

## The Markets in Financial Instruments Directive and the Single European Market in Investment Services

London  
January 20, 2006

The Markets in Financial Instruments Directive, or MiFID, is a key component of the European Union's Financial Services Action Plan (FSAP), the 5-year legislative program launched in 1999 to accelerate the development of a true single market for financial services across the 28 Member States of the European Economic Area (EEA)<sup>1</sup>.

MiFID<sup>2</sup> will replace the existing Investment Services Directive (ISD)<sup>3</sup> which together with the Banking Consolidation Directive<sup>4</sup> and the Insurance Directives<sup>5</sup> provide the foundations upon which it is intended that the fundamental commercial treaty rights – freedom of establishment and freedom to provide services cross-border – are given effect in the context of the financial services industry.

### *Background*

Since 1995, the ISD has provided a limited degree of harmonization in the provision of investment services within the EEA. The ISD sets the minimum level of regulation for investment services across the Member States and at the same time provides that, to a

<sup>1</sup> Norway, Iceland and Liechtenstein are members of the EEA (which includes all EU Member States) but are not members of the European Union. By operation of the EEA Agreement formed between those states and the EU, legislative measures passed in the EU are automatically adopted by those EEA states; as such the single European market incorporates not only the 25 Member States of the European Union but also those three states.

<sup>2</sup> Directive 2004/39/EEC of the European Parliament and of the Council of 21 April 2004.

<sup>3</sup> Council Directive 93/22/EEC of 10 May 1993.

<sup>4</sup> Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000.

<sup>5</sup> Directive 2002/83/EC of the European Parliament and of the Council of 5 November 2002 on life assurance, the Third Council Directive 92/49/EEC of 18 June 1992 on non-life assurance and Directive 2002/92/EC of the European Parliament and of the Council of 9 December 2002 on insurance mediation.

limited extent, investment firms regulated in one Member State must be permitted to establish a branch in, or provide certain of their investment services cross-border into, any other Member State – the ‘ISD passport’.

But the ISD has had limited effect in creating a true single market in investment services, firstly because the scope of investment activities to which it applies is narrow, and secondly because whilst Member States are required to permit EEA-regulated investment firms to passport into their jurisdiction, they are not prohibited from imposing additional local rules governing the manner in which those services may be provided.

This lack of harmonization, coupled with a growing awareness that the technology of investment services, and the financial markets generally, had developed considerably since the early Nineties when the ISD was enacted, led the European Union to revisit the investment services sector. When the FSAP was announced in May 1999, at the top of the list for action in the wholesale markets was to “prepare the ground for the effective cross-border provision of investment services” by “urgently updating” the ISD<sup>6</sup>.

### *Implementation*

MiFID was published in April 2004 with a two-year implementation timetable<sup>7</sup>. In June 2005, the Commission proposed to extend that original period by one year, and suggested an additional 6-month transitional period to allow firms affected by MiFID sufficient time to prepare for the changes that will follow. In December 2005, the Parliament adopted a revised proposal to extend the deadline for implementation to January 2007, with a 9-month transitional period expiring on 1 November 2007. The Parliament was required subsequently to refer its opinion back to the Commission and the European Council; although not yet formally announced, it is widely expected that a legislative measure adopting the revised timetable will shortly be agreed and published.

### *Key Consequences*

The implementation of MiFID across the EEA will have many consequences, and the impact

---

<sup>6</sup> European Commission communication of 11 May 1999.

<sup>7</sup> MiFID was prepared using the Lamfalussy legislative approach. Named after the Chairman of the Committee which devised it, the process was proposed in 2001 as a means of accelerating the development of European financial services legislation whilst enabling market experts to participate in the legislative process. The Lamfalussy process advocates a framework Directive under which subordinate ‘Level 2’ measures are prepared during the Directive’s implementation period. Level 2 measures set out the technical detail around the ‘Level 1’ Directive framework. The European Commission refers to the Committee of European Securities Regulators (CESR) for advice on Level 2 measures and CESR in turn consults with national regulators.

will be greater in some jurisdictions more than others<sup>8</sup>, but there will certainly be at least five headline consequences:

