

The market in financial instruments directive and its changes on the Czech capital market

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Abstract

The Markets in Financial Instruments Directive (MiFID), was came force in November 2007 and broadens the scope of both services and financial instruments covered previously by the Investment Services Directive (ISD). MiFID sets out new policies, processes and the conduct of business rules with clients and controls the way an investment firm works on a daily basis with clients. These rules are different depending on the classification of the clients themselves (retail client, professional client or eligible counterparty). MiFID sets out the basic information requirements and fiduciary duties of investment firms towards their customers. MiFID provides specific operating and conduct of business requirements for firms subject to the MiFID and seeks a more consistent application of these requirements in this country by providing a high-level of guidance.

Keywords: The Markets in Financial Instruments Directive or MiFID, categorization clients, investment firm, investment profile, suitability test, appropriateness test, organisational requirements

Introduction

In line with new local MiFID implementation Czech firms have to follow the regional practice of providing investment advisory services to their clients from the 1st December 2008 in accordance with regulatory requirements, as implemented in the investment sales process every investment firm. MiFID has introduced new requirements that firms are required to adopt and makes significant changes to the regulatory framework, reflecting recent developments in the financial services industry. MiFID sets out new and tougher requirements relating to the organisation of business in regulated firms, particularly in areas of compliance, internal audit, risk management, outsourcing, systems, control and record-keeping. MiFID sets out new policies, processes and the conduct of business rules with clients and controls around how an investment firm works

on a daily basis with clients. These rules are different depending on the classification of the clients themselves (retail client, professional client or eligible counterpart). MiFID sets out the basic information requirements and fiduciary duties of investment firms towards their customers. The need for MiFID is being driven by the increasing number of financial and investment services being provided to customers and the increasing sophistication of financial instruments.

The objective of this document is to describe the investments sales process for non-professional clients (the individuals who are not entrepreneurs) and provide detailed guidance concerning conduct of business and other relevant duties when providing respective investment services to such clients. This paper also describes how MiFID impacts organisations from the following perspectives: the scope of companies included, organisational issues around risk management and compliance, and some of the challenges inherent in dealing with MiFID.

Client categorization

The aim of the conduct of business rules is to create a level-playing field in customer protection across the European Union. The main organisational requirements from client classification are for investment firms to have processes that enable them to classify clients quickly and easily within the 3 classification grades (retail clients, professional clients and eligible counterparts), and ensure that subsequent processes treat all retail customers appropriately. Issues will appear if a retail customer is treated as a professional customer as the level of protection, information and other tests substantially differ. The compliance department needs to ensure that the original classification is appropriate, and that the investment firm then deals with each client on the basis of that classification.

All clients are to be classified in accordance with applicable laws as retail clients (MiFID categorization - non professional) therefore they are afforded the full protection of all the applicable rules. The investment firms must clearly explain to such clients rules that govern their classification, their right to ask for a change in the classification under given circumstances and potential limitation of protection as a result thereof. Many of the specific rules in MiFID relate predominantly to retail clients, as these clients are deemed to be less sophisticated in their knowledge of and expertise in financial markets and financial products. The potential or existing client is in accordance with applicable laws eligible to ask for upgrade into professional category, if certain criteria are met. However, such request does not need to be accepted by the firms as per applicable laws.

Profiling process

The main pillar for all investment advising is the profiling. The purpose of the profiling process is to establish the client's appetite for risk (risk attitude), the financial capability to handle risk exposure (risk capacity) and the knowledge

& experience (K&E) in various types of investment products. This information will be used by firms to determine the most appropriate investment strategy for the client. The client has to be offered the profiling process with an explanation of its purpose (determining of client's risk capacity, risk attitude and investments knowledge & experience), unless such client sufficiently understands such purpose as a part of the mandatory information duty towards him/her. The customer needs to be clearly informed by the investment firm that as long as all relevant information required for suitability and/or appropriateness test (S&A), as contained in the profiling form, is provided, the client may be eligible to investment advisory to the products up to his profile (S&A). Otherwise, only non-advisory services (transaction against advice and execution only transaction services as defined below) may be provided to such client. Every investment firm has created and maintains a fact-finding tool - a profiling form for use in determining the suitability & appropriateness of investment products for the client.

