CESR

THE COMMITTEE OF EUROPEAN SECURITIES REGULATORS

A consumer's guide to MiFID

Investing in financial products

March 2008

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What is MiFID and how does it affect you?

This guide is for you if you have invested or are planning to invest in financial products. It explains the basics of a new piece of European legislation called the Markets in Financial Instruments Directive (MiFID) and how it affects you when dealing with firms that provide investment services in Europe.

Think about the financial products that you own. You probably have one or more bank accounts, a mortgage, a credit card, some shares, a pension plan, an investment fund… MiFID only applies to some of these products such as shares, bonds, derivatives and units in investment funds. It does not apply to deposits or loans, or to insurance products. For those products which are covered by MiFID, firms may offer you services such as managing investments on your behalf, giving you advice on investments and buying or selling financial products.

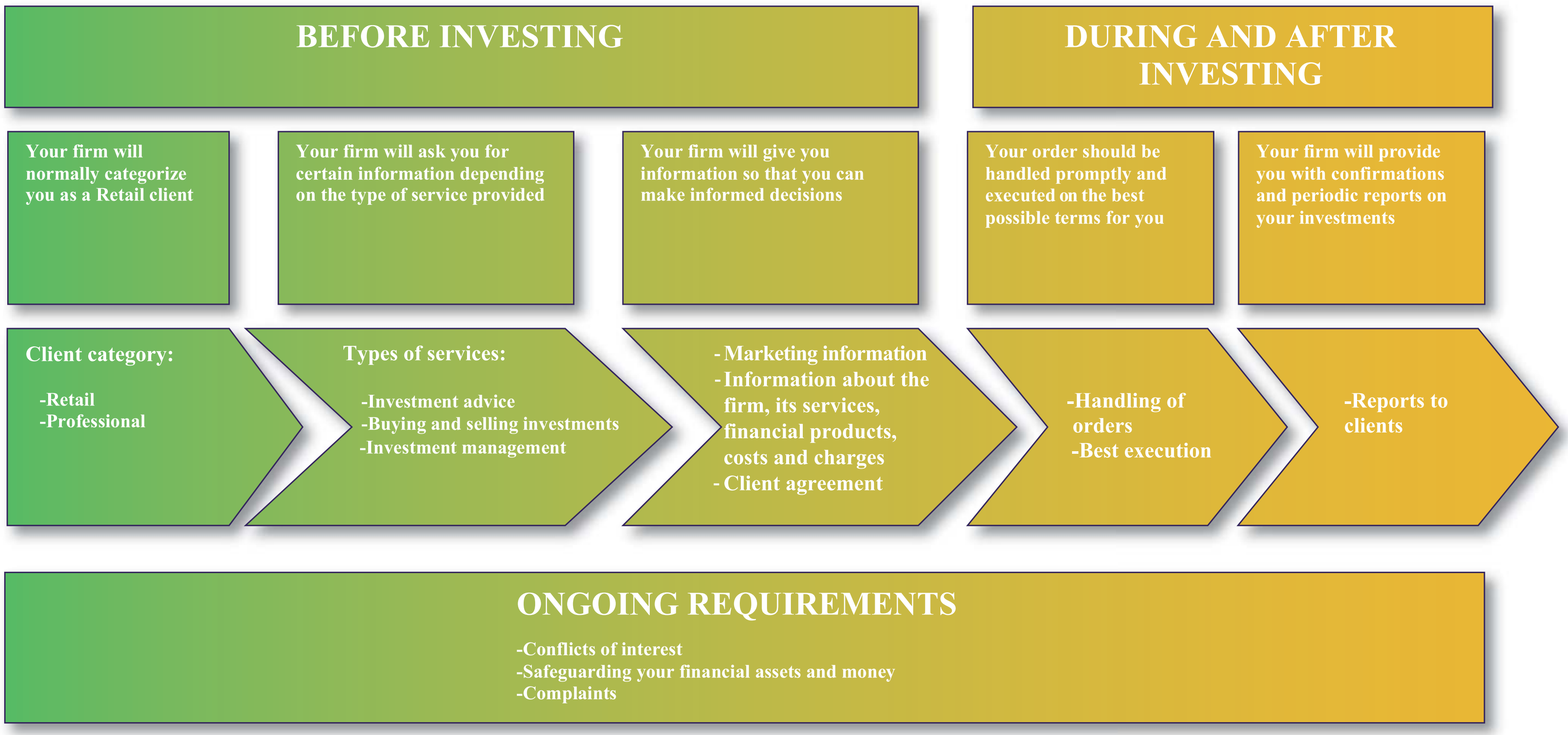
One of the main purposes of the directive is to harmonise investor protection throughout Europe. The degree of investor protection that you will receive is directly related to the reliance that you place on the firm and on yourself. For example, if your financial knowledge and experience are low and you are asking the firm to advise you or to take decisions on your behalf you will be afforded the highest degree of protection.

