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EC Securities Regulation, A Single Regime for an Integrated Securities Market: Harmonised We Stand, Harmonised We Fail? Part 1·

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LT [keywords to follow]

Introduction

EC securities regulation has been one of the cornerstones of all policy initiatives aiming at the integration of EU financial markets. Yet developing this body of EC law has been a very lengthy process frequently marred by controversy. Arguably, a marked lack of direction has been its most distinctive characteristic for almost two decades.[1] This was caused by three factors. The first factor was the existence of conflicting national agendas motivated by a desire to protect and preserve domestic investment firms, national securities markets, and local business customs. The second factor was the unwillingness of the global financial services industry to engage in a constructive dialogue and find a common language with EU legislators. This unwillingness was attributable to the inability of the industry to recognise the varied and important ways through which EC securities law was able to influence the evolution of its business processes, development of new products, and ultimately the competitiveness and profitability of investment firms. The third factor was the inability of EU officials and legislators to understand fully the intricacies of modern financial markets and in particular their global nature and the fast pace of innovation within them. This resulted in the production of legislation that often reflected the reserve, awe, and prejudice with which EC bodies used to view the workings of global finance. A good number of these dysfunctions have been addressed by the European Union's Action Plan for Financial Services (FSAP)[2] and the introduction of the Lamfalussy process.

With the publication of FSAP the Commission set out a framework for the reform of existing legislation, and the enactment of new legislation in the areas which had not been included in the preceding harmonisation attempts.[3] EC legislation passed in the context of FSAP departs radically from the principle of minimum harmonisation and creates self-standing pan-European regulatory regimes in a number of areas, most notably in the areas of market abuse, investment firm-retail customer relations, operation of licensed financial exchanges and of Alternative Trading Systems (ATS). Furthermore, FSAP legislation upgrades the EC legal framework that governs the regulation and supervision of investment firms and the public offer of securities and their admission to trading on securities exchanges.

The majority of the Securities Directives enacted under FSAP contain both provisions that promote the aim of integrated financial markets in the European Union (integrative legislation) and measures that deal with the effects of increased market integration (protective legislation). The most important examples of directives that serve this dual objective are the Directive on Markets in Financial Instruments (MiFID),[4] the Public Offers and Admissions Prospectus Directive (POPD II),[5] and the Directive on Takeover Bids.[6] On the other hand, the core of the Market Abuse Directive[7] and of the Transparency Directive[8] comprise protective rules that deal with the effects of market integration, by ensuring the availability of information to investors in the single market and a uniform prohibition of market abuse.

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1. See E. Avgouleas, ''The Political Economy of European Financial Services Law and the Advent of E-Commerce'', Research Papers on International and European Affairs (Ant. Sakkoulas Law Publishers, Athens, 2003).

2. See Commission Communication, Financial Services: Implementing the Framework for Financial Markets: Action Plan, COM (1999) 232.

3. For an appraisal of FSAP see N. Maloney, ''New Frontiers in EC Capital Markets Law: From Market Construction to Market Regulation'' (2003) 40 C.M.L.Rev. 809, pp.811–813 and E. Avgouleas, ''A Critical Evaluation of the New EC Financial Market Regulation: Peaks and Troughs in the Road Ahead'' (2005) 18 *The Transnational Lawyer* 179, pp.224–229.

4. Directive 2004/39 on markets in financial instruments [2004] O.J. L145/1.

5. Directive 2003/71 on the prospectus to be published when securities are offered to the public or admitted to trading [2003] O.J. L345/64.

6. Directive 2004/25 on takeover bids [2004] O.J. L142/12 (hereinafter the ''Takeover Bids Directive''). The enactment of this Directive came after a legal and political struggle that lasted well over a decade.

7. Directive 2003/6 on insider dealing and market manipulation (market abuse) [2003] O.J. L96/16 (hereinafter the ''Market Abuse Directive'').

8. Directive 2004/109 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34 [2001] O.J. L184/1 (hereinafter the ''Transparency Directive'').

The implementation of FSAP legislation has been inextricably bound up with the adoption of the so-called Lamfalussy process. Acknowledging the validity of complaints about the speed and efficiency with which EU bodies, national legislatures, and regulators enacted and implemented financial services legislation, in 2000 the Commission set up the so-called ''Committee of Wise Men''. The mandate given to this Committee was to identify and recommend the most efficient, flexible and speedy procedure to debate and enact legislation for EU securities markets, also taking into account the fast pace of change and innovation that financial markets have experienced on a continuous basis since the mid-1980s. The Committee of Wise Men published its Final Report in February 2001.[9] The Report suggested a new four-level regulatory approach and the establishment of two committees, which would be involved with the process of drafting and implementing relevant legislation: the EC securities committee (ESC) and an EU securities regulators' committee with advisory functions, a role that has been taken by the Committee of European Securities Regulators (CESR). The Stockholm European Council of March 2001 endorsed the final report of the Committee of Wise Men.