The profiling process consists of the profiling form which is a questionnaire designed to help focus on key elements essential for making an investment decision such as e.g. client's time scale, current financial objective and attitude towards taking risks. By defining the customer's acceptable level of risk, the investment firm together with the customer "comes to" customer's expectations on the returns from his or her investment. Defining risk and time scale guides the customer towards investment decisions. However, each time, the final decision on which investment matches the customer's needs/interests is up to the the customer's sole decision. For advised sales, the investment firms must explain the purpose of profiling to the client and obtain the client's agreement to proceed with the completion of the document. The investment firms must obtain sufficient detail from the client to ensure the profiling form is completed fully and clearly identifies the client's areas of needs and priorities. The investment firms should encourage the client to provide all the information required to make a suitable recommendation. Where the clients decline to provide any information, they must be told that their decision means no advice can be given and that they will not benefit from a suitability assessment and the client must be warned via appropriate disclaimers. Based on the profiling, a score is obtained reflecting the client's risk capacity, risk attitude and knowledge & experience. The profiling form suffices requirements for suitability & appropriateness testing. The client must be asked by the investment firms to complete both parts of the test at the beginning (suitability and appropriateness), though if the client refuses to provide such information, the investment firms must warn the client accordingly (there are also appropriate disclaimers in the profiling form).

Suitability test

Clients are recommended only suitable products (and hence considered advisory sales), which match their risk profile. Suitability, risk appetite, capacity and K&E are taken into consideration while assessing. Clients are offered investment

products which are less aggressive than their risk profile, if appropriate. Suitability can be determined by the information gathered through the completion of the profiling form. However, the risk rating alone is not the only consideration to determine suitability - the specific needs of the client must be taken into account. For example, a structured note with a risk rating matching a client's profile may be unsuitable if it has a 5-year term and the client has a 3-year time scale. The investment firms may not offer to the clients products which are not suitable and/or not appropriate for the customer as per the investment sales process. The investment firms can recommend to the client a single product or a group of products (based on currency, asset class, etc.) in line with client's instructions, but always relating to his/her profile and such products must be suitable and appropriate for the client. All purchases and other disposals with investment products above customer's profile are considered "non-advisory".

Appropriateness test

Appropriateness test or knowledge & experience continued test is the main part, mandatory for complex products, and must be completed together with the suitability test, otherwise no advisory services can be offered to clients in respect of complex products and such clients must be categorized as P99 clients. Moreover, this part is focused on extended scope of knowledge & experience with regard to 4 investment product categories and represents a developed appropriateness test. Within the non-advisory services concept, based on the results of this appropriateness test, the investment firm has sufficient information to determine whether the complex product is appropriate or not appropriate for a particular P99 client. To avoid any doubt, P99 client may not ever be given any advisory services.

The knowledge & experience test (part of the profiling form, used for appropriateness test), which the investment firm is required to complete with the client during the discussion, is used for all advisory discussions and complex products. This section includes questions regarding the client's previous history of purchasing investment products, his/her understanding of their nature and risks involved with investments, in addition to their level of education and area of profession. This section, in conjunction with other information collected in profiling form, aims to provide the investment firm with sufficient information to make a true assessment of a product's suitability and in case of complex products specifically - appropriateness of the trade. The client's answers to the knowledge & experience section will form the basis on which the transaction will proceed. If client's answers to the knowledge & experience questions indicate that they do not have an understanding of the risks and nature of complex investment products, the investment firms will not encourage the customer to purchase such products unless the customer expresses active interest in them. In such case, the investment firm is responsible for explaining to the client the details regarding the structure of investments in the investment products in question and their associated risks, until the client feels comfortable with his/her level of understanding and is happy to proceed however the trade would

be processed and assessed as per the previously recorded customer profile including the knowledge & experience.

For investment cases, from the information collected via the fact-finding process, the investment firm must be able to demonstrate that the recommendation meets the client's objectives, that the client can afford to bear any risks associated with the investment and that, based on his/her knowledge & experience, the client is able to understand the risks involved with the transaction.

The knowledge & experience test determines client's understanding or experience with investment products on four levels:

Level 1 – non-complex – Brokerage products, Mutual Funds and Pension Plans

Level 2 – complex – Capital Protected Structured Products (long and short tenor)

Level 3 – complex – Partially & Non Protected Structured Notes

Level 4 – complex – Leveraged Products and Hedge Funds

Conduct of business

The list of areas covered by the conduct of business rules is fairly wide rules and stretches from client classification to the provision of advice, tests of suitability and appropriateness for trades on behalf of clients, rules involving best execution and maintaining proof thereof, to rules involving financial promotions and transaction reporting. MiFID sets out new and tougher requirements relating to the organisation of business in regulated firms, particularly in the areas of compliance, internal audit, risk management, outsourcing, systems and controls and record-keeping. Many local firms falling under the MiFID regulation will be required to set up full-time compliance functions, internal audit functions and risk management functions. With an increased focus on outsourcing and shared service centres in Central Europe, firms will need to ensure that they comply with the MiFID requirements for outsourcing. The MiFID significantly increases the requirements for before and post trade price transparency, especially for firms that frequently and systematically deal on their own account.