MiFID sets three overarching principles that will apply to firms when they are doing investment business with you. These are:

- To **act honestly, fairly and professionally**, in accordance with your best interests. This principle protects you when you are dealing with a firm that, as a professional, is in a stronger position than you.
- To provide you with appropriate and comprehensive information which is **fair, clear, and not misleading**. This will help you to understand products and services so that you can make informed decisions and ensures that you do not receive biased or confusing information.
- To provide you with services that **take account of your individual circumstances**. This is to ensure that your investments correspond to your investor profile and requests.

The structure of this guide is broadly chronological, reflecting the different stages of the investment process and how firms organise and conduct their business with you on a day to day basis. The MiFID principles apply to every step of the firm's relationship with you.

Stages of the Investment Process

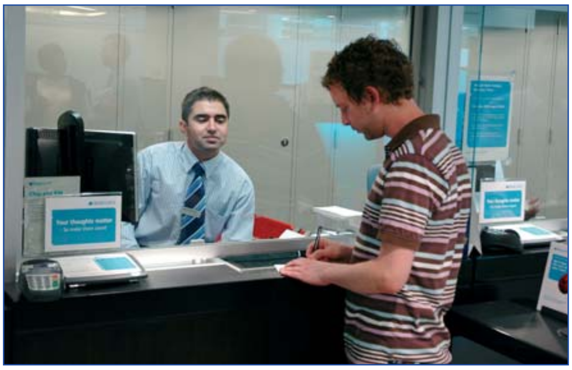


Part 1: Before investing

1.1 Which kind of client are you?

Before providing you with an investment service, your firm is required to categorise you as a Retail or Professional client. You will normally be categorised as a Retail client, a category which includes the majority of individuals.

As a Retail client you receive the highest level of investor protection. MiFID awards more protection to investors with less investment knowledge and experience (Retail clients), while investors with more investment knowledge and experience (Professional clients) are provided with less protection. Professional clients include banks, governments, pension funds, large companies and exceptionally some individuals.



What if you want to become a Professional client? What if a firm asks you to become a Professional client? What are the consequences?

In limited circumstances you can be treated as a Professional client. You may want to consider this to access products which are not available to Retail clients, or if you want to become a client of a firm that does not do business with Retail clients.

If you want to become a Professional client you need to feel confident that you are capable of making your own investment decisions, capable of assessing the risks that you incur, and do not need a high level of investor protection.

If you elect to be a Professional client, you will lose some of the regulatory protections that apply to Retail clients. The firm will explain this to you. For example, you will generally receive less information and fewer disclosures or warnings on a number of topics.

Before categorising you as a Professional client, a firm will first have to assess whether this category is appropriate for you. The purpose of the assessment is for the firm to establish that you are capable of making your own investment decisions and you are able to understand the risks involved.

Your firm will be able to categorise you as a Professional client only if you meet at least two of the following conditions:

- you frequently carry out transactions;
- you have a large portfolio;
- you have worked in the field of investment services.