Under the new approach the EC Commission, the Council, and the European Parliament produce general principle, framework directives, the so-called Level 1 legislation. Level 1 legislation is followed by Level 2 legislation (implementing measures). These are adopted by the Commission with the assistance of the ESC, following consultation with the CESR. Level 3 rules are imposed by national regulators through co-ordinated EU action, following consultation within the CESR, and should be applied consistently across the European Union in order to ensure common and uniform implementation of Level 1 and 2 legislation. Level 4 is concerned with the consistent implementation and enforcement of enacted legislation. The Lamfalussy process has been utilised in the drafting of the Market Abuse Directive, the Transparency Directive, the POPD II and the MiFID. A further legislative package of seven measures (one Directive[10] and six Commission Decisions)[11] has extended the Lamfalussy process to banking, insurance and occupational pensions, and to asset management.

As most FSAP Securities Directives have already been implemented into the legal orders of EU Member States, the last of the FSAP securities legislation that remains to be transposed into Member States' legal orders is MiFID and its implementing measures[12] (together comprising the MiFID regime). Transposition of and compliance with the MiFID regime constitute, due to its far reaching nature, a colossal, challenging and resource-intensive task for EU regulators. Thus, the first part of this two-part article comprises an analysis of the MiFID regime, describing the rationales for the enactment of MiFID and the main features of the regime.

The second part, to be published in the next issue of this journal, comprises an analysis of the EC's market abuse regime in conjunction with the new conduct of business rules for investment firms provided under MiFID. It then discusses the new regime for the public offering of securities and their admission to trading on a regulated market in the European Union, and the periodic disclosure obligations imposed by the Transparency Directive. A comprehensive conclusion follows.

Markets in Financial Instruments Directive: an uncertain revolution for the EU financial services industry

Reforming the ISD regime

The implementation of the Investment Services Directive (ISD)[13] brought about clear benefits in respect of the integration of the internal market in financial services. Its most important achievement was that it led to the creation of a level playing field

9. *Final Report of the Committee of Wise Men on the Regulation of European Securities Markets,* Brussels, February 15, 2001. For a very good analysis of the Lamfalussy process and of its intricacies see Eilis Ferran, *Building an EU Securities Market* (Cambridge University Press, 2004), pp.58–111.

10. Directive 2005/1 amending Council Directives 73/239, 85/611, 91/675, 93/6 and 94/19 and Directives 2000/12, 2002/83 and 2002/87 of the European Parliament and of the Council, in order to establish a new organisational structure for financial services committees [2005] O.J. L79/9.

11. Commission Decision 2004/9 of November 5, 2003 Establishing the European Insurance and Occupational Pensions Committee [2004] O.J. L3/34; Commission Decision 2004/6 of November 5, 2003 Establishing the Committee of European Insurance and Occupational Pensions Supervisors [2004] O.J. L3/30; Commission Decision 2004/5 of November 5, 2003 Establishing the Committee of European Banking Supervisors [2004] O.J. L3/28; Commission Decision 2004/10 of November 5, 2003 Establishing the European Banking Committee [2004] O.J. L3/36; Commission Decision 2004/8 of November 5, 2003 Amending Decision 2001/528 Establishing the European Securities Committee [2004] O.J. L3/33; Commission Decision 2004/7 of November 5, 2003 Amending Decision 2001/527 Establishing the Committee of European Securities Regulators [2004] O.J. L3/32.

12. Directive 2006/73 implementing Directive 2004/39 of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive [2006] O.J. L241/26; Regulation 1287/2006 implementing Directive 2004/39 of the European Parliament and of the Council as regards recordkeeping obligations for investment firms, transaction reporting, market transparency, admission of financial instruments to trading, and defined terms for the purposes of that Directive [2006] O.J. L241/1. Of course, the Regulation is directly applicable and does not require transposition into the national legal orders, yet, plausibly, most EU jurisdictions have chosen to incorporate its provisions in the legal instrument(s) that shall be used for the national implementation of the MiFID regime.

13. Directive 93/22 on investment services in the securities field [1993] O.J. L141/27.

between credit institutions and investment firms and prevented national regulatory regimes from discriminating against cross-border competition. However, the ISD regime had a number of weaknesses, which prevented it from becoming the driving force of market integration. In addition, market developments such as the technological revolution and the emergence of alternative trading venues, as well as the very significant increase in cross-border trade, made the ISD look rather outdated.[14] The main shortcomings of the ISD regime are summarised below:

