients do so in line with a policy designed to obtain the most favourable possible terms for the client.	This is transposed by FSA rules. The FSA already has a similar regulatory obligation, known as "best execution", in the Conduct of Business provisions of its Handbook. The provisions in MiFID have a wider scope and some difference in detail. The FSA are revising the existing provisions in their Handbook.	FSA
22 (and articles 47 to 49 of Directive 2006/73/EC)	To ensure investment firms and credit institutions treat the orders of different clients fairly and do not seek to unfairly profit themselves from knowledge of the orders of their clients.	These provisions are transposed by FSA rules. The FSA already has similar obligations, known as "client order handling", in the Conduct of Business provisions of its Handbook. The provisions in MiFID have some differences of detail from the existing rules. The FSA are revising the existing provisions in the Handbook.	FSA
23	To allow investment firms and credit institutions to do business through tied agents (ie firms who are not themselves regulated but act on behalf of a regulated firm) if their Member State permits.	The UK already permits firms to use tied agents, known domestically as "appointed representatives" under section 39 of FSMA and the ARR. Whilst the concepts are similar, there are some differences of detail between the domestic regime and MiFID. Schedule 5 to the MiFI revises sections 39 and 347 of FSMA (the latter deals with the FSA's register), and inserts section 39A to bring the domestic provisions into line with MiFID. The ARR(A) revise the ARR. FSA rules in the Supervision section of their Handbook also transpose this article, and are being revised.	HM Treasury and FSA
24 (and article 50 of Directive 2006/73/EC)	To enable clients who are sufficiently knowledgeable to look after their own interests to enter into transactions with investment firms and credit institutions without the firms having to comply with conduct of	The UK already has a system of client categorisation and requirements for firms in respect of the classification of clients. This is included in the Conduct of Business section of the FSA's Handbook. MiFID introduces different rules in respect of what type of person can fit in each category of client and the information firms must provide to clients about their classification. The FSA are revising the existing provisions	FSA

	business obligations.	in the Handbook.	
25 (and article 12(2) of Regulation 1287/2006)	To ensure that regulators get information from investment firms and credit institutions about transactions to help curb market abuse.	The UK already has transaction reporting requirements in the Supervision part of the FSA's Handbook. The FSA are revising the existing provisions in its Handbook to give effect to the wider scope of the MiFID transaction reporting requirements. Schedule 5 to MiFI inserts new sections 412A and 412B of FSMA which allow the FSA to approve and monitor trade-matching and reporting systems (as required by Regulation 1287/2006). The FSA is also revising its Handbook to take account of this change. Section 293A of FSMA, inserted by Schedule 2 to MiFI, allows FSA to obtain information for the purpose of monitoring investment exchanges' compliance with this article.	HM Treasury and FSA
6(3), 31 and 32	To ensure that investment firms can do business outside of the Member State in which they are based without facing additional authorisation requirements (so-called "passporting").	This is transposed by existing Schedule 3 to FSMA amended by Schedule 4 to MiFI, the PRR amended by the PRR(A) and changes to FSA guidance in SUP 13, 14 and 17 of the Handbook. Passporting rights for market operators operating an MTF are inserted as sections 312A and 312C of FSMA by Schedule 2 to MiFI.	HM Treasury and FSA
33, 34, 35 and 46	To ensure open access across the EEA to exchanges, clearing houses and securities settlement bodies for investment firms; the right for users of regulated markets to choose where they settle transactions; regulated markets and MTFs have open access to clearing and settlement infrastructure across the EEA.	This is principally transposed by paragraphs 4, 7B, 7C, 7D and 21A of the Schedule to the RRR as amended or inserted by the RRR(A), and paragraph 28 of Schedule 1 to the USR inserted by the USR(A). FSA SUP App 3.6.26 is also relevant.	HM Treasury

36 to 39, 41 to 43 and 47	To ensure that regulated markets are operated in a manner which protects investors and ensures they operate in an efficient manner	The recognition system and existing obligations placed on investment exchanges are contained in Part 18 of FSMA and the RRR. In the UK to run a regulated market it will be necessary to be a recognised investment exchange under FSMA. Part 18 of FSMA is amended by Schedule 2 to the MiFI, see in particular amendments to sections 287 and 297 and new section 292A. The RRR are amended by the RRR(A), see in particular amendments to paragraphs 1 to 4 and 8 of the Schedule to the RRR and new paragraphs 7B and 7E. FSA rules in REC, COBS and MAR sections of the Handbook also transpose these articles. Article 38(3) of MiFID requires that the FSA is notified in advance of the acquisition of a controlling stake in a recognised exchange, and has the opportunity to block the acquisition where it threatens the market being run properly. This is transposed by new Chapter 1A of Part 18 of FMSA inserted by Schedule 2 to MiFI. New Part 18A of FSMA inserted by Schedule 3 to MiFI transposes article 41. New sections 312A and 312C of FSMA inserted by Schedule 2 to MiFI transpose new passporting rights for market operators in article 42, and the EO(A) makes a consequential amendment to the EO. Article 47 does not require transposition.	HM Treasury and FSA
40	To ensure financial instruments admitted to trading on regulated markets are capable of being traded in a fair, orderly and efficient	The UK currently enforces a similar principle to that in MiFID through paragraph 4(2)(b) of the Schedule to the RRR. To accommodate the extra detail in MiFID, the RRR(A) inserts new paragraph 7A to the Schedule to the RRR.	HM Treasury

	manner to protect investors.		
27, 29, and 44	To ensure investors have adequate information available about expressions of interest in the trading of shares when making their investment decisions.	MiFID requires that specific rules are introduced for trading in shares on regulated markets and MTFs and on an OTC basis. Article 27 is transposed by FSA rules. Articles 29 and 44 are transposed new section 286(4A) and (4B) of FSMA (inserted by the MPR) and new paragraph 4A of the Schedule to the RRR inserted by the RRR(A). The FSA is making changes to the Market Conduct section of its Handbook to impose obligations on MTFs run by investment firms and credit institutions, and on OTC trading.	HM Treasury and FSA
28, 30 and 45	To ensure investors have adequate information about completed transactions in shares when making their investment decisions. MiFID provides much more specific obligations about the information that must be made available after a transaction has been completed and the circumstances in which the release of such information can be deferred.	Currently recognised investment exchanges are subject only to a general obligation to ensure investors have adequate information about share trading through paragraph 4(2)(a) of the Schedule to the RRR. Article 28 is transposed by FSA rules. Articles 30 and 45 are transposed new section 286(4C) and (4D) of FSMA inserted by the MPR and new paragraph 4B of the Schedule to the RRR inserted by the RRR(A). The FSA is making changes to the Market Conduct section of its Handbook to impose obligations on MTFs run by investment firms and credit institutions, and on OTC trading.	HM Treasury and FSA
48 to 51	To ensure that responsibilities for enforcing the directive are clearly delineated and that the relevant regulatory bodies have adequate powers to discharge their responsibilities; and that there are appropriate administrative sanctions available.	The FSA as the UK's financial services regulator will have responsibility for enforcing MiFID in the UK: for its responsibilities see generally Part 1 of, and Schedule 1 to, FSMA. The FSA already has extensive powers of enforcement under FSMA. The powers MiFID requires regulators to have are similar to those the FSA already possesses, but in some cases slightly broader. FSA's main relevant powers (including administrative sanctions) are in Parts 4, 5, 11, 13, 14,	HM Treasury

		18, 25 and 27 of FSMA. Section 354 is FSA's duty to cooperate with other regulatory authorities. The main changes to FSA's enforcement powers are made by Schedule 1 to MiFI, paragraphs 7 and 8 of Schedule 2 to MiFI, Schedule 3 to MiFI which inserts new Part 18A of FSMA, and paragraphs 5, 7 to 11, 13 to 15 and 17 of Schedule 5 to MiFI. FSA guidance in ENF section of the Handbook is also relevant here.	
52 and 53	To ensure that decisions under MiFI are subject to a right to apply to the Courts and that there are extra-judicial methods of redress.	Many decisions under FSMA are subject to a right to refer the matter to the Tribunal, and in the absence of such a right there is a right to seek judicial review. Provision to transpose article 52 in relation to exchanges is made by paragraphs 4 and 12 to 14 of Schedule 2 to MiFI. For extra-judicial methods of redress see Parts 15 and 16 of FSMA.	HM Treasury
54, 58 and 63	Safeguards surrounding the disclosure of confidential information and exchange of information with third countries.	This is transposed by sections 348 and 349 of FSMA and the DCI as amended by the DCI(A).	HM Treasury
55	Auditors' duties to report.	This is transposed by the FSMA 2000 (Communications by Auditors) Regulations 2001 (SI 2001/2587).	HM Treasury
56 to 62	To ensure that regulators across the EEA have the powers to enable them to work effectively together to deal with the challenges posed by regulating firms doing business on a cross-border basis.	The FSA already has the authority, under provisions in Parts 11 and 23 of FSMA and the DCI to co-operate with other regulatory bodies. FSA's powers of intervention in relation to incoming firms are at Part 13 of FSMA. Relevant changes to implement MiFID are made by Schedule 1 to MiFI which amends Part 13 of FSMA, Schedule 2 to MiFI which inserts new section 312B of FSMA and the DCI(A).	HM Treasury and FSA
64 - 73	Procedural provisions under MiFID,	Article 66 is transposed by amendments to articles 83 to 85 of the RAO made by	HM Treasury

	amendments to other Community legislation, transposition and transitional provisions	the RAO(A); article 67 is transposed by FSA rules; article 68 is transposed by FSA rules and Schedule 3 to FSMA; consequential amendments resulting from article 69 are at Schedule 6 to MiFI; provision transposing article 71 is at Part 3 of, and Schedule 7 to, MiFI, regulation 7 of the DCI(A) and in regulation 15 of the PRR(A). The remainder of these provisions do not require specific transposition.	and FSA

Regulatory Impact Assessment

Part 1 - Implementation of the Markets in Financial Instruments Directive (MiFID)[13]

Title of proposal

Implementation of MiFID.