1.2 What services might you receive?

In broad terms, you are likely to receive one or more of the following types of investment services:

- You are provided with personal recommendations on investments, products and courses of action (investment advice);
- You buy and sell financial products without investment advice;
- Your investments are managed by a firm on your behalf (investment management).

In this section we will explain the different types of services you may receive from firms and the processes they will follow to deliver the appropriate degree of protection to you.

Investment advice

When you receive investment advice, you are placing a higher degree of reliance on the investment firm than you would do in other circumstances such as in the case of simple non-advised transactions. You therefore need to have some comfort that the firm understands your individual needs and circumstances so that it recommends the right products for you. MiFID requires a process called the **Suitability test**, where the firm asks you some questions to reach an understanding of the types of investments that will be suitable for you.

As part of the Suitability test, you are likely to be asked questions about the following:

- **Your investment objectives**

This can include questions about the length of time you wish to hold the investment, your risk appetite and profile, whether you wish to invest for income or growth, keep the capital safe and avoid any risk or accept a high level of risk.

- **Your financial situation**

Information regarding your financial situation may be obtained through questions about matters such as the source and extent of your regular income, your assets, real estate property, any debts you have and other financial commitments.

- **Your knowledge and experience**

Questions regarding your knowledge and experience can include the types of services and products you are familiar with; the nature, volume and frequency of your previous transactions; and your level of education, profession or former profession.

If a firm does not, or cannot, obtain the necessary information to assess Suitability, then it can not make a recommendation. If you provide only limited information, this will affect the nature of the service the investment firm will be allowed to provide to you.

Trading in products without investment advice

(a) the Appropriateness test

As we have described, when a firm is giving you investment advice, it must ensure that its advice is suitable for you.

When you are not receiving investment advice from a firm (or not relying on a firm to manage your investments) you will generally be expected to take a greater degree of responsibility for your decisions. Where you want a firm simply to follow your instructions to buy or sell an investment a different set of protections apply. These protections are referred to as the **Appropriateness test**.

The test aims to protect those who may not understand or be aware of the implications and level of risk involved in a transaction, particularly where the products are 'complex' or where you have not taken the initiative to carry out the transaction.

Examples of 'non-complex' financial products are:

- Shares admitted to trading on a regulated market
- Money market instruments
- Many types of bonds
- Units in certain investment funds

Examples of 'complex' financial products are:

- Options, futures, swaps, and other derivatives
- Financial contracts for differences
- Convertible bonds
- Warrants

As part of the Appropriateness test, you are likely to be asked questions about your investment knowledge and experience.

- If the firm concludes that you have the necessary knowledge and experience to understand the risks involved, then the firm may simply go ahead with the transaction.
- If the firm concludes that you do not have the necessary knowledge and experience, or you have not supplied enough information to enable it to reach a view, then you will receive a warning from the firm saying that either the firm does not regard the proposed transaction as appropriate or that the information is not enough to enable it to determine appropriateness. If you insist on going ahead with the transaction, you must accept the risk.

(b) Trading in 'non-complex' financial products on an Execution-only basis

The Appropriateness test does not apply in the case of some kinds of 'non-advised' transactions. This service can be described as Execution-only. The circumstances where the test does not apply are as follows:

- the product involved in the proposed transaction is what MiFID calls 'non-complex'; and
- you have chosen to contact the firm to carry out your transaction. This means that you are not responding to a personalised approach to you from the firm which was intended to influence you in respect of a specific product or transaction (for example in certain situations when you are buying shares on line).

You will be warned that the firm is not exercising any judgement on your behalf.

In such cases, you do not have to answer any questions about your investment knowledge and experience, financial situation or investment objectives. The firm may of course ask you questions for other purposes, particularly if you are a new customer.

Investment management

Finally, when your investments are managed by a firm, you are reliant on the firm's decisions and choices. As the firm will not communicate with you every time it makes an investment on your behalf, it will need to have enough information from you at the outset to enable it to provide you with the required service. To achieve this, as in the case of investment advice above, the firm will carry out a **Suitability test**. If you do not supply the firm with adequate information it cannot provide the service of investment management to you. If you provide only limited information, this will affect the nature of the services the investment firm will be allowed to provide to you.