- *Technological revolution*: In the 1990s, the European Union witnessed significant growth in cross-border trade (both retail and institutional) facilitated by technology and the proliferation of electronic trading venues, which were not licensed exchanges. However, the ISD did not address the regulatory issues arising by virtue of competition for trading volume between regulated markets and ATSs, and it did not provide a comprehensive regulatory framework within which markets and systems could compete for business. Thus, under the ISD regime the functionality of the operation of ATSs did not correspond directly to any of the ''investment services'' able to be offered under the ISD's passport.
- *Internalisation*: The ISD did not provide a framework for the execution of client orders internally (''off exchange'') by investment firms and banks, by either matching them ''in house'' with another client order, or executing them against a proprietary position. The traditional regulatory model, on which the ISD was based, made a clear distinction between the functions of a market intermediary and those of a marketplace. This distinction could no longer be made because of the subsequent emergence of strong competition between different methods of trade execution: exchanges, new trading systems, and in-house order execution by investment firms.
- *The change in the status of EU securities exchanges*: The majority of EU securities exchanges have gradually become profit-driven corporations, the securities of which are often listed, moving away from the old organisational model of state ownership or mutual ownership. As a result, today, licensed exchanges perform a reduced portfolio of regulatory duties.
- *Insufficient harmonisation of national prudential regulation and conduct of business regimes*: The absence of a clear ''country of origin'' regime and the ability of the host state to impose additional requirements invoking the concept of the ''general good'' seriously inhibited the effectiveness of the ISD passport. In addition, the lack of comprehensive harmonisation of national conduct of business rules led to continuing compliance with different sets of national conduct of business rules.[15]
- *Limited scope*: The ISD did not cover the full range of services offered to investors by investment firms, such as the provision of investment advice, dealing in commodity derivatives, and the production and dissemination of investment research.
- *Regulatory co-operation*: The ISD provisions for supervisory co-operation were designed for an era when linkages between national financial markets were not intensively employed. As a result, the ISD did not provide a clear allocation of supervisory and enforcement responsibilities between national regulatory authorities within the European Union. Effective co-operation and information exchange between national authorities is imperative for a well supervised integrated market.

The formal discussion on the revised ISD opened with the publication by the Commission of its Communication (''Green Paper'') in November 2000.[16] The Green Paper discussed a number of issues relating to the operation and application of the ISD, and the Commission received a very large number of responses. These responses obliged the Commission to admit that a wide-ranging review of the ISD was required. The response to the Commission orientations by industry bodies was less than enthusiastic in a number of areas. The revised recommendations were also subjected to open consultation. Relevant responses were taken into account before the submission of the Commission's Proposal in November 2002.[17] Both the European Parliament in its first reading, and the Council in its Common Position[18] introduced a large number of changes to the Commission's Proposal. Following a compromise with the Council,[19] further changes were introduced by the European Parliament in its second reading, which adopted several of the recommendations of the relevant Parliamentary Committee. The Directive was formally adopted by the Council of Ministers on April 27, 2004.[20]

14. For a comprehensive account of the ISD regime see N. Moloney, *EC Securities Regulation* (Oxford University Press, 2002), Chs 6–8 and Y. Avgerinos, *Regulating and Supervising Investment Services in the EU* (Palgrave Macmillan, 2003).

15. See E. Avgouleas, ''The Harmonisation of Rules of Conduct in EU Financial Markets: Economic Analysis, Subsidiarity and Investor Protection'' (2000) 6 *European Law Journal* 72.

16. Communication from the Commission to the European Parliament and the Council—Upgrading the Investment Services Directive (93/22), COM(2000) 729 final.

17. Proposal for a Directive on Investment Services and regulated markets 2000/12, COM(2002) 625 final.

18. Common Position 9/2004 of December 8, 2003 [2004] O.J. C60/E/1. The Common Position was adopted by qualified majority.

19. [2004] O.J. C102, PE T5-0212/2004.

20. For an analytical discussion of the different aspects of MiFID see E. Avgouleas, ''The New EC Financial Markets Legislation and the Emerging Regime for Capital Markets'' in P. Eechout and T. Tridimas, eds, *Yearbook of European Law 2004* (Oxford University Press, 2005), pp.321–336.

The principal features and objectives of MiFID

The MiFID regime intends to facilitate market integration through the broadening of the ''common passport''. In this mode, MiFID introduces a new core investment service relating to the operation and provision of multilateral trading facilities (MTFs). This brings under a common EU regulatory umbrella the most important ATSs,[21] since the definition of MTFs in MiFID[22] captures systems which support the multilateral disclosure of firm orders/indications of interest between the users of the system and the execution of orders resulting from the interaction of buy/sell interests expressed through the system. It also extends to ''auction-crossing'' systems, where user orders are executed against a reference price imported from outside the system. Furthermore, MiFID extends the scope of the new regulatory regime to the provision of investment advice and dealing in commodity derivatives, which were not covered by the ISD. MiFID's expanded scope allows investment firms to provide cross-border investment advice and commodity derivatives dealing services.

The objective of investor protection is pursued through the establishment of a new regulatory framework for the execution of investor transactions on exchange, through ATSs, or internally by investment firms. MiFID intends to protect investors and the integrity of the market by containing extensive obligations on both pre-trade and post-trade transparency in qualifying equity transactions.[23] In addition, MiFID lays out the foundations for an EU-wide conduct of business regime that covers ''best execution'' of client orders,[24] ''client order handling'',[25] receipt of inducements,[26] conflicts of interest,[27] and provision of information to clients and potential clients and reporting to existing clients.[28]

21. MiFID, Annex I, ''List of Services and Financial Instruments'', Section A, ''Investment services and Activities''.

22. MTF means ''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''. MiFID, Art. 4(1), (15).

23. *ibid.*, Arts 27–29, 30, 44, and 45, and Regulation 1287/2006, Arts 17–19, 24, and 27–29.