Purpose and intended effect of measure

Objective

2. MiFID was passed in April 2004 and is due to come into effect on 1 November 2007. It is a directive dealing with the buying and selling of shares, bonds, money market instruments, units in collective investment undertakings and derivatives, and the regulation of the markets where financial instruments are traded. It replaces the Investment Services Directive ("ISD")[14]. MiFID is part of the EU's Financial Services Action Plan ("FSAP") which is aimed at integrating Europe's capital markets to bring down the cost of capital and facilitate enhanced growth and employment. Specifically the Commission felt MiFID was needed to:

- reduce regulatory overlap for investment firms doing cross-border business;
- update investor protection provisions in the light of new business models and market structures;
- ensure coverage of the full range of investment services;
- facilitate competition between exchanges and other market places;
- enable regulators to have the tools to properly enforce rules within and between Member States.

Background

3. MiFID includes:

[13] Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments (OJ No. L145, 30.4.2004, page 1).
[14] Council Directive 93/22/EEC of 10 May 19993 on investment services in the securities field (OJ L141, 11.6.93, page 27).

- the conditions for the authorisation of investment firms involved in providing services linked to the buying and selling of financial instruments;
- investor protection rules governing the treatment of clients by investment firms;
- the conditions for the authorisation of organised market places for the trading of financial instruments ("regulated markets" and "multilateral trading facilities");
- a comprehensive set of rules governing the information that must be made public about interest in trading shares and deals that have been done in shares ("pre-trade" and "post-trade" transparency rules);
- rules to facilitate investment firms, regulated markets and multilateral trading facilities doing business across the European Economic Area ("the EEA") on the basis of their authorisation in a single Member State ("passporting");
- powers for regulators to enforce the directive, and to co-operate to facilitate its enforcement.

4. MiFID has been adopted within the "Lamfalussy" framework for European financial services legislation. This means that the directive is a framework directive and has been supplemented by subordinate implementing measures[15].

5. Implementing MiFID requires changes to primary and secondary legislation and to the FSA's Handbook. In addition some of the provisions in the implementing measures are directly applicable in the UK as they are contained in an EC regulation.

6. The starting point for the Treasury's implementation has been the general commitment in respect of European financial services legislation not to go beyond the minimum required, unless there is a strong cost benefit rationale for doing otherwise, and to implement in a proportionate fashion.

Consultation

7. A three-month public consultation by the Treasury on the legislative implementation of the directive was held between 15 December 2005 and 31 March 2006. The FSA issued several consultation papers and other documents on the implementation of MiFID during the course of 2006.

8. There was a general welcome from respondents to the Treasury's proposals for the implementation of MiFID. However, some changes were made as a result of the comments made. Those included:

- greater specificity to the increases in scope of investments covered by UK regulation;

- equal treatment of branches of EEA and non-EEA firms operating in the UK and providing investment services;

[15] Commission Directive 2006/73/EC of 10 August 2006 implementing Directive 2004/39/EC (OJ No. L241, 2.9.2006, page 26) and Commission Regulation (EC) No 1281/2006 of 10 August 2006 implementing Directive 2004/39/EC (OJ No. L241, 2.9.2006, page 1).

Benefits and costs

Sectors affected

9. About 2,100 to 2,800 firms will be affected by the UK's implementation of MiFID, of which approximately 5 per cent are large firms, 20 per cent are medium-sized firms and 75 per cent are small firms.[16] They include a wide diversity of firms including:

- retail banks;
- investment banks;
- venture capital firms;
- stockbrokers;
- investment managers;
- proprietary trading firms;
- corporate finance firms;
- wholesale market brokers;
- providers of custody services.

Benefits

10. The FSA has undertaken various bits of work to look at the impact of MiFID in the UK – these are the best estimates we currently have of its likely benefits and costs[17]. They suggest first-round benefits of some £200 million a year and potential second-round benefits of some £240 million. There is, however, a considerable range of uncertainty around these numbers. In the economic impact assessment published with the proposal for the directive which became MiFID, the Commission said the following about its economic impact:

> "*Overall economic impact.*
>
> *A competitive and flexible market based financing can make a substantive contribution to the growth and employment of the European Union. The integration of the European Financial Markets will result in a significant reduction in the trading costs and the cost of the equity/corporate bond finance. Pooling European liquidity will maximise the depth of trading interests, reduce stock-specific volatility and limit adverse price impacts for large trades.*
>
> *The consequence of lower costs of capital and increasing returns on investments should be an increase of the overall wealth of the European Union. This will mean a higher investment rate and its corollary of more employment.*
>
> *The results of a study commended by the European Commission on the "Quantification of the Macro-economic impact of Integration of EU Financial Markets[18]", reflect that the integration of the European Financial Markets could*

[16] This figure comes from the FSA. It is a refinement of the range of 3,000 to 3,500 used in the partial regulatory impact assessment published in the December 2005 consultation paper on the legislative implementation of MiFID. This figure reflects the exercise of the optional exemption in Article 3. Legislation to transpose this exemption will be introduced separately.

[17] The FSA published a document in November 2006 entitled "The overall impact of MiFID" which is available on its website www.fsa.gov.uk.

[18] Study by London Economics in association with PricewaterhouseCoopers and Oxford Economic Forecasting.

result[19] *in a 1.1% increase of the Union's GDP and a 0.5% rise in the level of employment.*

On the industry.

The proposal will increase the confidence of investors in the fair functioning of the market due to the application of the market efficiency and investor protection oriented rules. This could well soar the European savings rate.

In addition, it enhances the competitiveness of the financial industry as a whole. It creates a playing field which can adapt to the future evolution of the financial markets. It encourages innovation whilst taking due account of the interest that are to be protected.

This openness will reinforce the European financial industry making it stronger and more adapted to the needs of its customers.

Competitiveness, innovation and development will not only result in more employment in the financial sector but also in better shaped strategies towards investors. These will be able to get better risk-adapted financial products which should enhance the medium and long term returns of their savings."

11. The Commission was arguing that the directive would help to bring about greater integration of financial markets in Europe (ie move towards a situation where the supply and demand for any given financial instrument operates on a Europe wide rather than purely national basis) and thereby contribute to enhanced growth and employment within Europe.

12. The figures which the Commission quotes above were based on macro-economic simulations of the impact of reductions in the cost of capital arising from a move towards complete financial market integration amongst the then 15 members of the EU. It looked at the impact of reductions in the cost of equity, debt and bank finance, and an increase in the proportion of financing based on debt.

13. The study provided figures broken down by individual Member States. The figure given for the UK was a 1 per cent long-run increase in GDP. In turn this could be broken down between a reduction in the cost of equity finance (which contributed 0.5 per cent of GDP), an increase in the share of debt finance (which contributed 0.3 per cent of GDP) and a reduction in the cost of bank finance (which contributed 0.2 per cent of GDP).

14. A static long-run increase of 1 per cent of GDP (about £11 billion pounds) is at the top end of the range of possible estimates of the impact of MiFID on the UK. MiFID does not directly concern itself with bank finance and so, in and of itself, will not bring about the 0.2 per cent increase in GDP estimated to stem from that source. Also the study factored into the calculations of the reduction in the costs of equity trading a reduction in clearing and settlement costs which again are unlikely to be affected by the directive. And it is not clear to what extent the current lack of financial integration is specifically due to the regulatory hurdles addressed by this directive. Other factors, including clearing and settlement, fiscal regimes, and differing legal structures for financial instruments may also play a significant role in inhibiting financial integration. The FSAP, of which MiFID is a part, includes a wide range of other measures and initiatives to address some of the other barriers to financial market integration.

[19] Static effects.