- **More firms will be brought into the regulated sector:** MiFID extends both the list of core investment services and the list of regulated financial instruments, which together determine the core activities that Member States are required to regulate. As a result, certain categories of firms that are currently operating on the perimeter of the regulated investment services sector in some EEA jurisdictions will be brought within the scope of mainstream regulation. In particular, standalone investment advisers, broker-dealers active in commodity derivatives and the operators of many alternative trading systems will need to be regulated when MiFID is implemented<sup>9</sup>. The Exhibit to this memorandum sets out the investment services (Section A) and financial instruments (Section C) to which the requirement to regulate will apply.
- **The MiFID passport will apply to a wider range of investment services:** Firms operating within the scope of MiFID regulation will be able to make use of a wider passport to provide investment services throughout the EEA. MiFID, like the ISD, permits firms carrying on Section A investment services and activities to provide those services in other Member States, either by establishing a branch or by providing services cross-border, without becoming separately regulated in each ‘host’ jurisdiction. MiFID, again like the ISD, also permits firms that are relying on the passport in order to provide Section A services to passport the provision of certain ancillary services at the same time<sup>10</sup>.
- **National-level obstacles to the single market will be minimized:** MiFID provides that Member States should not impose *any* additional local requirements on an investment firm which relies on the passport to provide services into that Member State on a cross-border basis<sup>11</sup>; in short, this means that if an investment firm uses

---

<sup>8</sup> The ISD was implemented in a variety of ways across the then members of the EEA; some, like the United Kingdom, implemented with ‘super-equivalent’ effect, so that the impact of certain measures in MiFID may not be as significant as in jurisdictions which have implemented only minimum ISD standards.

<sup>9</sup> Annex I, Section A of MiFID sets out the core “Investment services and activities” to which the Directive applies (see the reproduction of Annex I in the Exhibit to this memorandum).

<sup>10</sup> Annex I, Section B of MiFID sets out the “Ancillary services” to which the passport element of the Directive applies; whilst provision of an ancillary service does not trigger the requirement to become regulated under MiFID (although in some Member States such activities will in any case be regulated), the MiFID passport enables firms passporting Section A activities at the same time to passport the provision of those ancillary services; Section B ancillary services cannot be passported independently of Section A activities.

<sup>11</sup> Article 31(1), MiFID.

the passport to provide investment services from its home state into other EEA Member States, only the home-state regulator's conduct of business rules will apply to that activity. MiFID also provides, however, that Member States can impose limited local conduct of business requirements on an investment firm which relies on the passport to provide investment services in that host Member State by establishing a local branch<sup>12</sup>.

- **Some core business standards will be prescribed at European-level:** For the first time, the European legislature will, after having taken technical advice from CESR, issue Level-2 measures which prescribe certain detailed regulatory requirements; in particular, measures concerning organizational requirements for investment firms, customer classification, the management of conflicts of interest, investment suitability tests and best execution.
- **Transparency requirements for on- and off-market trading will be harmonized:** To encourage the increased market liquidity which alternative trading venues support and at the same time to mitigate any potential competitive or market distortion which they may create, MiFID has introduced pre- and post-trade transparency requirements for equity<sup>13</sup> which will apply not only to trading on the mainstream regulated exchanges but also to trading in alternative venues that are functionally similar to exchanges: *Multilateral Trading Facilities* are platforms which enable multiple participants trade with each other<sup>14</sup>; *Systematic Internalisers* are investment firms which on a regularized basis match dealing orders between customers internally – i.e., without going to the markets. MiFID requires that all such trading venues disclose firm bid/offer prices (pre-trade) and price and volume (post-trade) information, subject to certain limited exceptions.

### *Conclusions*

MiFID will have a significant effect on the European securities markets, both by harmonizing key regulatory standards across the Member States and by removing barriers to the provision of investment services on a truly pan-European basis.

---

<sup>12</sup> Article 32(1), MiFID.

<sup>13</sup> Member States will have discretion to apply these transparency requirements to trading in debt and derivative instruments.

<sup>14</sup> In contrast to bilateral trading facilities, which are generally trading platforms facilitating dealing between participants and a single platform operator.

Investment firms with a presence in Europe are already being encouraged by national regulators to prepare for inevitable changes in the regulatory environment, and it is clear that they will need to start acting now in order to be ready.

Firms hoping to take advantage of the new improved EEA passport to gain greater access to the European investment services market, will need to take careful steps in order to maximize the opportunities which are now coming available.

\* \* \*

If you have specific questions about MiFID and its impact or any other aspects of the European Financial Services Action Plan, or if you would like to request copies of the Directive or related materials, please get in touch through your regular contacts at the firm.

CLEARY GOTTLIEB STEEN & HAMILTON LLP

## EXHIBIT

### MiFID: Annex I

#### LIST OF SERVICES AND ACTIVITIES AND FINANCIAL INSTRUMENTS

##### Section A

##### Investment services and activities

- (1) Reception and transmission of orders in relation to one or more financial instruments.
- (2) Execution of orders on behalf of clients.
- (3) Dealing on own account.
- (4) Portfolio management.
- (5) Investment advice.
- (6) Underwriting of financial instruments and/or placing of financial instruments on a firm commitment basis.
- (7) Placing of financial instruments without a firm commitment basis.
- (8) Operation of Multilateral Trading Facilities.