The diagram below is a summary of what we have discussed in this section.

You would normally go to a MiFID investment firm for one of the following reasons:

1. To ask the firm to **manage** your MiFID investments.

2. To get **investment advice** from the firm on MiFID financial products or investment decisions.

3. To ask the firm to buy or sell a MiFID financial product for you, or to ask the firm to pass your order to someone else to execute, **without the firm advising you** at all.

What happens next:

1 - 2. The firm will ask you for information about your investment objectives, financial situation and knowledge and experience so that it can provide a suitable investment management service to you or recommend suitable products or transactions for you. MiFID calls this the **Suitability test**.

3. What happens next will depend on whether the product involved in the proposed transaction is 'complex' or 'non-complex'.

If the product is 'complex', the firm will ask you for information to enable it to assess whether you have the necessary knowledge and experience to understand the risks involved in the proposed transaction. MiFID calls this the **Appropriateness test**.

If the product is **'non complex'**, the Appropriateness test will apply unless you are approaching the firm on your own initiative to ask the firm to execute or arrange a transaction for you. MiFID calls this service **Execution only.**

1.3 What information will you receive before investing?

All information provided to you throughout your business relationship with a firm should be 'fair, clear and not misleading'. This principle refers both to the content of the information and to the way it is presented to you.

Your firm should provide you with the relevant information in good time before you invest so that you can make informed decisions. Types of information you will receive before investing include:

Marketing communications
Whether or not you are a client of a firm, you may receive advertisements and other marketing communications issued by a firm. All advertisements and marketing communications have to be presented in such a way that you can identify them as being of a promotional nature.

Contracts
If you are a new retail client that a firm has taken on for the provision of investment services other than investment advice, you will be asked to agree in writing to a contract which will contain your and the firm's essential rights and obligations.

Information about the firm
A firm must give you general information about itself, including who regulates it and the services it offers to clients, to help you understand the nature of the services on offer and the risks involved.

Information on investment management
Where you have asked a firm to manage investments on your behalf, you should expect to receive information including a description of the management objectives and the related level of risk, what types of products or transactions may be involved in your portfolio and information about the valuation method and the frequency of valuations of your investments.

Information about financial products
You will receive information explaining the nature, risks and costs of financial products. Such information includes, for example, a description of the products' risks and whether prices/values may fluctuate. The amount of information will depend on the type of product, its complexity and risk profile.

Information about costs and charges
You will receive information about the direct and indirect costs and charges of a service or product, including any commission charged or paid. This should clearly show you the total costs. Sometimes, however, the precise amount of the total costs is not available at the time when the information is communicated to you. In such cases, you should instead receive sufficient information to see how the costs are going to be calculated, so that you can verify the total price once it is available.

Before investing, it would be sensible for you to make sure that you know what the arrangements are if you need to make a complaint about the firm or seek redress, and which investor compensation scheme covers the firm. The firm should give you this information.

Part 2: During and after the investment

2.1 What happens when you give an order to a firm

How is your order handled?

When you instruct a firm to buy or sell a product, your order should be executed **promptly, sequentially** (in the order in which it was received by the firm) and in a **timely** manner.

If for any reason a firm has a material difficulty in handling your order sequentially, it should notify you.

What is Best Execution?

To complete the purchase or sale of financial products your firm has to execute your orders in such a way as to **consistently achieve the best possible result for you**. This is referred to as 'Best Execution'.

In essence, your firm will identify 'execution venues' that enable it to obtain best execution. Examples of execution venues are stock exchanges, trading platforms, other firms, or even your firm.

Your firm can achieve Best Execution for your orders by taking a variety of factors into account, such as price, costs of execution, speed and likelihood of execution.

The most important factors a firm will take into account when executing your order are **price and total costs** (that is, the total financial consideration to be paid by you for a transaction, including the price, all expenses, execution venue fees, clearing and settlement fees and any other fees paid to third parties involved in the execution).