15. The linking of MiFID to the benefits of financial integration also begs the question of how the directive is likely to facilitate greater financial integration. In respect of equities trading some of the ways in which the directive seeks to promote greater integration are as follows:

- **Establishing a common European framework for the regulation of the main equity exchanges** – This should help to encourage investors to consider trading on platforms based outside their own jurisdiction, as well as possibly facilitating corporate transactions amongst exchanges;

- **Creating a passporting regime for MTFs, including those which trade equities** – This should encourage competition amongst trading venues putting downward pressure on transactions costs, and enable EEA-wide access to such platforms;

- **Abolition of concentration rules –** This should help to facilitate competition between execution venues by ensuring that orders are not sent to central market places simply as a result of regulatory fiat. (The concentration rule allows national authorities to stipulate that retail investor orders be executed only on a regulated market.);

- **Simplifying the regulatory regime for brokerage firms doing business on a cross-border basis** – This may reduce the cost of doing business on a cross-border basis, intensifying competition in the market for brokerage services putting downward pressure on transactions costs, and possibly broadening the range of services offered in different countries;

- **Introducing a Europe-wide regime governing pre- and post-trade transparency in equity trading** – This may aid the process of price formation, whilst giving investors access to the same sort of information in relation to the trading of domestic and non-domestic equities;

- **Creating a Europe-wide obligation for intermediaries to deliver "best execution" for their clients** – This should help the process of price formation and competition in brokerage services and execution venues, as well as providing investors with reassurance that they get an equivalent form of protection when trading domestic and non-domestic equities, or using domestic or non-domestic brokers;

- **Facilitating co-operation of regulators across Europe** – This should help to reassure investors that there is an adequate pan-European system of regulation in place to protect them when using cross-border service providers.

16. Concentrating on equities trading, however, provides a narrower focus than the directive itself. One factor the study quoted above did not take account of was the impact of the extension of the scope of regulation between the ISD and MiFID to include non-financial derivatives.

17. MiFID creates a European regime for the trading of non-financial derivatives, which allows:

- regulated markets and MTFs trading non-financial derivatives to admit remote members from across the EEA on the basis of home state authorisation of the regulated market or the MTF;

- intermediaries trading non-financial derivatives to do so across Europe on the basis of their authorisation in a single member state.

18. The European regime for non-financial derivatives should help liquidity for such products to be pooled on a pan-European basis. This in turn should tend to drive down the costs of trading and enable companies to hedge more effectively than was previously the case. It also enables new markets, such as that emerging in the trading of derivatives linked to emission allowances, to develop on a European rather than country-by-country basis. However, some smaller trading clients (such as certain emissions trading clients) could be classed as retail under the new MiFID criteria. A higher level of conduct of business regulation will apply to within-scope activity conducted with these types of clients/counterparties than does at present – and this may impact the amount and cost of business done with these type of clients.

Costs

19. The directive will involve a one-off cost to firms to implement. The one-off costs of implementation are likely to include the following:

- **Updating of existing practices** – In several areas the directive will modify existing obligations for firms which in turn will require firms to change what they do at the moment. This is likely to include such areas as conflicts policies, monitoring of personal transactions by staff, best execution policies, and procedures for client classification;

- **Communication with clients** – The directive does not require that firms have to replace existing agreements and contracts with clients. But in some areas, such as best execution, it may require firms to communicate with existing customers in order to update them about changes to policies or procedures;

- **New obligations** – In a limited number of areas the directive imposes new obligations on firms. These include a requirement for an appropriateness test when selling certain types of financial instrument (ie to check the product is appropriate for the client) and transparency requirements in specified circumstances when dealing in shares away from regulated markets or multilateral trading facilities.

20. Costs in the latter category will be a source of additional ongoing cost to firms, relative to the current position, because they include obligations that are additional to existing obligations.

21. Central to the calculation of the one-off costs of MiFID implementation is additionality ie resources devoted to MiFID implementation which would not otherwise have been engaged in doing the same work as part of day-to-day business. For example, some firms already have policies on conflicts of interest which in the ordinary course of events they will review. The calculation of time spent on MiFID should in principle capture only the time spent working

on conflicts policies that flows directly from the differences between existing requirements and practices and those in the directive.

22. Additionality has two aspects to it:

- **Extra inputs**. Because of implementing MiFID firms might hire new staff, not release existing staff, or remunerate existing staff for working longer; and

- **Opportunity cost.** Because of implementing MiFID staff time might be moved away from other duties.

23. If firms are relying to a significant extent on existing resources this could complicate the task for firms of providing an accurate picture of the additionality involved. As indicated above, part of MiFID implementation might be wrapped up in what the firm does on a day-to-day basis making it difficult to calculate exactly what is the additional effort involved in the implementation of the directive. Also if a firm is relying on existing resources this may involve, at least in some part a rise in productivity, the additional task might not simply displace other activities but cause other activities to be performed in a more efficient manner than might otherwise be the case. The one-off systems costs that MiFID gives rise to may also be substantial: while firms may seek to incorporate MiFID-generated changes into current IT projects rather than budget for them in isolation, it is important to recognise that MiFID is responsible for a relevant proportion of these cost impacts.

24. The costs of implementation and the ongoing costs of the directive are likely to be relatively small against the potential benefits of the full integration of financial markets in the EU. But as noted above, implementation of MiFID, in and of itself, is unlikely to realise the figures quoted for the impact of full financial integration.

25. There is also a point about timing. Most of the costs of MiFID are likely to be front-loaded. The same may not be true of the benefits. These may come more slowly over time as firms adapt to the new regime introduced by the directive and to the greater competition it is hoped it will bring.

Offsetting measures

26. As previously mentioned, MiFID is not a wholly new piece of European legislation replacing, as it does, the ISD. Repeal of the ISD and its replacement by MiFID is deregulatory for cross-border investment services in the EU. As set out above, a key reason for the new directive was to reduce regulatory overlap. Under the ISD, firms attempting to do business from the UK into other Member States were often faced with additional regulatory requirements above and beyond those imposed by the FSA. MiFID will put an end to that for UK firms seeking to provide investment services in other Member States. There should therefore be a net reduction in regulation for UK firms operating overseas in the EEA as a result of constraints being placed on the regulators in other Member States.

27. MiFID is both wider in scope than the ISD and more detailed. However, three points need to be noted about this in the UK context:

- First, MiFID involves three main additions to the scope of the ISD: the inclusion of two new services/activities – the giving of investment advice and the operation of a

multilateral trading facility – and the inclusion of commodity and other non-financial derivatives. The UK already regulates in these areas. MiFID does not therefore significantly extend the boundaries of UK financial regulation. It results in marginal changes to the financial instruments covered, with an extension of the derivatives that are inside the boundaries;

- Second, the greater detail in MiFID relative to the ISD will not automatically add to the level of detail in UK regulation. The FSA has rules in virtually all of the areas covered by the directive and these are being replaced by an "intelligent" copy out of the directive. In some areas this is resulting in a shrinking of the FSA's Handbook but some aspects of MiFID are more onerous and detailed, or apply to a wider range or firms or customer relationships than current FSA rules;

- Third, the detail in MiFID will bring a significant degree of harmonisation of regulation in Europe. For UK companies operating branches in other Member States this will mean that the conduct of business rules their branches have to follow (which govern how they interact with clients and for branches are set by the member state in which the branch is located) will be broadly similar. This should simplify the process of managing branches.

28. Earlier in 2006, the Treasury and FSA published a joint MiFID implementation plan. This set out the responsibilities of the two organisations with respect to implementation, key milestones on the path to implementation and how Treasury and FSA will continue to engage with industry on issues raised by implementation. The plan has subsequently been updated and reissued.

FSA work on the costs and benefits of the directive

29. The FSA published a document in November 2006 entitled "The overall impact of MiFID" which is available on its website www.fsa.gov.uk. This summarised various bits of work the FSA has done looking at the impact of MiFID. This work covers the overall impact of MiFID – subsequent sections in this RIA will focus on two specific areas of implementation. The FSA's work has comprised two main strands:

- looking at the incremental costs and benefits of individual changes to the UK's regulatory regime arising from the directive ("the bottom-up approach");

- looking at the overall costs and benefits of MiFID in the UK ("the top down approach").

30. These strands of work have drawn on several sources of information including:

- a description, based on the FSA's database of firms and their permissions, of the likely population of firms affected by MiFID, and some assumptions about how that population is distributed in terms of firm size.

- a report prepared for the FSA by consultants Europe Economics seeking to quantify the benefits of MiFID;

- a web survey of a sample of firms potentially affected by MiFID, seeking out estimates of the overall cost impact of MiFID;

- a report prepared for the FSA by Law and Economics Consulting Group on the costs of implementing various aspects of MiFID;

- a report prepared for the FSA by LEK consulting on implementation of the financial promotion aspects of the directive;

- internal work by FSA staff, including discussions with industry, and external literature on the costs and benefits of MiFID.

