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Questions and answers on MiFID:
Common positions agreed by CESR Members
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INTRODUCTION - The context and status of this 'Q and A':

MiFID overview:

MiFID is a major part of the European Union's Financial Services Action Plan (FSAP), which is designed to help integrate Europe's financial markets and to establish a common regulatory framework for Europe's securities markets. MiFID comprises two levels of European legislation:

- Level 1, the Directive itself (2004/39/EC), was adopted in April 2004. It is a 'framework' Directive and makes provision for its requirements to be supplemented by technical implementing measures, the so-called Level 2 legislation.
- The Level 2 legislation consists of a directive (2006/73/EC) and a regulation (1287/2006). The Level 2 measures were developed on the basis of technical advice provided by CESR and were the subject of negotiation at European level in the European Securities Committee (ESC). They were formally adopted by the Commission and published in the Official Journal of the European Union on 2 September 2006.

MiFID came into effect on 1 November 2007. Its predecessor is the Investment Services Directive (ISD). MiFID allows regulated markets, multilateral trading facilities (MTFs) and investment firms to operate throughout the EU on the basis of authorisation in their home Member State (the "single passport"). MiFID extended the coverage of the ISD and introduced new and more extensive requirements that firms have had to adapt to, in particular for their conduct of business and internal organisation. In general, MiFID covers most, if not all, firms that were subject to the ISD, plus some that were not. This includes investment banks, portfolio managers, stockbrokers and broker-dealers, corporate finance firms, many futures and options firms and some commodities firms. One of the main purposes of MiFID is to harmonise investor protection throughout Europe.

MiFID Level 3 work to provide supervisory convergence in day-to day implementation across the EU and clarity for market participants:

Following the delivery of CESR's MiFID Level 2 technical advice to the European Commission, CESR's work has now consequently shifted towards developing mechanisms to ensure consistent implementation and towards fostering supervisory convergence among CESR Members. Together with its two sub-groups, the MiFID Level 3 Expert Group has taken a leading role in the implementation of MiFID. CESR's MiFID Level 3 activity is available at http://www.cesr.eu/index.php?page=groups&mac=0&id=53.

The Q and A publication:

This consolidated Q and A publication follows the model that is used by CESR for the Prospectus Directive. It is intended to provide market participants with responses in a quick and efficient manner to 'everyday' questions which are commonly posed to CESR by market participants, CESR Members, or the public generally. CESR responses do not constitute standards, guidelines or recommendations. The main purpose of the MiFID Q&A is to address issues of practical application, for which a formal consultation process is considered to be unnecessary. CESR intends to operate in a way that will enable its Members to react quickly and efficiently if any aspectsof the common positions published need to be modified or the responses clarified further.

CESR is currently developing a new, more advanced website, which will contain a number of useful tools for market participants. One of the modules in the new website is a database for Q&A, which CESR plans to use for a number of different Q&As, such as MiFID. Answering to the questions submitted will be closely coordinated with the Commission.

If you have any questions to CESR on the practical application of any of the MiFID requirements, please send them to the following email address (**mifid@cesr.eu**).

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1. Article 19(4) of Directive 2004/39/EC - Client profile review	*April 2008*

Q) **How can an investment firm continue to ensure that it can rely on information provided by the customer (i.e., that the information is not manifestly out of date, inaccurate or incomplete), particularly where the firm is providing an ongoing advisory or portfolio management service?**

A) An investment firm should take reasonable care to keep the customer profile under review, also taking into consideration the development of the relationship between the investment firm and the customer. For example, the customer could be advised that he should inform the investment firm of any relevant changes affecting his investment objectives, risk profile, financial situation/capacity, trading restrictions, or the identity or capacity of his representative. If the firm becomes aware of a relevant change in the clients' situation, it should request any additional information that appears necessary.