2.2 What information will you receive during and after the investment?

What information should you expect to receive from firms that execute your orders?

You will receive information about how your firm achieves best execution for you in practice. Such information includes:

- how the firm determines the factors that are more important for achieving best execution;
- what are the execution venues that the firm relies on;
- a warning that if you give a specific execution instruction to the firm this will take priority and the firm will not be able to follow its own process for achieving Best Execution for you – it will simply follow your instruction. For example, if you instruct your firm to execute your transaction on a specific market, you may lose the benefit of achieving a better price somewhere else.

What reports will you receive?

After you have bought or sold a financial product, your firm will send you a transaction confirmation with essential information such as name of the product, price, date and time and the total sum of commissions and expenses charged.

Where your firm manages your investments on your behalf, the firm should send you periodic reports with information such as the contents and valuation of your investments, the total amount of fees and charges and how your investments have performed during the reporting period.

It is in your interest to retain copies of all documentation you receive from a firm.

Part 3: Ongoing requirements

MiFID establishes organisational requirements on how a firm must run its business at all times. Some of these are especially relevant when doing business with you.

3.1 Conflicts of interest

Firms should act in accordance with your best interests; to this end they should have in place effective arrangements to **prevent conflicts from adversely affecting your interests**. Your firm should avoid unduly putting other clients' interests or the firm's interests ahead of yours when providing you with a service.

Examples of conflicts of interest are when the firm is likely to make a financial gain or avoid loss at your expense; or when it has an incentive to favour another client's interests over yours.

Your firm will also inform you of the key steps it follows to identify and manage conflicts of interests.

When your firm's arrangements are not sufficient to manage a conflict of interest, then it should disclose to you in a clear manner the nature and sources of this conflict of interest, before it does business with you.

3.2 Safeguarding your financial assets and money

When you place financial assets or money with a firm, the firm will safeguard your ownership rights by having arrangements in place to:

- keep them separate from both the firm's and other clients' assets and money;
- keep accurate records and accounts and perform regular reconciliations;
- send you a statement at least once a year with details of the assets and money held on your behalf.

3.3 Customer complaints

Firms are required to establish effective and transparent procedures for the handling of your complaints. When you send a complaint to a firm, the firm should keep a record of it, including the measures it has taken to resolve it.

Conclusion

With the publication of this paper, our intention is to raise consumers' awareness of the changes that are going to affect you as a consequence of MiFID. All the changes and aspects detailed in this guide have been designed to ensure that you are adequately protected when investing in financial products.

Remember the key principles that firms need to fulfil when dealing with you:

- To act **honestly, fairly** and **professionally**, in accordance with **your best interests**
- To provide you with appropriate and comprehensive information which is **fair, clear and not misleading**
- To provide you with services that take **account of your individual circumstances**

Ref. CESR/08-003

This guide is only a brief overview and not a full description of your rights under MiFID. The contents are merely descriptive and do not constitute legal advice. The MiFID legal texts are available at http://ec.europa.eu/internal_market/securities/isd/index_en.htm

CESR is an independent Committee of European Securities Regulators which has contributed to the preparation of the MiFID legal texts. One of the main objectives of CESR is to foster cooperation between its members in the exercise of their core functions, including raising public awareness on financial services issues and investor information.

The Guide has been prepared by the MiFID Level 3 Expert Group chaired by Mr Jean-Paul Servais, Chairman of the Executive Management Committee at the CBFA, and by its sub-Group on Intermediaries, chaired by Mrs Maria Jose Gomez Yubero, Director at the CNMV. For more information on this document or on CESR activities regarding intermediaries please contact Diego Escanero at descanero@cesr.eu.

A new CESR website is currently being developed to provide more information on CESR activities for consumers. The site, which is expected to be available during the second half of 2008, will include a dedicated investor's corner. The address for this website will be the same as the current one: www.cesr.eu. In the meantime, should you have further queries please contact Victoria Powell at vpowell@cesr.eu.

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