31. The bottom up approach was spread across four consultation documents dealing with MiFID implementation (CP 06/09, CP 06/14, CP 06/19 and CP 06/20). In line with the FSA's obligation under the Financial Services and Markets Act 2000, it involved efforts to estimate costs and provide an analysis of the benefits of specific elements of the implementation of MiFID.

32. The figures for the costs of the individual elements of the directive come with assorted caveats in the FSA consultation papers. Figures based on totalling up the costs from the individual elements therefore need to be treated with extreme caution. The table below provides the headline summary figures, with the FSA seeking to provide a range.

Summary of bottom up costs of MIFID		
	One-off	**Ongoing**
High	£490 million	£268 million
Low	£355 Million	£203 million

33. Perhaps what is most significant about the bottom up approach is that it illustrates that:

- the one-off cost of implementation significantly exceeds the expected on-going costs;

- the areas where the most significant costs for implementation are likely to lie.

34. The figures suggest that the areas likely to involve the highest costs in implementing the directive include the following:

- **Client categorisation**: This involves dealing with the fact that the client classification regime in the directive is different from that which currently operates in the UK, and that the regime in the directive allows clients to change status on a transaction by transaction basis if the firm is willing to allow this.

- **Appropriateness test:** For some sales where clients do not receive investment advice, firms will need to collect information to tell the client whether or not the transaction is appropriate for them. There is no such test currently in UK regulation.

- **Best execution:** The UK already has rules governing how firms should execute client orders. The rules in the directive involve a greater degree of procedure and documentation.

- **Systematic internalisers:** Currently there are no specific rules concerning the information that firms should make available to the market about their willingness to conclude deals in shares away from exchanges and other organised markets. The directive requires firms executing orders in this way on a systematic basis to issue firm quotes which are publicly visible to the market as a whole. This has significant systems implications.

- **Training:** there is a significant one-off cost for firms to train their employees to cope with the new rules and regulations that MiFID brings.

35. The top down approach seeks to estimate the overall level of additional resources firms will need to commit to MiFID implementation and obligations, and how MiFID might benefit firms and then the wider economy through greater integration of financial markets. Both approaches, but particularly that in relation to estimates of the benefits, rest heavily on a series of assumptions.

36. The approach to estimating the benefits of the directive considered first-round benefits in a number of areas, for example: reduced costs of compliance, improved access to new markets; increased competition in the publication of firms' data; improved functioning of markets; reduced transaction costs; and improved prices. The report concluded that the main quantifiable first-round benefits would be expected to arise in relation to reduced costs of compliance, reductions in transactions costs from aggregation effects and realisation of economic value of data. The report provides estimates of the scale of these benefits for four scenarios. The most likely scale of these benefits was some £200 million per annum, although the most optimistic scenario would suggest benefits of some £1.1 billion per annum.

37. The second round indirect benefits stem from the direct benefits leading to more integrated European financial markets putting downward pressures on the cost of capital and facilitating improvements in economic growth. The report notes: " if the cost of capital is lower, then investment may increase, and consequently there may be increases in GDP across the EU". The estimates of such second-round effects are potentially substantial and vary widely: between zero and £6.6 billion. The FSA conclude that the benefits are most likely to be at the lower end of this at around some £240 million.

38. In summary the top-down approach yields the following figures for the costs and benefits of the directive. The overall one-off costs to firms of implementation are put in the region of £877 million to £1.17 billion and the annual costs at around £100 million. The annual benefits are put at around £200 million, whilst possible second-round benefits, from greater integration of capital markets, are put at around £240 million a year. The divergence between these figures and those from the bottom-up approach are to be expected.

The small firms impact test

39. There are approximately 1,500 to 2,100 small firms who may fall within the scope of our implementation of MiFID in the UK. The only provisions in the directive which apply on a differential basis depending on the size of the firm are those relating to the organisation of firms and prudential requirements.

40. The principles of how an investment firm must be organized to receive authorization under the directive are set out in the directive itself. These principles apply to all firms. The ways in which they apply are set out in the directive's implementing measures. The application of the detail in the implementing measures frequently has regard to the size of the firm. For instance there is likely to be an increased focus on the "functional independence" of the compliance function within a firm. It is recognised, however, that this may impose a disproportionate cost on small firms with only a handful of staff. They therefore may have greater flexibility in terms of what is required to meet this aspect of the directive.

41. The prudential requirements that firms must meet under the directive are those in the CRD. These depend on the nature and volume of the business being done by an investment firm and so are related to the size of the business in terms of the amount of business done. Small firms should also benefit from the exercise of the optional exemption in Article 3 relating to firms which only undertake receiving and transmitting orders and/or providing investment advice. Legislation transposing this exemption will follow early in the New Year.

42. Overall therefore the directive should not have a disproportionate impact on small firms.

Competition assessment

43. The directive affects a variety of different markets with differing levels of concentration. To the extent that the passporting arrangements in this directive are more effective than those in its predecessor, it should make markets for investment services in all Member States more contestable than was previously the case.

44. The directive is also designed to stimulate competition between execution venues. It prevents Member States from requiring that trading in equities is concentrated on a specific stock exchange, and provides investment firms with the freedom to determine how details of trades in equities that they have done are made public. It also requires brokers to have a "best execution" policy to ensure that they obtain the best possible result on a consistent basis for client orders across all financial instruments. This should put pressure on brokers to search for venues that provide this best execution rather than relying on execution venues with which they are familiar.

Enforcement, sanctions and monitoring

Enforcement

45. Under FSMA, the responsibility for enforcing financial services regulation lies with the FSA. They will continue to be responsible for this after the implementation of the directive.

Sanctions

46. Article 51 of the directive requires administrative sanctions as a minimum standard. The FSA has the right to take disciplinary action against those breaking rules set under FSMA, and will be given the right to take action against those breaking a directly applicable regulation implementing MiFID.

Monitoring

47. Under FSMA, the responsibility for ongoing monitoring of financial services firms is the responsibility of the FSA. They will continue to be responsible for this after the implementation of the directive. The financial services section of the Treasury is responsible for FSMA. It will monitor whether the legislation operates in a satisfactory role having regard to:

- the proper implementation of MiFID;
- the need to protect investors; and
- the competitiveness of the UK as a location for financial services activity.

48. The financial services section of the Treasury has an ongoing dialogue with representatives of a wide cross-section of financial services firms and trade associations about FSMA.

Regulatory Impact Assessment

Part 2 - Implementing the scope of MiFID

Title of Proposal

Implementation of Annex I of MiFID.

Purpose and objective

Objective

2. This part of the regulatory impact assessment for MiFID deals with the impact of the scope of the services and activities and financial instruments covered by the directive. Relative to its predecessor, the ISD, MiFID has a wider scope in three main ways through the inclusion of:

- investment advice as an investment service/activity;
- the operation of a Multilateral Trading Facility ("MTF") as an investment service/activity;
- commodity and other non-financial derivatives as financial instruments.

3. In its proposal for a directive, the Commission explained the rationale for the expansion of scope thus:

"*It is proposed to expand the scope of the Directive to integrate some investor-facing activities or dealing activities that are financial in character, are widely offered to investors, clients, or financial market participants, and/or which give rise to investor or market-facing risks which could usefully be addressed through the application of core ISD disciplines.*"

4. In other words the Commission was seeking to ensure that there was a common investor protection regime across the full range of investment services and activities and common regulatory standards across all organized financial markets, with the purpose of encouraging greater integration of financial markets within Europe.

Background

5. The scope of financial services regulation in the UK is set in the Financial Services and Market Act 2000 (Regulated Activities) Order 2001[20] ("RAO"), which is made under powers contained in section 22 of FSMA (as supplemented by Schedule 2 to FSMA). The scope of the ISD is subsumed within the RAO.

6. The scope of the ISD is transposed in the RAO on the basis that its activities/services and financial instruments are a subset of those in the RAO. As a result the language used to describe activities/services and financial instruments in the ISD does not appear in the main body of the RAO. The language used in the RAO to describe UK regulated activities and investments is UK-specific language. There is only one place in the RAO where the RAO's function of transposing the ISD is made explicit. This is in article 4 where exclusions from

[20] Statutory Instrument 2001/544.

the RAO are disapplied where they are inconsistent with exemptions in the ISD. Schedules 2 and 3 to the RAO list the services/activities and financial instruments in the ISD, and the exemptions from the ISD. Those seeking to identify the links between the RAO and the ISD are therefore left to draw their own conclusions, or rely on mapping provided by the FSA.

7. The expansion of scope in MiFID has only a limited impact on the current scope of the RAO. Providing investment advice and operating an MTF are already regulated activities in the UK, and, to an extent, commodity and other non-financial derivatives are already inside the definition of investments in the UK. However, the directive's definitions of commodity derivatives and other non-financial derivatives are slightly wider than those in the RAO.

8. The ISD contained an exemption for firms only undertaking the service/activity of the reception and transmission of orders, provided that they met certain restrictions (such as they did not hold client money or securities). This exemption is not matched by an exclusion in the RAO, so whilst firms falling into this category are outside of the ISD they are not outside of UK regulation.