24. MiFID Arts 21(1) and 19(1), and Directive 2006/73, Arts 44–46.

25. MiFID Arts 22(1) and 19(1), and Directive 2006/73, Arts 47–49.

26. MiFID Art.19(1) and Regulation 1287/2006, Art.26.

27. MiFID Arts 13(3) and 18, and Directive 2006/73, Arts 21–23.

28. MiFID Art.19(3) and Directive 2006/73, Arts 27–33 and 40–43.

Organisation, operation, and transparency obligations of financial exchanges and of MTFs

MiFID introduces rules for the licensing and operation of regulated markets[29] and requirements regarding the management of regulated markets and persons exercising significant influence over the management of regulated markets.[30] MiFID's definition of regulated markets extends to all licensed financial exchanges.[31] The persons who effectively direct the business and the operations of the regulated market must be ''of sufficiently good repute and sufficiently experienced as to ensure the sound and prudent management of the regulated market''.[32] The competent authority must ensure, ''at the time of authorisation and on an ongoing basis'', that the regulated market is endowed with the financial resources needed to secure its orderly functioning.[33]

As mentioned above, MiFID introduces a new ''investment service'' relating to the operation of MTFs.[34] This allows the operators of such systems to be authorised as investment firms, subject to a customised regulatory regime. Following the implementation of MiFID by Member States, MTF operators shall be able to benefit from the Directive's ''common passport'' and make their trading facilities and services available to users throughout the European Union, on the basis of home country authorisation.[35] MiFID gives the right to MTFs to finalise, clear, and settle transactions concluded on them through access to central counterparty and clearing and settlement facilities operated in another Member State.[36] Such connectivity is necessary to facilitate the finalisation of transactions concluded on MTFs and safeguard traders' legal rights.

Furthermore, the MiFID establishes pre-trade and post-trade transparency obligations imposed on operators of regulated markets or of MTFs in respect of orders and quotes concerning shares admitted to trading in a regulated market.[37] As regards their pre-trade transparency obligations, regulated markets and MTFs are required to make public, as close to real time as possible, on reasonable commercial terms and on a continuous basis, ''current bid and offer prices which are advertised through their systems for shares admitted to trading''.[38] This obligation is

29. MiFID, Arts 36 and 39.

30. *ibid.*, Arts 37–38.

31. *ibid.*, Art.4(1), (14).

32. *ibid.*, Art.37(1).

33. *ibid.*, Art.39(f).

34. *ibid.*, Annex I, ''List of Services and Financial Instruments'', Section A, ''Investment services and activities''.

35. *ibid.*, Art.31(5).

36. *ibid.*, Art.35.

37. *ibid.*, Arts 29–30 and 44–45 and Regulation 1287/2006, Arts 17–19 and 27–31.

38. MiFID, Art.44(1).

further specified in Regulation 1287/2006, which is the relevant Level 2 implementing measure.

Under Art.17 of the Regulation, regulated markets and MTFs that operate a continuous auction order book trading system, must, for every relevant share, make public continuously throughout its normal trading hours the aggregate number of orders and of the shares those orders represent, at each price level, for the five best bid and offer price levels.[39] In the case of quote-driven trading systems, the operator of the regulated market or of the MTF must, for each relevant share, ''make public continuously throughout its normal trading hours the best bid and offer by price of each market maker in that share, together with the volumes attaching to those prices'', provided that the market makers' quotes are binding commitments to buy and sell the shares concerned at the indicated price and volume.[40] Article 17 also provides the specific pre-trade publication obligations of operators of periodic auction trading systems and of hybrids, which admittedly have a very limited presence in EU equity markets.

MiFID provides that the display of large size orders and quotes or of orders and quotes in illiquid securities may be waived.[41] Waivers may also be granted on the basis of the market model and the type of the order or transaction.[42] More specifically, the conditions of Art.18(1) of Regulation 1287/2006 for the granting of a waiver by the competent authority are satisfied if: (a) the trading system uses as a basis for the determination of the trade price the reference price generated by another system, ''where that reference price is widely published and is regarded generally by market participants as a reliable reference price'', or (b) the trade constitutes the formalisation of (pre-)negotiated transactions[43] and meets the criteria of Art.18(1)(b).

As regards their post-trade transparency obligations, regulated markets and MTFs have to publish, in the format provided in Annex I, Table 1 of Regulation 1287/2006, the price, volume, and time for all trades in shares admitted to trading on the regulated market, or in shares admitted to trading on a regulated market executed under the MTF's systems, on a reasonable commercial basis and as close to real time as possible.[44] Post-trade information relating to such transactions shall be made available in any case within three minutes of the relevant transaction.[45]

The reporting of the details of large trades and trades in illiquid securities could be deferred[46] for a period that ranges between 60 minutes and the end of the third trading day next after trade, as specified in Annex II, Table 4 of the Regulation. Such trades qualify for deferred publication if: (a) the transaction is of a size that qualifies for deferral under Annex II, Table 4, and (b) it is a transaction concluded between an investment firm ''dealing on own account and a client of that firm''.[47] Finally, MTF operators do not have post-trade transparency obligations, where such information is made public under the system of a regulated market.[48]

Organisation, operation and supervision of investment firms under the MiFID regime