Prior to any actual subscription, switch and redemption of investment products, the investment firms must duly inform the client of the nature and risks associated with particular investment products, while in general must provide the minimum disclosures, which are:

- Investment products are not insured or guaranteed by any governmental agencies
- Investment products are subject to investment risks, including the possible loss of principal invested;
- Investment products may be subject to currency and/or foreign exchange fluctuations (where applicable)

- Past performance is not indicative for future results; prices can go up or down
- The identity of the legal means or firm's selling / distributing the investment product
- The investment firm must inform clients of the nature, characteristics and risks associated with particular investment products
- Inform clients of any specific information required by the particular prospectuses/statutes or other constitutional documents for relevant investment products, annual reports and semi-annual reports ("constitutive documents") and provide current fact-sheets for such products, if approved for distribution by the investment product management for such purposes. The investment firms are able to check client's investment portfolio and transaction history.
- Inform clients of fees, inducements and costs related to particular investment products, and namely to present a current fee schedule to clients;

In general, the following types of firms fall under MiFID: investment banks, portfolio managers, stockbrokers and broker dealers, corporate finance firms, many futures and options firms and some commodities firms. MiFID specifically expands the list of investment services, financial instruments, ancillary services and execution venues. However, given the increased availability of other, more complex financial instruments, it was decided to bring more financial services under the umbrella of MiFID. For example, the following securities were not covered by the ISD (Investment Services Directive) but are included in the scope of MiFID: derivatives (whether securities, currencies, interest rates and yields), commodity derivatives traded on a regulated market, OTC commodity derivatives, credit derivatives, financial contracts for differences and derivatives relating to climatic variables.

Investment transactions overview

The MiFID provides guidance on the treatment of investment transactions entered into on behalf of clients. Transactions with the clients should fall into either of two categories and four subcategories:

- a) Advised
- b) Non-Advised
 - Transaction against advice
 - Execution only transaction
 - Non-appropriate execution only complex product transactions

a) Advisory sales process

The advisory sales process must follow this sequence to ensure a compliant sale:

1. Duly completed profiling process where a client provides all required information;
2. Presentation of investment products according to profiling;
3. Determining suitability (both at initiative of a client and/or a firm's presentation);
4. Completion of sales and associated after sales service as the investment sales process.

Unless the above conditions are fully met, the investment firm may not characterize or otherwise present the investment services as the advisory sales. In addition, the investment firm should always consider whether any transaction is in the best interest of the client. If not, such transaction shall not be accepted by the investment firm.

b) Non-advisory sales

1. Non-advisory - if a client does not wish to follow the recommendation provided by the investment firm, based on his/her identified risk profile as determined in accordance with investment sales process. If there is no change in client's circumstances and facts affecting the information contained in the profiling form, or the client refuses to revisit them and feels that his/her risk profile is correct, they can still give instructions to the investment firm. The investment firm can proceed - but - without any investment advisory services involved, i.e. no personal recommendations in respect of investment products may be given, and thus the client will be offered such particular investment products on an against advice basis only.
2. Execution only - in case the client:
 - refuses to follow the conclusions consequent upon the profiling form or;
 - does not want to be profiled based on profiling process or;
 - does not agree with the profiling form's results of profiling;

If the client is not willing to answer some or all appropriateness test questions (knowledge & experience test) or refuses to complete the profiling form, the investment firm does not have sufficient information to capture the appropriateness of the product for the particular client. Such product/transaction is classified as execution only (P99) without advisory entitlement and not appropriate.

Organisational requirements

This aim of the impact of MiFID on firms covers the following areas: compliance, internal audit, risk management, outsourcing and other systems and controls. Respective of the size of the firm, senior management needs to be more involved in monitoring on-going compliance with MiFID. This is especially important in relation to the conduct of business requirements, as these are important to clients, and the potential for inappropriate client protection and mismanagement of client transactions. The MiFID regulation also sets out the type of information that needs to be reported to the home competent authority. The investment firm should not be requested to provide information over and above this requirement to any other authority or supervisor in other EU states. The information provided to the home country regulator/authority should be sufficient for other EU state regulators.

- Compliance - monitoring (on an on-going basis) the adequacy and effectiveness of the firm's internal policies and procedures and reporting results to senior management.
- Internal audit function - must establish, implement and maintain an audit plan to examine and evaluate the adequacy and effectiveness of the firm's systems, internal control mechanisms and arrangements, issue recommendations based on the results of work performed; verify compliance with recommendations, and report on internal audit matters to senior management on a frequent basis, and at least once annually.
- Risk management function - must establish, implement and maintain adequate risk management policies and procedures which identify the risks related to the firm's activities, processes and systems and adopt effective arrangements, processes and mechanisms to manage the risks within the firm's business.
- Outsourcing - MiFID includes a number of important conditions that firms must meet to enter into outsourcing arrangements. It is important that firms can provide adequate documentation to supervisors concerning meeting the obligations of MiFID in this area - putting together a file of supporting documentation and information on the setting-up of the outsourcing arrangement and the continual assessment and monitoring of compliance is a must for all firms.
- Other systems and controls - firms must focus solely on the compliance, risk management and internal audit requirements. However, there are other requirements that should not be forgotten: for example, the need to implement and maintain systems and controls adequate to safeguard the integrity and confidentiality of client information.