2. Article 19(5) of Directive 2004/39/EC - Appropriateness	*April 2008*

Q) **According to article 19 (5) of MiFID when an investment firm ascertains that a product or investment service is not appropriate to a client or potential client, it must warn the client or potential client. In such cases, may the investment firm proceed to the provision of the service right after the receipt of the warning by the client?**

A) If a client wishes to proceed with a transaction after the client has been given a warning, it is for the investment firm to decide whether to do so, having regard to the circumstances of the case. But in such cases it may be prudent for the investment firm to ask the client or potential client to confirm in a durable medium his intention to proceed with the service.

3. Articles 48 and 49 of Directive 2006/73/EC – Aggregated orders and trade allocations	*April 2008*

Q) **(a) Does Article 48 apply to investment firms when providing the service of portfolio management? In particular, does it apply to decisions to deal giving rise to a single order that may affect two or more client accounts? Or should the expressions "aggregation" and "aggregated orders" be understood as meaning that this Article applies only to cases where there are two or more orders received from clients?**

(b) Does c) of Article 48(1) only require a general order allocation policy at the level of the investment firm? Or does this provision imply that firms should define, prior to transmitting an aggregated order, the way in which the resulting trade (or trades) will be allocated to the relevant accounts? Can firms comply with the requirement to establish and implement an allocation policy that is fair without defining, order by order, how the trade(s) will be allocated, at least in "sufficiently precise terms" to limit the risk of post-trade abuse?

(c) Do Articles 48(2) and 49(3), which require firms to allocate trades in accordance with their order allocation policy and to put in place procedures designed to prevent reallocations detrimental to clients, require allocations to be done promptly?

A) (a) The expression "carry out a client order" is used in the implementing directive in order to cover both the reception/transmission of client orders and the transmission of decisions to deal on behalf of a client when providing the service of portfolio management, as well as the execution of client orders. Therefore, Article 48 applies to investment firms when they provide portfolio management services. The references to "client orders" in Article 49 should also be understood as encompassing decisions to deal by a portfolio manager, including a single order that may affect two or more client accounts, or one client account and the own account of the firm.

(b) This provision requires firms to establish an order execution policy "in sufficiently precise terms for the fair allocation of aggregated orders and transactions", which means that a general order allocation policy will not suffice to be compliant. A fair allocation policy should state that the intended basis of allocation for each order that may affect more than one account is to be defined prior to execution of the order or transmission of the order for execution, as the case may be. This interpretation is consistent with CESR's recommendations on the list of minimum records that investment firms must keep (CESR/06-552-c).

(c) A fair allocation policy should provide for the prompt allocation of trades, and prompt allocation furthers the objective of preventing reallocations. In addition, Article 47(1) of the implementing directive requires investment firms to ensure, when "carrying out client orders" (see above), that "orders executed on behalf of clients are promptly and accurately recorded and allocated".

4. Article 32(2) of Directive 2004/39/EC – Tied agents	***December 2008***

Q) **Question for CESR concerning the Recommendations for implementation of Directive 2004/39/EC (CESR/07-337b, Chapter C, paragraph no. 30 - 32) undertaken by the MiFID Level 3 Expert Group through the MiFID Level 3 Intermediaries Sub-group.**

If an investment firm located in a Member State intends to provide investment services through a tied agent established in a country where the investment firm has no existing branch, which notification procedure should the home authority use - notification procedure under Art. 31(2)(1) MiFID or under Art. 32(2)(2) MiFID?

According to the paragraph no. 30 of the Recommendations the investment firm can have recourse to a tied agent to exercise either its right to provide services or its right to free establishment. In both cases, the home authority informs the host authority of the firm's intention to use tied agents, and if available at the time of notification, the identity of prospective tied agents according to the standard notification procedure. This implies that both notification procedures (either under Art. 31(2) MiFID or under Art. 32(2) MiFID) are possible.