MiFID and its implementing measures provide an extensive framework governing the organisation and operation of investment firms,[49] including rules on outsourcing,[50] safeguarding of client funds,[51] investment firm record-keeping,[52] provision of information to clients and potential clients,[53] and reporting both to its clients[54] and the regulatory authorities. It also mandates the creation of an internal audit division within investment firms that is independent of all other functions and activities of the firm.[55] Although in some cases the new regime provides some flexibility, as is the case with outsourcing, in other cases it is unduly cumbersome

39. Regulation 1287/2006, Art.17(2).
40. *ibid.*, Art.17(3).
41. MiFID Arts 29(2) and 44(2)–(3) and Regulation 1287/2006, Art.20. Annex II (Table 2) of the Regulation provides the minimum size of orders qualifying as large in scale compared to orders of normal market size and thus qualifying for the waiver. The thresholds differ depending on the size of annual daily turnover for that share, calculated in accordance with the procedure of Art.33 of the Regulation.
42. MiFID Arts 29(2) and 44(2)–(3) and Regulation 1287/2006, Art.18.
43. A negotiated transaction is ''a transaction involving members or participants of a regulated market or an MTF which is negotiated privately but executed within the regulated market or MTF and where that member or participant in doing so undertakes one of the following tasks: (a) dealing on own account with another member or participant who acts for the account of a client; (b) dealing with another member or participant, where both are executing orders on own account; (c) acting for the account of both the buyer and seller; (d) acting for the account of the buyer, where another member or participant acts for the account of the seller; (e) trading for own account against a client order''. Regulation 1287/2006, Art.19.
44. MiFID, Arts 30(1) and 45(1).
45. Regulation 1287/2006, Art.29(2).
46. MiFID, Arts 30(2) and 45(2).
47. Regulation 1287/2006, Art.28.
48. MiFID, Art.30(1).
49. *ibid.*, Arts 5–13, 16–17.
50. *ibid.*, Art.13(2) and Directive 2006/73, Arts 13–15 and Recitals 3, 14, 18–22. Article 2(6) of the implementing Directive defines ''outsourcing'' as ''an arrangement of any form between an investment firm and a service provider by which that service provider performs a process, a service or an activity which would otherwise be undertaken by the investment firm itself''.
51. MiFID, Art.13(7)–(8) and Directive 2006/73, Arts 16–20.
52. MiFID, Art 13(6) and Directive 2006/73, Art 51.
53. MiFID, Art.19(2), (3) and Directive 2006/73, Arts 27–34.
54. MiFID, Art.19(8) and Directive 2006/73, Arts 40–43.
55. MiFID, Art.13(5) and Directive 2006/73, Art.8. The establishment of an internal audit function must be ''proportionate in view of the nature, scale and complexity of their business and the nature and range of investment services and activities undertaken in the course of that business''. *Ibid.*

and rigid, making the survival of small and medium size investment firms in the European Union questionable, due to significantly increased costs of compliance. It is doubtful if small and medium size investment firms present such a threat to systemic stability, or have ever been implicated in such serious and widespread infractions of prudential and investor protection regulation, as to justify this extensive revamping of the respective regimes.

MiFID introduces a number of obligations imposed on investment firms that deal on their own account by executing client orders on an organised, frequent, and systematic basis off a regulated market or an MTF, called "systematic internalisers" (SIs).[56] On the basis of the clarification of the definition of SIs offered in the Regulation, an investment firm does not perform this activity on an organised, frequent and systematic basis and, thus, it is not an SI, where[57]:

(a) the activity is performed on an *ad hoc* and irregular bilateral basis with wholesale counterparties as part of business relationships which are themselves characterised by dealings above standard market size;

(b) the transactions are carried out outside the systems habitually used by the firm concerned for any business that it carries out in the capacity of a systematic internaliser.

The competent authority in each Member State must maintain and publish a list of all firms it has authorised to act as SIs, in respect of shares admitted to trading on a regulated market, which it shall review at least annually and make available to the CESR.[58] SIs are obliged to maintain, for each *liquid* share for which they act as systematic internalisers[59]:

(a) a quote or quotes which are close in price to comparable quotes for the same share in other trading venues;

(b) a record of its quoted prices, which it shall retain for a period of 12 months or such longer period as it considers appropriate.

SIs are subject to this obligation only if they deal in liquid shares[60] in sizes up to standard market size.[61] SIs are obliged to execute retail client orders they receive on the terms (quoted prices) published at the time of reception of the order.[62] However, SIs may offer their professional clients a better price for orders which "are of a size bigger than the size customarily undertaken by a retail investor" provided that this price falls within a public range close to market conditions.[63] An order is regarded "as being of a size bigger than the size customarily undertaken by a retail investor if it exceeds EUR 7 500".[64] Moreover, SIs may execute orders they receive from their professional clients at prices different than their quoted ones, without having to comply with the above conditions, where the transaction concerns execution in several securities as part of one transaction (portfolio trade) or in respect of orders that are subject to conditions other than the current market price.[65]

In addition, MiFID imposes post-trade transparency obligations to SIs, which are very similar to those imposed to regulated markets and MTFs,[66] both discussed above. Also similar are the conditions for deferred publication of large transactions.[67] All of the above obligations imposed on SIs revolutionise the regulatory regime in the Member States governing the internal execution of client orders in equities by broker-dealers, and their impact on the

56. MiFID, Art.4(1)(7). Regulation 1287/2006, Art.21(1) adds the following criteria indicating whether an investment firm deals on own account by executing client orders outside a regulated market or an MTF, on an organised, frequent and systematic basis and, thus, it is an SI: "(a) the activity has a material commercial role for the firm, and is carried on in accordance with non-discretionary rules and procedures; (b) the activity is carried on by personnel, or by means of an automated technical system, assigned to that purpose, irrespective of whether those personnel or that system are used exclusively for that purpose; (c) the activity is available to clients on a regular or continuous basis".