9. MiFID, in its article 3, includes a revised version of this exemption to the ISD. It now extends to firms receiving and transmitting orders and/or providing investment advice which meet certain other criteria. Discretion is given to Member States as to whether they take advantage of the exemption, but if they do so they are required to regulate domestically firms who fall within the exemption. The UK will exercise this exemption and already satisfies the requirement that there be domestic regulation.

Rationale for intervention

10. As a member of the EU, the UK is obliged to implement directives. However, neither MiFID nor its predecessor, the ISD, have required the UK to significantly change the boundaries of the scope of our financial regulation. We regulate what MiFID requires us to regulate because we think it is a good idea to and not simply because it is a requirement under a directive.

11. There are several justifications for regulating financial services firms in respect of prudential requirements and conduct of business requirements. One of the most significant is **asymmetric information:** Investors have significantly less information about the operation of financial markets than the markets themselves. In the absence of regulation, this might lead to under-consumption of exchange services if investors are concerned that as a result of asymmetric information they may consume services of an inferior quality.

12. A full discussion of the rationale for the regulation of financial services was provided in an FSA Occasional Paper.[21]

Consultation

13. A three-month public consultation by the Treasury on the legislative implementation of the directive ran between 15 December 2005 and 31 March 2006. The responses to the consultation in respect of the scope of the directive touched on several points:

[21] David Llewellyn – 'The Economic Rationale for Financial Regulation', FSA Occasional Paper No.1, April 1999.

- Many respondents wanted as much clarity as possible on the face of the RAO about which additional financial instruments were being brought into the scope of regulation by MiFID. The final order tries to spell out more clearly where the scope of coverage is being increased.

- Most respondents welcomed the inclusion of a new activity of operating an MTF as providing welcome clarity. However, some respondents thought it would cause confusion rather than create clarity.

- Most respondents wanted the definition of investment firms to include UK branches of firms based outside the EEA. The final order includes UK branches of firms based outside the EEA. This ensures such branches are treated no more favourably in the UK than branches of investment firms based in the EEA.

Options

Option 1

14. **Do nothing.** Taking no action to implement the scope provisions of the directive would mean that the UK would not have a legislative regime fully implementing the scope of MiFID. Even if the references in the RAO to the ISD were replaced with references to MiFID, the differences between the two directives are such that the UK would not have properly implemented the directive.

15. There would be four main risks of this option. First, UK firms would not be able to benefit from the passporting regime for the new activities and instruments covered in the directive. Second, the UK regulatory regime would be weakened due to the absence of co-operation agreements with other EU regulators and lack of contact over regulatory responsibility. Third, UK investors would also lose out on the protections offered by MiFID. Finally, the UK would be infracted by the Commission for failure to implement the directive correctly (and possibly exposed to claims for damages). We judge that infractions proceedings would have a good chance of succeeding. The UK would then be forced to revise the RAO to make it consistent with the directive.

Option 2

16. **Pass the draft implementing legislation.** The draft legislation[22] seeks to implement MiFID as follows:

- minimise the changes to the RAO
- exercising the MiFID article 3 exemption.

18. The logic behind minimising the changes to the RAO is that changes to the RAO have knock-on effects on the UK's regulatory system. For example, firms who are authorised by the FSA have a permission statement. This is framed in terms of the activities and investments in the RAO. Changing the categories of activities and instruments would require

[22] The exercise of the MiFID article 3 exemption will follow in a subsequent MiFID implementing measure that will be introduced in early January. Absent this change, the costs outlined in Option 3 would be relevant.

changes to permission statements which in turn would require the FSA and firms to spend time and effort on making the changes.

19. Exercising the article 3 exemption is in effect a continuation of the existing position. It is proposed, however, that the exemption works in such a way that firms who meet the criteria for the exemption can opt to be regarded as investment firms for MiFID purposes. Some firms who would otherwise be exempt may feel that there is commercial advantage in them being caught by the directive so that they can do business on a cross-border basis.

Option 3

20. **Radically revise the RAO and do not exercise article 3 exemption.** There are alternative ways to implement the scope of the directive than that represented in the order. One possibility would be to create a new RAO activity of performing a MiFID service/activity, and a new RAO investment of MiFID financial instruments. MiFID firms would fall under a single section of the RAO, instead of being distributed across several sections along with non-MiFID firms.

21. This would provide a more transparent transposition of the directive, consistent with Cabinet Office guidance to mirror the language of directives where appropriate. It would produce a clearer link between domestic and European legislation which might be particularly helpful to firms where directives interact, such as MiFID and the CRD.

22. Not exercising the article 3 exemption would mean that all firms undertaking the same MiFID services/activities would be subject to the same regulation.

Benefits and costs

Sectors affected

23. See paragraph 9 of Part 1 of the assessment.

Benefits

Option 1

24. The main benefit of this option is that it would involve no change to the existing regime. Everyone could continue to work under a regime with which they are familiar, and there would be no one-off or ongoing costs of change. However, because the UK's existing regime does not give effect to all of the provisions in the directive it is probable that the UK would be successfully infracted by the Commission for failure to implement the directive properly. At that stage the UK would have to change its regime, choosing either of the second or third options.

Option 2

25. Implementing the draft order would be consistent with the UK's obligation to implement the directive. It would also minimise the degree of change to the RAO so that to the extent people are familiar with it as it stands they would continue to be familiar with most of it post implementation.

26. Exercising the article 3 exemption means that the prudential requirements for the firms concerned would be set domestically. This enables them to be tailored to the specifics of the industry in the UK rather than having to take account of circumstances elsewhere in Europe. Such an approach is likely to be particularly suitable for this group of firms given that most of them are small businesses with no interest in conducting business on a cross-border basis.

Option 3

27. Including language from the directive in the body of the text may help in understanding the interaction between UK and European regulation and make the text easier to follow. In turn this might have some impact in reducing firms' legal bills. This is likely mainly to be an issue for larger firms who may seek legal advice about the scope of the RAO. Current experience is that most smaller firms rely on the FSA to help provide guidance on how the regulatory system works.[23]

28. Not exercising the article 3 exemption could enhance consumer protection. Consumers would be doing business with firms who would be in a better position to withstand losses than would otherwise be the case and compensate clients in the event that this is appropriate (although the prudential requirements may be in excess of what is required to balance the costs of such protection against the benefits).

Costs

Option 1

29. There would be no new costs for investors, intermediaries or companies in the short term (and no need for offsetting measures). But potentially the government would have to bear the costs of infractions proceedings. Such proceedings would involve policy and legal input within government and the use of external legal resources. The internal input might require 200 hours of policy input and 200 hours of legal input. At an average cost of £90 an hour this would cost £36,000. About 50 hours of external legal advice might be required. At an average cost of £250 an hour this would cost £12,500. There would also be a contingent liability in respect of claims for damages from those who suffered loss as a result of the UK failing to implement MiFID properly.

30. In the event of successful infraction proceedings, investors, intermediaries and companies would then need to bear the costs of either of options 2 or 3 depending on which was chosen to bring the UK's regime into compliance with that in the directive.

Option 2

31. Changes to the RAO have one-off cost implications for the FSA, which are borne by the industry. These include[24]:

[23] For example, see AIFA response to the FSA Consultation Paper 05/10, October 2005.

[24] These costs have been estimated by the FSA. A central estimate has been produced and then, on the basis of standard project planning assumptions, a range has been created which provides a low estimate which is 25 per cent below the central estimate and a high estimate which is 75 per cent higher than the central estimate.

- **Update the FSA's main database**. The FSA has a central database with information on authorised firms. Updating this with new fields as a result of adding the activity of operating an MTF to the RAO would cost £10,000 - £20,000;

- **Update the FSA register**. The FSA has a register open to public inspection of authorised firms. This is based on the activities and investments in the RAO. Updating it to take account of adding the activity of operating an MTF to the RAO (using costs for changes to the regulatory database as a proxy) would cost the FSA £10,000 - £20,000;

- **Update the application packs and associated authorisation systems**. This work would be needed to take account of MiFID referencing and guidance and on the basis of staff costs would cost the FSA £10,000 – £20,000;

- **Update the fee and levy regimes**. These operate from RAO activities and investments and so would need to be updated at a cost to the FSA of £10,000 - £20,000;

- **Update regulatory reporting systems**. These are linked again to the RAO and would need updating at a cost to the FSA of £100,000;

- **Changes to the Handbook and associated publishing systems**. On the basis of staff time these are likely to cost the FSA £160,000-£400,000.

32. Overall the costs outlined above puts the one-off cost to the FSA at £300,000 to £580,000. Direct one-off costs to firms will principally involve assimilating changes to the Handbook. Assuming the firms inside the scope of the directive spend 2 hours on average considering the changes at a cost of £130 per hour (which is based on the costs of senior FSA lawyers) this produces a central estimate of around £640,000 or £480,000 to £1,150,000 applying tolerance levels.