Furthermore, according paragraph no. 31 of the Recommendations, when making use of the right to free establishment to provide investment services through a tied agent established in a country where the investment firm has no existing branch, the tied agent will be treated as a branch presence in that country. In this case, where the investment firm exercises only its right to provide services in the host Member State and wants to use just a tied agent there without a branch establishment, we are not sure about the notification procedure.

In the above mentioned case we should according to our opinion use Annex 1 – standard notification form for cross-border services - mentioned in the Protocol on MiFID Passport Notifications (CESR/07-317b) and after this notification this tied agent shall be assimilated to the branch and shall be subject to the provisions of MiFID relating to branches (Art. 32(2) MiFID). The use of Annex 2 – standard notification form for branch establishment mentioned in the Protocol on MiFID Passport Notifications (CESR/07-317b) would in our opinion deprive Art. 31(2)(1) MiFID of its purpose.

Moreover, if we should use Art. 32(2) MiFID, how is the investment firm supposed to fill out the Annex 2 (Program of operations - corporate strategy, commercial strategy, organizational structure) in case of legal entities and in case of natural persons as an established tied agent? Should we then verify the tied agent like a person responsible for the management of the branch or is it enough that the tied agent is verified by the authorisation as a tied agent?

In conclusion, we would like to make the right to free establishment clear. We suppose that this right after MiFID application lies in possibility to provide investment services and/or activities as well as ancillary services either through the establishment of a branch in the host Member State or through the establishment of a tied agent there as well. In this case, would it be possible.

1) **to establish tied agents in the host Member State and notify them according to Art. 31(2) MiFID; and**
2) **to use cross-border tied agents established and also registered in the home Member State or in other Member States (other than the host Member State where tied agents are active under the full responsibility of the investment firm) and notify them according to Art. 31(2) MiFID?**

A) The notification of the appointment of a tied agent established in a Member State where the investment firm does not have any branch should be made under MiFID Article 32(2) which states that:
"...In cases where an investment firm uses a tied agent established in a Member State outside its home Member State, such tied agent shall be assimilated to the branch and shall be subject to the provisions of this Directive relating to branches."

According to the prevailing opinion[1], where a branch does not currently exist, the branch notification provisions in the CESR Protocol on MiFID Passport Notifications (CESR/07-317b) should be effective, as if the firm was notifying its intention to establish a branch for the first time. The home Member State authority should be satisfied that the investment firm has sufficient systems and controls over the tied agent's activities in the host Member State.

Notification under article 31(2) would be appropriate, for example, where the tied agent is established in the home Member State and not the host Member State and intends to provide investment services in the host Member State on a cross-border services basis.

5. Articles 29(2) and 44(2) of Directive 2004/39/EC and Article 18(1) of Commission Regulation (EC) No 1287/2006 – Dark pools of liquidity ***December 2008***

Q) **(a) Can all orders be submitted to a dark pool? If not, what restrictions apply?**

[1] BaFin and the Czech National Bank infer from the wording and context of Art. 32(2) subparagprah 2 MiFID that an investment firm that wants to use tied agents in a country where it is not established through a regular branch, must file a notification according to the rules on the cross-border provision of services (Art. 31 (2) MiFID).

(b) Must a dark pool order be completely filled or can a residual remain?

(c) If an order is routed to a dark pool, what is the time frame it can reside there before having to be routed onwards?

A) (a) Although not a term defined in MIFID, in answering this question, a dark pool of liquidity (dark pool) is understood as a trading facility where there is no pre-trade transparency, i.e. where orders are not publicly displayed based on pre-trade transparency waivers provided by MIFID.

The type of orders that can be submitted to a dark pool depends on the pre-trade transparency waiver criteria being used by the dark pool.

Where the waiver is based on the market model, there are no specific provisions governing which orders can be submitted to such a dark pool. Where the waiver is based on the characteristics of the order (e.g. an order large in scale compared to normal market size), the waiver criteria place restrictions on the orders which can be accepted by a dark pool.

