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MiFID and the IMD – what you can and can't do

15 February 2011 by Sam Instone, Managing Director, AES International

The international financial marketplace is rapidly changing as compliance requirements tighten. As such there is a high degree of misunderstanding and misinformation about areas such as the Markets in Financial Instruments Directive ("MIFID"), the Insurance Mediation Directive ("IMD") and passporting.

This article clearly outlines the practical implications of these directives and rules so providers and distributors can assess the impact upon their respective businesses alike.

MIFID came into being on November the 1 2007 as a very significant legislative change to EU financial services regulation.

MIFID identified investment advice as an investment service, the provision of which, on a professional basis, generally requires authorisation as an investment firm. According to Article 4(4) investment advice means the provision of personal recommendations to a client, either upon his request or at the initiative of the investment firm in respective or one or more transactions relating to financial instruments. 'Financial Instruments' include such things as shares, unit trusts and collective investments schemes.

The UK and Gibraltar secured an opt-out or Article 3 exemption from MIFID for their financial advisers who agreed not to conduct any cross-border business so that they could continue to operate under the Insurance Mediation Directive if they failed to meet the minimum standards required of a MIFID firm.

Insurance mediation is defined as 'the activities of introducing, proposing or carrying out other work preparatory to the conclusion on contracts of insurance, or of concluding such contracts, or of assisting in the administration and performance of such contracts, in particular in the event of a claim.' As a consequence of this all other EEA advisers and non-exempt firms that make personal recommendations that a client would understand as investment advice are automatically subject to MIFID.

In contrast, advice on life policies from countries within the EEA that contain investment elements that are unit linked i.e. have been 'unitised' into units of insurance are subject to the IMD - but portfolio management, advice on life policies containing equities (unless provided by an exempt insurer themself) or the non-unitised collective investment schemes of the type heavily promulgated by international advisers, require MIFID authorisation.

So What?

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MIFID introduces a raft of key organisational changes that effect providers and distributors alike. Strategically these cover corporate structure, governance and oversight, policies and procedures and infrastructure. Operationally these impact on issues as far ranging as financial management/capital adequacy, IT systems, data capture, suitability analysis, marketing, risk analysis, compliance, HR, Legal, data management and IT/system organisation.

One of the main purposes of MIFID is to clarify how firms "passport" on a cross border basis or establish a branch in another member state, in each case on the basis of their home state authorisation. This system is mirrored by IMD authorised firms.

Providing services on a 'cross-border basis' means delivering services from one state into another. This can happen by way of letter, e-mail or telephone. Firm's advisers briefly visiting clients in another EEA state may also constitute providing cross-border services. This means that a Cypriot company may phone and advise clients of that firm that are resident in Spain if it holds the requisite authority to do so by way of a Freedom of Services passport. In this example the home state (i.e. Cypriot) organisational and conduct of business requirements apply.

If a firm has agents/advisers living or working within another state then it must establish a branch under Freedom of Establishment rules. Whilst home state rules apply to the firms organisational shape – host state requirements apply to the conduct of business rules which are also known as that country's 'general good' requirement.

As an example, a Belgium firm wishing to operate from within the UK must establish a branch which is appropriately registered with their home state regulator (the CBFA), UK Companies House (for tax and legal purposes) and the UK FSA (host state regulator).

They must then follow the UKs conduct of business rules (general good) which in this case means things such as commission disclosure and enhanced training and competency. It is for this reason that the concept of UK firms moving overseas and passporting back in after the RDR is pure fallacy – the requirement would still be to meet the general good requirement required by the host states (in this case the UK's) regulator.

It therefore follows that a firm simply cannot have advisers living and working in one country under a Freedom of Services passport from another country as seems to be the existing prevalent method with Europe. Likewise, to deliver MIFID investment services i.e. investment advice with an IMD license instead of the required MIFID license is equivalent to an unqualified student practicing as a lawyer, doctor, architect or engineer – it is simply professionally, legally, morally and in many cases criminally wrong.

The potential impact of this on the conventional international advisory market is as follows: -

1. Both providers and distributors need to consider fundamental strategic options in order to establish an effective operating model in the post MiFID world. The breaching of this legislation in most EEA countries is at worst a criminal, and at best a civil, offence that may result in fines, bans or more serious sanction. Current regulatory actions by Spanish, Belgian, Dutch and UK regulators are beginning to clarify what has to date been a largely ignored or conveniently termed a 'grey area' but by written legislation is in fact nothing of the sort.

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2. Consolidation of both product provision and distribution is likely as the economies of scale, resources and expertise required to meet MIFID requirements require enhanced standards. This may improve outcomes for clients, advisers, advisory firms and those providers that make the effort to comply with this legislation. Cottage industry distribution by small IFAs is likely to wither and fail. Whilst some providers still allow unauthorised firms and individuals to place business with them, it is likely that this grey market will simply fade away. A key reason for this is that the litigation when things go wrong is likely to be re-directed from the IFA towards these providers or their onshore parent companies, who are not necessarily themselves in breach but provide a legitimately registered target that cannot simply disappear.

The Future

Despite relatively clear existing guidelines many conventional grey market firms will continue to procrastinate or claim they have not been accurately informed of their regulatory and legal responsibilities. This is simply not the case – guidelines on the provision of investment advice with the EEA are very clear and it is the duty of all firms to ensure they understand these, and are appropriately informed. Not all regulators see things the same way and firms are advised to request local clarification and on-going guidance from their specific home state regulator to keep abreast of changing views.

Since April 2009, the EUs 3L3 Committees have worked together on a report covering Packaged Retail Investment Products (“PRIPS”). This is hoped to clarify for once and for all the regulatory framework for investments packaged as life insurance policies (ie. unit linked life cover) which are subject to financial market fluctuations. It is widely expected that the outcome will be to bring the distribution of this last product class (those insurance products that don’t contain equities or collectives investment scheme) in parallel to those of the MIFID Regime.

The overall outcome is that the traditional black and grey methods of operating in markets such as Europe are well and truly finished and a new framework for conducting business will ensure better results for clients, distributors and providers alike.

1 Some exemptions are provided for where investment advice is incidentally provided and not ‘specifically remunerated’ for (Article 2 (1)(j)).
2 UK FSA Factsheet ‘Financial Advisers and Passporting’ August 2007.
3 Directive 2002/92EC of the European Parliament and of the Council of 9 December 2002 on insurance Mediation.
4 In this case the insurer, whilst exempt from MiFID, would be subject to the IMD.

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