33. The overall one off-cost of implementing this option is thus around £780,000 to £1, 730,000. There should be little or no additional ongoing costs from this option which represents minimum change in respect of the way the boundaries of financial regulation are drawn.

34. The main offsetting measure to balance the introduction of MiFID is the repeal of its predecessor, the ISD. The net effect of this is to simplify the regulatory regime for cross-border business. Instead of having to comply with regimes across Member States, investment firms should only have to comply with that in the jurisdiction in which they are based. The Treasury will also during the course of this Parliament conduct a review to see whether the RAO could be simplified and made more consistent, in linguistic terms, with the directives it implements, and whether any super-equivalence can be removed.

Option 3

35. This option involves more significant changes to the RAO and therefore higher one-off costs for the FSA and for firms as a result.

36. The one-off costs to the FSA would include the following:

- **Update the FSA's main database.** The FSA has a central database with information on authorised firms. Updating this with new fields as a result of changes to the activities and instruments in the RAO would cost £100,000 to £200,000;

- **Update the FSA register**. The FSA has a register open to public inspection of authorised firms. This is based on the activities and investments in the RAO. Updating it to take account of changes to the RAO (using costs for changes to the regulatory database as a proxy) would cost the FSA £100,000 - £200,000;

- **Update the application packs and associated authorisation systems**. This work would be needed to take account of MiFID referencing and guidance and on the basis of staff costs would cost the FSA £50,000 – £100,000;

- **Update the fee and levy regimes**. These operate from RAO activities and investments and so would need to be updated at a cost to the FSA of £100,000 - £200,000;

- **Update regulatory reporting systems**. These are linked again to the RAO and would need updating at a cost to the FSA of £500,000;

- **Changes to the Handbook and associated publishing systems**. On the basis of staff time these are likely to cost the FSA £200,000-£400,000.

37. But there would also be an additional source of one-off cost to the FSA. It would need to oversee a grandfathering exercise for the firms within the scope of the directive. This would involve sorting out and sending out new permission statements to firms and dealing with resulting queries. It is estimated this could cost between £225,000 and £450,000. This would put the total one-off cost to the FSA at around £1,275,000 to £2,050,000.

38. The one-off costs to firms of this option would include two main elements:

- **Grandfathering of permissions**. Firms will need to check new permission statements and follow up on any problems. It is assumed all firms spend a day of internal resources on checking at a cost of £1,000 (based again on the costs of FSA lawyers). 20 per cent of firms are also assumed to buy-in two days of external advice at the same price. This produces a range of £2,205,000-£5,145,000 when applying tolerances to a central estimate;

- **Assimilating changes to the Handbook**. These are as per the previous option at £480,000 - £1,150,000.

39. Overall therefore, the total direct one-off cost to firms comes to £2,685,000 to £6,295,000. And the overall total one-off cost of implementing this option is thus estimated to be around £3,960,000 to £8,345,000. It is conceivable that if this option made the boundaries of UK regulation clearer than they are today, it would reduce the costs of dealing with boundary issue for firms on an ongoing basis. But it is not obvious that the saving would be substantial.

40. A reasonable estimate is that there are approximately 4,700 firms who are likely to fall within the category of firms within the article 3 exemption, on the basis of the information currently available.[25] As explained above, this does not mean they fall out of regulation, simply that they are not subject to MiFID. The main impact being outside of the directive is likely to have on such firms is in respect of their prudential requirements. The directive requires such firms to have:

- initial capital of €50,000; or
- professional indemnity insurance (PII) of €1 million applying to each claim and €1.5 million per year for all claims; or
- a combination of capital and PII which provides a level of coverage equivalent to the above.

41. There are slightly different requirements for firms who are also regulated under the Insurance Mediation Directive[26] ("IMD"). The IMD sets only indemnity insurance requirements. Firms caught under MiFID as well as the IMD have to hold, in addition to the PII requirements of the IMD:

- initial capital of €25,000; or
- PII of €500,000 applying to each claim and €750,000 per year for all claims; or
- a combination of capital and PII which provides a level of coverage equivalent to the above.

42. Most firms likely to fall into the category of firms in article 3 of MiFID are likely to be caught by the IMD. It is probable therefore that the figures above are of most relevance to calculating the costs of not exercising the article 3 exemption. In the UK these firms are required to hold £10,000 of capital. Falling within MiFID would require them to hold an extra £7,000 of capital (on the basis that the MiFID capital requirement equates to a capital requirement of £17,000). This implies an additional ongoing annual cost of between £350 and £560 assuming a cost of capital bounded by 5 and 8 per cent. Overall therefore not exercising the article 3 exemption would add between £16 million and £26 million to industry costs on an annual basis.

43. The main offsetting measures in this option would be those mentioned in option 2.

Small Firms Impact Test

44. There are around 1,800 small firms who may fall within the scope of MiFID (not counting those likely to fall within the article 3 exemption).[27] The overwhelming majority of these are likely to rely on the FSA, rather than internal or external legal resources, for guidance on the scope of financial services regulation. The FSA has taken various steps,

[25] Based on FSA estimates. It should be noted that since implementation of the optional exemption is based on a factual test, an analysis of permissions alone will not identify whether firm falls within the exemption or otherwise. In some important cases, part of a category of firms will be subject to MiFID and another part outside, depending on their business model and whether they wish to structure themselves to fall inside MiFID or otherwise.

[26] Directive 2002/92/EC of the European Parliament and of the Council of 9 December 2002 on insurance mediation (OJ No. L9, 15.1.2003, p. 3).

[27] As above, this is an estimate based on available information.

including simplified application packs, to help such firms deal with issues raised by the boundaries of financial services legislation.

45. This means that changes in the legislation that sets the boundaries of financial services legislation have limited consequences for the ways in which such firms approach boundary issues. For most these issues are mediated through the FSA who will update their guidance and forms to take account of changes to the legislation.

46. The biggest potential impact on small firms relates to the article 3 exemption. The prudential requirements for firms who might fall within the article 3 exemption are not differentiated by size or turnover of the business. Inevitably therefore they impose a greater relative cost on small firms. And all but a handful of the 4,700 firms who could be affected by decisions over the exercise of the exemption are small firms. The trade association representing the sort of firms affected has indicated that it favours exercising the article 3 exemption.

Competition Assessment

47. All of the options should have little or no effect on competition.

48. The changes to the RAO are likely to have a very limited affect on the number of firms covered by financial regulation in the UK. They should not therefore have a major impact on competition in UK financial markets.

49. Exercising the optional exemption would also not significantly affect competition for investment advice services. There is already a different prudential regime for those who fall inside the article 3 exemption and others providing investment advice. Of more relevance is what conduct of business rules are applied to the two groups.

Enforcement, sanctions and monitoring

50. See paragraphs 44 to 47 of Part 1 of the assessment.

Summary and recommendation

51. The Treasury's policy is to implement MiFID in a proportionate fashion. In respect of the scope issues, the best way to achieve this is to apply the article 3 exemption and minimise the structural changes to the RAO.

Regulatory Impact Assessment

Part 3 - Title III of MiFID

Title of Proposal

UK implementation of Title III of MiFID.

Purpose and intended effect of measure

Objective

2. This section of the impact assessment deals with the implementation of those aspects of MiFID related to market operators. Market operators are firms which run what the directive designates as regulated markets, although they may also operate what the directive designates as multilateral trading facilities. The directive sets minimum regulatory standards for market operators and the markets they run, and provides them with the right to provide their services across the EEA on the basis of their authorization in their home state.

3. The objective of these parts of the directive are to:

- promote confidence in Europe's financial markets;
- protect investors buying and selling through financial markets;
- encourage competition between financial markets.

Background

4. The ISD created the concept of a 'regulated market' as a means of allowing stock exchanges and financial futures exchanges to put their trading screens in other countries within the EEA without the need to obtain additional authorisation. Rather than set a common regulatory framework for these entities it was left to each individual Member State to set its own standards and determine what markets based in its own country it would approve as a regulated market.

5. To fill in the gap in common regulatory standards, FESCO, the forerunner of CESR as the organisation of European securities regulators, agreed a set of high-level standards for regulated markets. MiFID took the FESCO standards as the basis for creating a common EU legislative framework for regulated markets. Going forward, the basic framework for the authorisation and operation of regulated markets will derive from MiFID as transposed domestically across the EU rather than individual national regimes for the regulation of exchanges.

6. The UK's regime for the regulation of exchanges is the recognised investment exchange (RIE) regime which dates from the Financial Services Act 1986 and was updated in FSMA. The RIE regime is based around a set of high-level principles for the activities of RIEs which are set out in secondary legislation, the Financial Services and Markets Act 2000

(Recognition Requirements for Investment Exchanges and Clearing Houses) Regulations 2001[28] ("RRR"). The RRR cover the following main points:

- financial resources;
- suitability;
- systems and controls;
- safeguards for investors;
- promotion and maintenance of standards;
- rules and consultation;
- discipline;
- complaints.