57. Regulation 1287/2006, Art.21(3).

58. *ibid.*, Art.21(4).

59. MiFID, Art.27(1) and Regulation 1287/2006, Art.24.

60. Shares admitted to trading on a regulated market shall be considered to be liquid, i.e. to have a liquid market, if they are traded daily, with a free float not less than €500 million, and one of the following conditions is satisfied: "(a) the average daily number of transactions in the share is not less than 500; (b) the average daily turnover for the share is not less than EUR 2 million". Regulation 1287/2006, Art.22(1). However, Member States may, at their discretion, in respect of shares for which it is the *most relevant market* (as defined in Art.9 of the Regulation), specify by public notice that both of the above conditions apply. *Ibid.*

61. According to MiFID, Art.27(1), the "standard market size" for each share traded by a "systematic internaliser" is derived by grouping shares "in classes on the basis of the arithmetic average value of the orders executed in the market for that share". The market for each share comprises "all orders executed in the European Union in respect of that share excluding those large in scale compared to normal market size for that share". It follows that "the standard market size for each class of shares shall be a size representative of the arithmetic average value of the orders executed in the market for the shares included in each class of shares". *Ibid.* Annex II, Table 3 of the Regulation provides the standard market size for each class of liquid shares grouped in terms of average value of transactions, Regulation 1287/2006 Art.23.

62. MiFID, Art.27(3).

63. *ibid.*

64. Regulation 1287/2006, Art.26.

65. MiFID, Art.27(3) and Regulation 1287/2006 Art.25(1). More specifically, Art.25(1) of the Regulation provides that "execution in several securities shall be regarded as part of one transaction if that one transaction is a portfolio trade that involves 10 or more securities. For the same purposes, an order subject to conditions other than the current market price means any order which is neither an order for the execution of a transaction in shares at the prevailing market price, nor a limit order."

66. MiFID, Art.28(1) and Regulation 1287/2006, Art.27.

67. MiFID, Art.28(2) and Regulation 1287/2006, Art.28.

liquidity of this market and the trading volume of European equity markets (regardless of executing venue) remains uncertain.[68]

The MiFID conduct of business regime for investment firms

MiFID and its Level 2 implementing measures create an extensive and in some cases detailed regime governing the conduct of business (provision of investment service and of ancillary services) of investment firms. The new regime extends to ''best execution''[69] and ''client order handling''[70] requirements, rules on client reporting,[71] conflicts of interest,[72] production of investment research[73] and portfolio management,[74] criteria for client categorisation,[75] uniform criteria for the assessment of suitability and appropriateness,[76] and a detailed regime for the safeguarding of client funds.[77] Therefore, in yet another example of maximum harmonisation, MiFID essentially creates a self-standing regulatory regime for the provision of retail financial services in the European Union.[78]

Although it is impossible to cover within the limited space of this article most of the different aspects of MiFID's conduct of business regime, a brief analysis of its rules on ''best execution'' and conflicts of interest should be sufficient to indicate the very wide reach of the new regime. MiFID's rules on ''best execution'' cover both the firm that is assigned the immediate task of execution of an order and firms providing reception and transmission of orders and portfolio management services.[79] Investment firms acting on behalf of clients may show that they have provided their clients with ''best execution'', if they can prove that[80]:

- they take all reasonable steps to obtain, when executing orders, the best possible result for their clients taking into account price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order, unless the client has given specific instructions otherwise[81];
- they have executed their orders in accordance with the firm's execution policy, which allows them to obtain the best possible result for their client orders[82];
- they have informed investors of the different channels through which their orders may be executed.

Directive 2006/73, which is the relevant Level 2 implementing measure, specifies that in providing best execution investment firms must take into account[83]:

- the characteristics of the client including the categorisation of the client as retail or professional;
- the characteristics of the client order;
- the characteristics of financial instruments that are the subject of that order; and
- the characteristics of the execution venues to which that order can be directed.