##### Section B

##### Ancillary services

- (1) Safekeeping and administration of financial instruments for the account of clients, including custodianship and related services such as cash/collateral management.
- (2) Granting credits or loans to an investor to allow him to carry out a transaction in one or more financial instruments, where the firm granting the credit or loan is involved in the transaction.
- (3) Advice to undertakings on capital structure, industrial strategy and related matters and advice and services relating to mergers and the purchase of undertakings.
- (4) Foreign exchange services where these are connected to the provision of investment services.
- (5) Investment research and financial analysis or other forms of general recommendation relating to transactions in financial instruments;
- (6) Services related to underwriting.
- (7) Investment services and activities as well as ancillary services of the type included under Section A or B of Annex I related to the underlying of the derivatives included under Section C - 5, 6, 7 and 10 - where these are connected to the provision of investment or ancillary services.

Section C  
Financial Instruments

- (1) Transferable securities.
- (2) Money-market instruments.
- (3) Units in collective investment undertakings.
- (4) Options, futures, swaps, forward rate agreements and any other derivative contracts relating to securities, currencies, interest rates or yields, or other derivatives instruments, financial indices or financial measures which may be settled physically or in cash.
- (5) Options, futures, swaps, forward rate agreements and any other derivative contracts relating to commodities that must be settled in cash or may be settled in cash at the option of one of the parties (otherwise than by reason of a default or other termination event).
- (6) Options, futures, swaps, and any other derivative contract relating to commodities that can be physically settled provided that they are traded on a regulated market and/or an MTF.
- (7) Options, futures, swaps, forwards and any other derivative contracts relating to commodities, that can be physically settled not otherwise mentioned in C.6 and not being for commercial purposes, which have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are cleared and settled through recognised clearing houses or are subject to regular margin calls.
- (8) Derivative instruments for the transfer of credit risk.
- (9) Financial contracts for differences.
- (10) Options, futures, swaps, forward rate agreements and any other derivative contracts relating to climatic variables, freight rates, emission allowances or inflation rates or other official economic statistics that must be settled in cash or may be settled in cash at the option of one of the parties (otherwise than by reason of a default or other termination event), as well as any other derivative contracts relating to assets, rights, obligations, indices and measures not otherwise mentioned in this Section, which have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are traded on a regulated market or an MTF, are cleared and settled through recognised clearing houses or are subject to regular margin calls.

*Office Locations*

---

**LONDON**

City Place House  
55 Basinghall Street  
London EC2V 5EH, England  
44.20.7614.2200  
44.20.7600.1698 Fax

**NEW YORK**

One Liberty Plaza  
New York, NY 10006-1470  
1.212.225.2000  
1.212.225.3999 Fax

**WASHINGTON**

2000 Pennsylvania Avenue, NW  
Washington, DC 20006-1801  
1.202.974.1500  
1.202.974.1999 Fax

**PARIS**

12, rue de Tilsitt  
75008 Paris, France  
33.1.40.74.68.00  
33.1.45.63.66.37 Fax

**BRUSSELS**

Rue de la Loi 57  
1040 Brussels, Belgium  
32.2.287.2000  
32.2.231.1661 Fax

**MOSCOW**

Cleary Gottlieb Steen & Hamilton LLP  
CGS&H Limited Liability Company  
Paveletskaya Square 2/3  
Moscow, Russia 115054  
7.501.258.5006  
7.501.258.5011 Fax

**FRANKFURT**

Main Tower  
Neue Mainzer Strasse 52  
60311 Frankfurt am Main, Germany  
49.69.97103.0  
49.69.97103.199 Fax

**COLOGNE**

Theodor-Heuss-Ring 9  
50668 Cologne, Germany  
49.221.80040.0  
49.221.80040.199 Fax

**ROME**

Piazza di Spagna 15  
00187 Rome, Italy  
39.06.695.221  
39.06.69.20.06.65 Fax

**MILAN**

Via San Paolo 7  
20121 Milan, Italy  
39.02.72.60.81  
39.02.86.98.44.40 Fax

**HONG KONG**

Bank of China Tower  
One Garden Road  
Hong Kong  
852.2521.4122  
852.2845.9026 Fax

**TOKYO**

Cleary Gottlieb Steen & Hamilton LLP  
20th Floor Shin Kasumigaseki Building  
3-2, Kasumigaseki 3-chome  
Chiyoda-ku, Tokyo 100-0013, Japan  
81.3.3595.3911  
81.3.3595.3910 Fax