7. The FSA provides guidance on what is required to satisfy the recognition requirements in its REC sourcebook. There are currently seven recognised investment exchanges:

- EDX London Ltd – EDX is an equity derivatives exchange owned by the London Stock Exchange and OMX.
- ICE Futures – ICE Futures is an exchange for the trading of energy derivatives, principally oil derivatives. It is owned by the US Intercontinental Exchange (ICE).
- The London International Financial Futures Exchange (LIFFE) – LIFFE is principally, although not exclusively, a financial derivatives exchange, offering trading in currency, interest rate and equity derivatives. It is owned by a public company, Euronext SA which owns the main stock and futures exchanges of France, Belgium, the Netherlands and Portugal.
- The London Metal Exchange (LME) – The LME is an exchange focused on derivatives linked to non-ferrous metals. It is owned by its members.
- The London Stock Exchange plc – The stock exchange is the major market for the trading of the shares of UK companies, whether on the main market or the smaller AIM market. However, the stock exchange also provides a venue for trading of a wide variety of other financial instruments including UK government bonds (gilts), corporate bonds and derivatives (covered warrants). The London Stock Exchange is a public company whose shares trade on its own market;
- NYMEX Europe – NYMEX Europe is an energy derivatives exchange. It is a wholly-owned subsidiary of the US exchange, NYMEX.
- Virt-x Ltd – Virt-x is a stock exchange which trades blue-chip Swiss stocks and other key European stocks. It is owned by SWX the Swiss exchange.

8. The RIEs operate a variety of trading mechanisms including electronic order-books, market-making, auctions and open outcry. They also have a diversity of membership regulations and structures. However, the majority of their members are entities who will be authorised as investment firms under MiFID.

9. All the current EU regulated markets are operated by the RIEs. The list of UK regulated markets is as follows:

[28] SI 2001/ 995.

UK Regulated Markets

1. Domestic Market 2. Gilt Edged and Fixed Interest Market 3. International Retail Service (Regulated Segment) 4. International Order Book (Regulated Segment) 5. International Bulletin Board (Regulated Segment – order book only) 6. Dutch Trading Service (order book only)	Markets 1-6: London Stock Exchange Ltd.
7. The London International Financial Futures and Options Exchange (LIFFE)	7. LIFFE Administration and Management
8. Virt-x	8. Virt-x Exchange Limited
9. EDX	9. EDX London Limited

10. There are three main differences between the UK's RIE regime and the regulated markets regime in MiFID:

- the regulated market regime, as its name suggests, is framed in terms of obligations on those running individual markets rather than, as with the RIE regime, the activities of an exchange which might in turn run several markets. But given that UK exchanges run all of their markets out of a single legal entity this difference is probably more apparent than real;

- some of the detail in MiFID is not currently a legislative requirement but is contained in the FSA's guidance on how to satisfy the recognition requirements;

- the obligations in the directive are both wider and narrower than those of the RIE regime. They are wider in such areas as requiring regulators to have a right to veto changes of controlling interest. They are narrower in such areas as not requiring default rules in respect of market contracts and not requiring complaints arrangements.

11. Two groups will be most directly affected by the legislative changes required to implement the regulated market provisions of MiFID. These are the seven RIEs (as set out in paragraph 7 above) and their members. The provisions obviously bite directly on the RIEs and they affect their members to the extent they change the way the RIEs operate. RIEs members also provide much of the competition for RIEs through OTC transactions and the operation of multilateral trading facilities. Investors will be indirectly affected by the impact on the way the exchanges are run.

Rationale for intervention

12. As a member of the EU, the UK is obliged to implement directives. However, UK regulation of RIEs commenced in 1986, 7 years prior to the adoption of the ISD and 18 years

prior to the regulatory standards for regulated markets in MiFID. This indicates that the UK on its own had reached the conclusion that there is a rationale for the regulation of investment exchanges.

13. There are two main justifications for the regulation of investment exchanges:

- **Asymmetric information.** Investors have significantly less information about the operation of financial markets than the markets themselves. In the absence of regulation, this might lead to under-consumption of exchange services if investors are concerned that as a result of asymmetric information they may consume services of an inferior quality.
- **Externalities.** Investors, issuers and the wider economy benefit from well-run financial markets. For the markets themselves, however, there may be, at least in the short term, a conflict between profit maximization and high standards of regulation. As a result, without government intervention, the regulation of financial markets may be set at too low a level.

A full discussion of the rationale for the regulation of financial services is provided in an FSA Occasional Paper.[29]

Consultation

14. A three-month public consultation by the Treasury on the legislative implementation of the directive ran between 15 December 2005 and 31 March 2006. The proposals in respect of the implementation of Title III were generally welcomed. Some technical comments were made, in particular:

- That the admission to trading standards for regulated markets should not be applied to MTFs run by RIEs; and

- That the requirement that an issuer be notified when an MTF run by an RIE admits one of the issuer's securities which trade on a regulated market should be dropped as it goes beyond what the directive requires.

15. Both comments were acted upon.

Options

Option 1

16. **Do nothing.** Taking no action to implement the directive would still mean that the UK would have a legislative regime governing exchanges based in the UK. But it would be a regime that was not fully compliant with the directive. Paragraph 10 explained that there are some obligations in the directive which are not direct legal obligations in the UK, and other requirements which have no direct equivalent in the existing UK regime.

[29] David Llewellyn – 'The Economic Rationale for Financial Regulation', FSA Occasional Paper No.1, April 1999.

17. The main risk of this option is that the UK would be infracted by the Commission for failure to implement the directive correctly, and that UK RIEs would not be able to passport their services into other European jurisdictions. We judge that infractions proceedings would be likely, particularly given the emphasis the Commission has placed on achieving a common framework for transparency in equity trading through the directive and that infraction proceedings would be likely to succeed. We would then be forced to revise our RIE regime to make it consistent with that in the directive.

18. Being locked out of other European jurisdictions could have serious consequences for some of the UK exchanges. It would seriously impede their business models.

Option 2

19. **Adopt the proposals in the MiFID implementing legislation.** The legislation seeks to meet our objectives by incorporating the directive's provisions into the UK's existing regime for RIEs.

Option 3

20. **Replace the RIE regime with an investment firm regime.** MiFID is relatively permissive on the legislative architecture surrounding market operators. In the process of implementing MiFID it would be possible for the UK to create a new regime for RIEs. This could involve making operating a regulated market explicitly an authorisable activity under the RAO, in the same way it is proposed that operating an MTF become an authorisable activity. Today's RIEs would become authorised persons.

21. The RIE regime was born in 1986. At this time, exchanges were mutually-owned utility type organisations. Most are now much more explicitly commercial. The main regulatory development is European legislation. Whilst regulated markets are in a separate title of MiFID from investment firms, there are some important parallels between the regulatory obligations of the two (principally between articles 9 and 37, 10 and 38, and 13 and 39) and when investment firms operate an MTF, there is substantial overlap between the way in which they are regulated and the way in which a regulated market is regulated.

22. The main obvious change stemming from a move to authorised person status is that RIEs would no longer be subject to two regulatory regimes if they conducted other activities than running an RIE. They would have a single authorisation which would cover the full range of activities they wished to pursue.

23. The main risk of this option is that in the process of dismantling the old regime and putting a new one in place the UK would end up with an inferior regime. The current regime has adapted to fit changing circumstances. A rules-based regime may be less able to do this. It may also undermine international understanding of the UK's framework of regulation for markets with adverse consequences for the attractiveness of the UK as a location for exchanges.

Benefits and costs

Sectors affected

24. Those most directly affected by the relevant provisions of the directive are the seven current RIEs. There is an indirect effect on the intermediaries who are members of the exchanges and the investors who buy and sell through the intermediaries.

25. The sections below on benefits and cost do not take into account any environmental or social impacts arising out of the options considered. This is because none of the options directly impact on them. The operation of financial markets may have significant implications for sustainable development, but the directive does not directly impact on the environment or our natural resources. Likewise the operation of financial markets may have significant implications for the distribution of wealth and income, but the directive does not directly impact on the distribution of wealth and income. The focus of the analysis is therefore on the economic costs and benefits.

Benefits

Option 1

26. The main benefit of this option is that it would involve no change to the existing regime. Everyone could continue to work under a regime with which they are familiar. However, because the UK's existing regime does not give effect to all of the provisions in the directive (as indicated earlier), it is probable that the UK would be successfully infracted by the Commission for failure to implement the directive properly. At that stage the UK would have to change its regime, choosing either of the second or third options.

Option 2

27. There are three main benefits of this option:

- it is consistent with the UK's obligation to implement MiFID;
- it introduces the minimum change necessary consistent with the obligation to implement MiFID;
- it enables exchanges running commodity derivatives markets to operate in other EEA countries on the basis of their authorisation in the UK.