Furthermore, where an investment firm executes an order on behalf of a retail client, what constitutes ''the best possible result'' shall be determined by reference to the total consideration, representing the price of the financial instrument and the costs related to execution. The latter ''shall include all expenses incurred by the client which are directly related to the execution of the order''.[84] In this context, where the firm may choose between competing venues to execute an order for a financial instrument, in assessing and comparing the results for the client that would be achieved by executing the order on each of the eligible execution venues listed in the firm's order execution policy, ''the firm's own commissions and costs for executing the order'' should be taken into account.[85]

Moreover, MiFID requires investment firms to take ''reasonable steps'' to identify and manage, through the establishment of appropriate organisational structures, conflicts of interest that may arise between themselves and their clients in the course of providing ''investment services'' and ''ancillary services'' to their clients,[86] as defined in Annex I of MiFID. Relevant interests include the identifiable interests of investment firms' managers, employees, tied agents, and of any other person ''directly or indirectly linked to them by control'' or to the interests of different clients of the firm.[87] Where the

68. For a first approach see E. Avgouleas and S. Degiannakis, ''The Impact of the EC Financial Instruments Markets Directive on the Trading Volume of EU Equity Markets'', Working Paper, available from *http://papers.ssrn.com*.
69. MiFID, Art.21 and Directive 2006/73, Arts 44–46.
70. MiFID, Art.22 and Directive 2006/73, Arts 47–49.
71. MiFID, Art.19(8) and Directive 2006/73, Arts 40–43.
72. MiFID, Arts 13(3) and 18 and Directive 2006/73, Arts 21–23, and Arts 24–25 as regards conflicts of interest in the context of production of investment research.
73. MiFID, Art.19(2) and Directive 2006/73, Art.24 and Recitals 29–30, 38.
74. MiFID, Arts 4(1), (9) and 19(4) and Directive 2006/73, Arts 30(2)-(3), 35, 41, and Recitals 26, 51, 57–58, 63.
75. MiFID, Art.19(3) and Directive 2006/73, Art.28.
76. MiFID, Art.19(4)–(5) and Directive 2006/73, Arts 35–37.
77. MiFID, Art.13(7)–(8) and Directive 2006/73, Arts 16–20.
78. See also N. Maloney, ''Promoting the Retail Investor: The EU's Emerging Strategy and Conduct of Business'' in Guido Ferrarini and Eddy Wymeersch, eds, *Investor Protection in Europe Corporate Law Making, The MiFID and Beyond* (Oxford University Press, 2006), Ch.6
79. MiFID, Art.21 and Directive 2006/73, Arts 44–46.
80. Directive 2006/73, Art.44(1).
81. MiFID, Art.21(1).
82. MiFID, Art.21(2)–(5) and Directive 2006/73, Art.46.
83. Directive 2006/73, Art.44(1).
84. *ibid.*, Art.44(3).
85. *ibid.*
86. MiFID, Art.18.
87. *ibid.*, Art.18(1). More specifically, it is considered that the following situations give rise to conflicts of interest: ''(a)

proper management of conflicts of interest through the firm's internal mechanisms is not possible and there remains a reasonable risk that the clients' interests may be damaged, MiFID requires investment firms to disclose clearly "the general nature and/or sources of conflicts of interest to the client before undertaking business on its behalf".[88] In order to manage such conflicts of interest investment firms are required to set out, implement, and maintain an effective conflicts of interest policy, which will be appropriate to the size and organisation of the firm and the nature, scale and complexity of its business.[89] The conflicts of interest policy must take into account any circumstances, of which the firm is or should be aware, which may give rise to a conflict of interest arising as a result of the structure and business activities of other members of the group and the safeguards specified in Art.22(2) and (3) of Directive 2006/73,[90] especially in respect of "relevant persons",[91] i.e. the directors, managers, tied agents, and employees of the firm.

The expanded scope of MiFID

MiFID extends the list of "investment services" that firms may offer on the basis of the "common passport", on a stand-alone basis, to the provision of investment advice,[92] which was listed as an "ancillary service" under the ISD. The principal implications of the inclusion of investment advice in the list of "investment services" are the following:

- investment advisers become subject to MiFID's initial authorisation and ongoing supervision obligations, including initial capital and continuing adequate resources;
- entities (including natural persons) providing investment advice as their principal/exclusive activity will be required to be licensed as an "investment firm", as opposed to being subject to a variety of specialised national regimes; and
- even firms which provide investment advice on a "stand-alone" basis and not in conjunction with any other investment business will be able to utilise the common passport and set up a branch in another Member State, or conduct business on a cross-border basis.

MiFID defines as investment advice: "the provision of personal recommendations to a client, either upon its request or at the initiative of the investment firm, in respect of one or more transactions relating to financial instruments".[93] Article 52 of Directive 2006/73 provides that "a personal recommendation is a recommendation that is made to a person in his capacity as an investor or potential investor, or in his capacity as an agent for an investor or potential investor". Furthermore, the recommendation must be presented "as suitable for that person, or must be based on a consideration of the circumstances of that person". Finally, it must be a recommendation to take one of the following steps:

> (a) to buy, sell, subscribe for, exchange, redeem, hold or underwrite a particular financial instrument;
>
> (b) to exercise or not to exercise any right conferred by a particular financial instrument to buy, sell, subscribe for, exchange, or redeem a financial instrument.