In addition, investment firms responsible for executing the order on behalf of a client will need to decide whether submission to a dark pool complies with the order-handling and best execution obligations to which they are subject under MIFID.

(b) There are no explicit provisions in MiFID requiring that orders submitted to a dark pool have to be completely filled. However, whether the residual part of an order ('stub') can continue to remain dark to the market depends on which pre-trade transparency waiver is being used (e.g. waiver for crossing systems, waiver for orders that are large in scale compared to normal market size) and on whether the conditions of the pre-trade transparency waiver granted to/used by the dark pool continue to be fulfilled. The fulfillment of the waiver conditions needs to be assessed by the operator of the dark pool, and if required on the basis of the national implementation of MiFID, also by the relevant competent authority.

(c) There are no specific provisions in MiFID governing how long an order may be left in a dark order-book before being routed elsewhere, as long as the waiver criteria from pre-trade transparency continue to be met. As in the first answer, an investment firm acting on behalf of a client will need to determine, in light of the order-handling and best execution obligations that it is subject to under MiFID, how long it is appropriate for an order to be held in one trading venue (whether light or dark) without being executed.

6. Article 41(3)(c) of Directive 2006/73/EC – Leveraged portfolio	***May 2009***

Q) **According to Article 41(3)(c) of the MiFID L2 Directive, "In the case of retail clients, the periodic statement referred to in paragraph 1 shall be provided once every six months, except in the following cases: (c) where the agreement between an investment firm and a retail client for a portfolio management service authorises a leveraged portfolio, the periodic statement must be provided at least once a month".**

What should be taken into account to determine if the reporting must be provided once a month:

- **the exposure of the portfolio (due to leverage)?; or**
- **the risk incurred by the portfolio (due to leverage)?**

In other words, the concern here is to know if the monthly reporting requirement applies:

- **as soon as the portfolio allows leverage (exposure - for example, if the portfolio manager has bought a call option, the portfolio will be "exposed" to the underlying asset and there should be a monthly reporting) (option 1); or,**
- **only when the portfolio incurs a potential risk of loss due to leverage (for example, if the portfolio manager has sold naked call options, the portfolio may be at risk depending on the value of the underlying asset and there should be a monthly reporting) (option 2).**

A) According to Article 41(3)(c) of Directive 2006/73/EC, the periodic statement of the portfolio management activities must be provided at least once a month where the agreement between an investment firm and a retail client for a portfolio management service authorises a leveraged portfolio. There are two questions to discern: (a) what is meant by "leveraged portfolio"?; and (b) must such a monthly reporting be done as soon as the portfolio management agreement authorises a leveraged portfolio or only when the portfolio incurs a potential risk of loss due to leverage transactions authorised by the agreement ?

CESR considers that regarding the notion of "leveraged portfolio", reference should be made to question n° 116 of the European Commission's (EC) Q&A on MiFID which defines this notion. In its MiFID Q&A, the EC has defined 'leveraged portfolio' as follows: "'Leveraged portfolio' is a term that can designate two situations. The first one is the case where the portfolio manager has borrowed in order to finance investment. The term is also used for portfolios containing derivatives or structured products that create investment which is leveraged." (see question n° 116, page 82). CESR understands the second part of the EC definition as meaning that as soon as there is one transaction that creates leverage, there is a leveraged portfolio. A portfolio containing leveraged transactions which are perfectly hedged (i.e. 100% inverse correlation to the initial position) would not amount to a leveraged portfolio for the purposes of this answer. A portfolio containing leveraged transactions which are imperfectly hedged (i.e. less than 100% inverse correlation to the initial position) would amount to a leveraged portfolio for the purposes of this answer.

CESR considers that the wording of Article 41(3)(c) of Directive 2006/73/EC is not ambiguous; as soon as the agreement between an investment firm and a retail client for a portfolio management service authorises any type of leveraged transaction(s), monthly reporting should be conducted. This is irrespective of whether there is a potential risk of loss due to leverage.