28. This option should ensure the UK avoids infractions proceedings for failure to implement the directive properly. It should also mean the least change for RIEs and their members. Currently the definition of a regulated market only covers markets trading shares and financial derivatives. Implementing MiFID would extend this to markets trading commodity and other derivatives.

29. The UK's non-financial derivative markets already have substantial participation from firms based in other EU countries. They are truly international markets. Their inclusion inside the definition of regulated markets should therefore have limited impact in the short run. It may, however, bring longer-term benefits as new products develop. It will enable the exchanges to operate more easily on a pan-European basis at an earlier stage in the development of the markets for such products.

Option 3

30. Replacing the UK's existing regime for exchanges with a firm-based regime would give exchanges greater flexibility to undertake other financial services activities. This might enhance competition in financial services (but not by very much given the small number of exchanges involved).

Costs

Option 1

31. There would be no new costs for investors, intermediaries or companies in the short term (and would not require offsetting measures). But potentially the government would have to bear the costs of infractions proceedings. Such proceedings would involve policy and legal input within government and the use of external legal resources. The internal input might require 200 hours of policy input and 200 hours of legal input. At an average cost of £90 an hour this would cost £36,000. About 50 hours of external legal advice might be required. At an average cost of £250 an hour this would cost £12,500. There is also a contingent liability that would arise from the ability of people to take action where they have suffered loss stemming from the improper implementation of the directive.

32. In the event of successful infraction proceedings, investors, intermediaries and companies would then need to bear the costs of either of options 2 or 3 depending on which was chosen to bring the UK's regime into compliance with that in the directive.

33. Failure to implement the directive could also hinder the access of UK RIEs to other EU countries. If the UK were not compliant with the directive they may be prevented from doing business on a cross-border basis. This could have very significant implications for markets which operate on a cross-border basis today. For example, more trading in non-domestic equities happens in London than in any other major financial centre.

Option 2

34. Adapting to a new regime will involve one-off costs. The main cost comes from the effort required to be put in to discuss changes to the existing regime and then adapt to them. Following discussion with the RIEs we believe that the following is the best estimate of the man-hours per exchange to engage in this process:

Average man-hours per RIE for consideration of impact of MiFID implementation under option 2

Activity	**Number of days**	**Number of exchange officials**	**Total days**
Involvement in policy development and consideration of draft proposals	9	4	36
Work in response to final regulations and handbook changes	4	4	16

Total work on new regime	**13**	**4**	**52**

35. Assuming:

- the exchange officials are compliance officers on an annual salary of £65,000;
- there is an overhead rate of 100 per cent;
- and a 230 day working year;

this means a cost per day per exchange official of £565.

At the rate of £565 per day, 52 man days of work rounds to £29,000 per exchange or £176,000 across the six exchanges who were recognised when the discussions on MIFID implementation began. NYMEX Europe was recognised after the initial policy development. Its costs for 16 days work in response to the final regulations and handbook changes would come to £9,000

36. Across most of the range of an exchange's business, the ongoing costs of complying with the new regime should not be different from the costs of complying with the existing regime given their broad similarities. The main potential sources of increased costs are:

- A requirement to disclose ownership and changes in ownership, in particular where the owners are in a position to exert significant influence over management;
- A requirement for all changes in controlling interests to be submitted to the FSA for approval.

37. Making public ownership and changes in ownership should have a modest cost. The RIA on market abuse indicated that a regulatory news statement cost £150. Only two of the RIEs are currently public companies with fluctuations in ownership on a day-to-day basis. Across the RIEs it seems unlikely that more than 15 changes of ownership would need to be notified in any year. This would have a cost of £2,250.

38. In respect of changes of controlling interest these will happen on an even more infrequent basis. Since 2000 there has been on average about one change of controlling interest in an exchange per year. Going forward it is difficult to see them happening more frequently given the relatively small number of companies involved.

39. The cost will fall on the person with the controlling interest rather than the exchange itself. They will have to wait up to three months for approval from the FSA and potentially have to supply information to the FSA. Assuming they engage an external lawyer at a charge-out rate of £300 per hour and the lawyer spends at least 25 hours on preparing material for the FSA, a change of control could cost £7,500.

40. Given this option involves no significant new ongoing burdens on business no consideration has been given to offsetting measures.

Option 3

41. The one-off costs of change for this option would be more substantial. This is because the regime introduced would be a more significant departure from existing practice than the previous option.

42. A best-estimate of the amount of extra time involved in considering a change to a wholly new regime would be double that required for an adaptation of the existing regime shown in the previous option.

Average man-hours per RIE for consideration of impact of MiFID implementation under option 3

Activity	**Number of days**	**Number of exchange officials**	**Total days**
Involvement in policy development and consideration of draft proposals	17	4	68
Work in response to final regulations and handbook changes	8	4	32
Total work on new regime	**25**	**4**	**100**

43. Assuming:

- the exchange officials are compliance officers on an annual salary of £65,000;
- there is an overhead rate of 100 per cent;
- and a 230 day working year;

this means a cost per day per exchange official of £565.

At a rate of £565 per day, 100 man days of work rounds to £57,000 per exchange or £339,000 across the six exchanges who were recognised prior to the start of discussions on MiFID. NYMEX Europe's involvement in looking at final regulations and handbook changes would cost £18,000.

44. There would also be the additional annual costs related to changes in ownership and control outlined in option 2.

The small firms impact test

45. None of the RIEs is a small business therefore none of the options is likely to have a significant impact on small businesses.

Competition assessment

46. All of the options should have little or no effect on competition.

47. The market most directly affected by the proposals is that for on-market trading of financial instruments. This is a highly concentrated market because of the network externalities associated with liquidity. For example, most of the on-market trading of short-term interest rate derivatives in Europe happens through LIFFE. Competition between exchanges (or between exchanges and multilateral trading facilities) happens (for instance, the UK now has two energy derivatives RIEs), but in any particular financial instrument one market tends to dominate.

48. Trading of financial instruments is not, however, confined to organised markets. There is substantial OTC trading which happens away from markets on a bilateral basis between market counterparties. Such trading is both a substitute for and complement to on-market trading. Large numbers of counterparties are involved in OTC trading.

Enforcement, sanctions and monitoring

Enforcement

49. Under FSMA the FSA is responsible for enforcing the legal framework for the regulation of RIEs. In respect of RIEs, the FSA has two main powers under FSMA: direction and derecognition. It can direct exchanges to comply with their obligations under FSMA, and it can derecognise them if they fail to comply with the recognition requirements. The FSA's role and powers in respect of RIEs would remain broadly unchanged under the first two options above. Under the third option, the FSA would have rulemaking powers in respect of RIEs which would probably need to be enforced by a different disciplinary regime. The FSA would probably need to be granted the power to fine RIEs for breaches of its rules.

50. To date the FSA has neither directed nor derecognised an RIE because of failures to comply with FSMA. The ongoing supervisory dialogue between the RIEs and the FSA has been sufficient to resolve any problems. Given that, in broad terms, under options 1 and 2 the regulatory regime would be similar to that today, we believe that the existing enforcement regime should suffice. Under option 3 the regulatory regime would have changed and it would make sense to align it with that faced by other firms who are authorised persons under FSMA.

Sanctions

51. Article 51 of the directive requires that Member States be able to impose administrative sanctions as a minimum for breaches of obligations under the directive. The UK's existing RIE regime is already compliant with this obligation as indicated in the previous section, as is the fining system for authorised persons which would possibly apply under option 3.

Monitoring

52. The FSA has day-to-day responsibility for monitoring compliance with the RIE regime, and will continue to do after the implementation of MiFID under all of the options. The Treasury is more broadly responsible for monitoring the effectiveness of the legislative regime dealing with issues relating to the FSMA legislative framework for RIEs. It has ongoing contact with each of the RIEs and the FSA team dealing with the supervision of RIES, and is the contact point for concern about the legislative framework whether it comes from the RIEs, the FSA, or members of RIEs and other third parties.

53. The Treasury will assess concerns about the RIE regime in relation to:

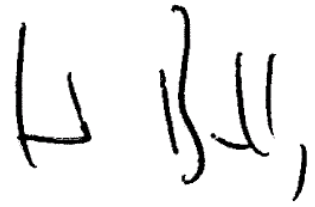
- the proper implementation of , and compliance with, the directive;
- the promotion of market confidence and investor protection;
- the competitiveness of the UK as a venue for the location of exchanges;
- fairness of treatment as between different exchanges, and between exchanges and other execution venues.

Summary and Recommendations

54. We consider that the most effective way to implement the provisions in Title III of MiFID is through adapting the existing provisions for recognised investment exchanges. There does not appear to be a need to tear up a regime which is well understood and worked well for 20 years.

Declaration

I have read the regulatory impact assessment and I am satisfied that the benefits justify the costs.



Ed Balls

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