A recommendation is not a "personal recommendation" if it is issued exclusively through distribution channels or to the public. Advice about financial instruments given in a newspaper, journal, magazine or any other publication addressed to the general public (including by means of the internet), or in any television or radio broadcast, should not be considered as a "personal recommendation" under the above definition.[94] Therefore, generic advice does not, in principle, constitute "investment advice".[95] The same applies to the provision of general investment recommendations in the form of financial analysis or research (research or other information recommending or suggesting an investment strategy), which explicitly or implicitly concern one or several financial instruments or the issuers of financial instruments, including any opinion as to the present or future value or price of such instruments, intended for distribution channels or for the public.[96] The latter constitutes an "ancillary" service within Section B(5)

the firm or that person is likely to make a financial gain, or avoid a financial loss, at the expense of the client; (b) the firm or that person has an interest in the outcome of a service provided to the client or of a transaction carried out on behalf of the client, which is distinct from the client's interest in that outcome; (c) the firm or that person has a financial or other incentive to favour the interest of another client or group of clients over the interests of the client; (d) the firm or that person carries on the same business as the client; (e) the firm or that person receives or will receive from a person other than the client an inducement in relation to a service provided to the client, in the form of monies, goods or services, other than the standard commission or fee for that service". Directive 2006/73, Art.21.

88. MiFID, Art.18(2).

89. Directive 2006/73, Art.22(1).

90. These, inter alia, require: "(b) the separate supervision of relevant persons whose principal functions involve carrying out activities on behalf of, or providing services to, clients whose interests may conflict, or who otherwise represent different interests that may conflict, including those of the firm; (c) the removal of any direct link between the remuneration of relevant persons principally engaged in one activity and the remuneration of, or revenues generated by, different relevant persons principally engaged in another activity, where a conflict of interest may arise in relation to those activities; (d) measures to prevent or limit any person from exercising inappropriate influence over the way in which a relevant person carries out investment or ancillary services or activities". Directive 2006/73, Art.22(3).

91. *ibid.*, Art.1(3).

92. MiFID, Annex I, "List of Services and Financial Instruments", Section A, "Investment services and activities".

93. MiFID Art.4(1), (4).

94. Directive 2006/73, Recital 79.

95. *ibid.*, *Recital* 81.

96. *ibid.*, *Art.24*(1) and Recital 83.

of Annex I of MiFID and is also subject to MiFID's safeguards.[97]

Commodity derivatives have been included in the list of financial instruments covered by MiFID.[98] Thus, both trading and intermediation services concerning these instruments fall within the scope of MiFID. The exclusion of commodity derivatives from the ISD's definition of financial instruments prevented investment firms from using the ISD passport for the cross-border provision of investment services in commodity derivatives. MiFID plausibly exempts from its scope firms dealing on their own account,[99] which do not need a regulatory licence in order to continue conducting business. As such entities do not purport to provide investment services outside a very limited circle of customers, which usually include affiliated and parent companies, it would have been very restrictive and unfair to force them to obtain authorisation to operate as investment firms.[1] The definition of commodity derivatives includes (beyond straightforward commodity derivatives), futures contracts traded on regulated markets (or MTFs), which are physically settled, and similar contracts that are not traded on a regulated market or an MTF, which are not for commercial purposes and possess the characteristics of financial instruments, because they are cleared and settled through recognised clearing houses or are subject to regular margin calls.[2]

Furthermore, the list of financial instruments covered by MiFID extends to a number of innovative contracts. Such contracts include credit derivatives,[3] contracts for differences,[4] and derivatives settled in cash or capable to be settled in cash at the option of one of the parties. The class of derivatives capable of being settled in cash includes contracts whose subject-matter refers to freight rates, emission allowances, economic statistics, and climatic variables[5] such as ''weather derivatives''. In addition, MiFID covers any other derivative contracts relating to assets, rights, obligations, and indices, which the Directive does not mention by name and which have the ''characteristics of other derivative financial instruments'', because they are traded on a regulated market or an MTF, or ''are cleared and settled through recognised clearing houses or are subject to regular margin calls''.[6] Article 39 of the implementing Regulation adds the following classes of instruments as belonging to the category of financial instruments described under Section C(10), provided that they meet the criteria set out in that Section and in Art.38(3) of the Regulation:

(a) telecommunications bandwidth;

(b) commodity storage capacity;

(c) transmission or transportation capacity relating to commodities, whether cable, pipeline or other means;

(d) an allowance, credit, permit, right or similar asset which is directly linked to the supply, distribution or consumption of energy derived from renewable resources;

(e) a geological, environmental or other physical variable;

(f) any other asset or right of a fungible nature, other than a right to receive a service, that is capable of being transferred;

(g) an index or measure related to the price or value of, or volume of transactions in any asset, right, service or obligation.

97. *ibid.*
98. MiFID, Annex I, ''List of Services and Financial Instruments'', Section C, ''Financial Instruments''.
99. *ibid.*, Art.2(1)(i), (k).
1. See Avgouleas, fn.20 above, pp.354–355.
2. MiFID, Annex I, Section C(6) and (7). See also Regulation 1287/2006, Art.38(1) and Recitals 21, 25.
3. MiFID, Annex I, Section C(8).
4. *ibid.*, Section C(9).
5. *ibid.*, Annex I, Section C(10) and Regulation 1287/2006, Arts 38(3) and 39.
6. *ibid.*

QUERIES TO SWEET & MAXWELL

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