Increasing investor protection across the EU is market transparency. Increased transparency around pricing and trade details is important to the European Commission in its drive to ensure equivalent market conditions across

the EU, and the sound functioning of securities markets. Indeed, transparency should lead to better integration between financial markets across the EU. The transparency requirements of MiFID also promote competition between market counterparties and trading venues (for example stock exchanges) as the choice of product, venue and price broadens. Is it also anticipated that investors will see a reduction in trading costs as transaction costs are reduced by trading venues competing with our venues for investors.

MiFID and his implications

MiFID sets out new and tougher requirements relating to the organization of business in regulated investment firms, particularly in the areas of compliance, internal audit, risk management, outsourcing, systems and controls and record-keeping. The directive sets out a high-level “lowest common denominator” approach to organisational requirements and approach to the areas of compliance, the directive also allows firms to apply the organisational requirements in a manner proportionate to the nature, size and complexity of the firm’s business.

In cases where the client states from the outset that they wish to transact on execution only basis and do not require any advice from the investment firm and declines to complete the profiling form, the investment firm still needs to determine the appropriateness of the product by using the appropriateness test. Where suitability cannot be assessed due to insufficient information or client’s refusal to receive advice, procedures for execution only transactions include a further responsibility for the investment firm to determine the appropriateness of the product, due to the complex nature of these products. In these cases, the knowledge and experience test can be used in isolation (only the appropriateness part of the profiling form), to determine whether the product is appropriate or not for the individual client. In each case, investment firms must understand differences between appropriateness and suitability, i.e. when and under which conditions investment advisory is provided. If the client asks the investment firm to go ahead with the transaction despite being given this verbal warning the investment firm must consider whether or not the purchase of the product would be in the client’s “best interest”, as an extra level of caution. The “best interest” rule entails the fact that a firm must act honestly, fairly and professionally in accordance with the best interests of its clients. For example if the investment firm recognizes that the client has never purchased a structured product before and does not understand financial products at all, he/she should not proceed with the transaction.

However, in all firms, the general requirements (legal and organisational requirements) for all areas must be adhered to. In summarising the requirements relating to the organization of MiFID for compliance, risk management, internal audit and outsourcing, we can show that a flexible solution is possible. The cost and resource elements are many of the requirements set out above and could be restrictive for smaller firms. Ensuring an effective organisational

solution for the MiFID requirements can help to minimise the cost impacts on individual firms.

Conclusion

MiFID specifically expands the list of investment services, financial instruments, ancillary services and execution venues. Investment firms needed to design an optimal solution that makes commercial sense for the organisation whilst meeting stakeholders' expectations and regulatory requirements. Investment firms needed to manage the relationship with the regulator and explain to external parties the impact on capital requirements and the conduct of business rules.

The aim of the conduct of business rules is to create a level-playing field in customer protection across the European Union. MiFID should provide to regulators and investors the ability to discern and punish inefficiency and poor conduct by investment firms. MiFID sets out the basic information requirements and fiduciary duties of investment firms towards their clients. Many of the specific rules in MiFID relate predominantly to retail clients, as these clients are deemed to be less sophisticated in their knowledge of and expertise in financial markets and financial products.

Investment firms put together all of the financial instruments and services covered by MiFID, you can see that most market players who trade or provide services to customers have to be covered. This can bring significant additional costs to market players who have not previously been covered by regulation to the extent of MiFID.

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Směrnice MiFID a změny na českém kapitálovém trhu

Směrnice o trzích finančních instrumentů (MiFID) vstoupila v platnost v listopadu 2007 a rozšiřuje rozsah služeb i finančních instrumentů, na které se před-

tím vztahovala směrnice o investičních službách (ISD). Tato směrnice nastavuje nové postupy, procesy a pravidla jednání ve vztahu k zákazníkům a kontrolní opatření při každodenním jednání obchodníka s cennými papíry se zákazníkem. Tato pravidla se liší v závislosti na klasifikaci zákazníka (drobný klient, profesionální klient a způsobilá protistrana) a definují základní požadavky na poskytování informací a povinnosti obchodníků s cennými papíry vůči zákazníkům a při správě cizího majetku. MiFID stanovuje specifické požadavky týkající se provozování činnosti a způsobu obchodování firem podle dané směrnice a usiluje o konzistentnější uplatňování těchto požadavků v dané zemi prostřednictvím rámcových předpisů.

Klíčová slova: směrnice o trzích finančních nástrojů – nazývána MiFID, kategorizace klientů, obchodník s cennými papíry, profilování klientů, test vhodnosti, test přiměřenosti, organizační požadavky

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