

Capital Markets Law and Compliance

The Implications of MiFID

Paul Nelson

CAMBRIDGE

Capital Markets Law and Compliance: The Implications of MiFID

PAUL NELSON



CAMBRIDGE
UNIVERSITY PRESS

CAMBRIDGE UNIVERSITY PRESS

Cambridge, New York, Melbourne, Madrid, Cape Town, Singapore,
São Paulo, Delhi

Cambridge University Press

The Edinburgh Building, Cambridge CB2 8RU, UK

Published in the United States of America by Cambridge University Press, New York

www.cambridge.org

Information on this title: www.cambridge.org/9780521889360

© Cambridge University Press 2008

© in the diagrams, Paul Nelson 2008

This publication is in copyright. Subject to statutory exception
and to the provisions of relevant collective licensing agreements,
no reproduction of any part may take place without
the written permission of Cambridge University Press.

First published 2008

Printed in the United Kingdom at the University Press, Cambridge

A catalogue record for this publication is available from the British Library

ISBN 978-0-521-88936-0 hardback

Cambridge University Press has no responsibility for the persistence or
accuracy of URLs for external or third-party internet websites referred to
in this book, and does not guarantee that any content on such
websites is, or will remain, accurate or appropriate.

For Myrtle, Aubrey, Dora, Saul, Joel,
with love and respect

Preface

This book, like all books, is a product of time, place, circumstances and personality. My aims in writing it are explained in Chapter 1; why I did it is, ultimately, a psychological question which I will not answer here. Instead, I want to acknowledge a number of debts which are important to me in its creation, although most will not recognise it and none have read the result in advance: Robert Orme, Head of History of Art at Latymer Upper School, Hammersmith, who taught me that history is the foundation of explanation; Graham Routledge, late Fellow of Corpus Christi College Cambridge, who taught me law as an analytic discipline; Iain Murray, late Partner of Linklaters, who showed me not only that all aspects of law are interconnected, but also that the socio-economic consequences are profound; Charles Allen-Jones, retired Senior Partner of Linklaters, who showed me law as a creative tool in solving commercial problems; Professor John Board, Director ICMA Centre, University of Reading, who has shown me not only great understanding but also how an economist's view of the Capital Markets can immeasurably enhance a lawyer's view; and my friend Dora Lawson who continues to teach me that in a world of relative, ever-shifting and, ultimately, futile values it is possible to live according to the highest standards of integrity. In the production of this book I have had the privilege of working with Andrea Philo, whose support over many years I cannot repay.

The law, or at least the regulation, is stated as at 20 September 2007.

Paul Nelson
West Hampstead

List of acronyms

APER	FSA's Statements of Principle and Code of Practice for Approved Persons
ATS	Alternative Trading System
AUTH	FSA's Authorisation Manual, part of its Handbook of Rules, in force on and after 1 November 2007
BCD	The Banking Consolidation Directive, 2000/12/EC
BN	Board Notice
CA	Companies Act
CCA	Consumer Credit Act 1974
CASS	FSA's Client Asset Rules, part of its Handbook of Rules, in force on and after 1 November 2007
CEBS	The Committee of European Banking Supervisors
CESR	The Committee of European Securities Regulators
CIS FPO	The FSMA (Promotion of Collective Investment Schemes) (Exemptions) Order 2001, SI 2001/1060
CJA	Criminal Justice Act 1993
COAF	FSA's Complaints against the FSA Rules, part of its Handbook of Rules, in force on and after 1 November 2007
COBS	FSA's Conduct of Business Rules, part of its Handbook of Rules, in force on and after 1 November 2007
COLL	FSA's Collective Investment Scheme Sourcebook, part of its Handbook of Rules, in force on and after 1 November 2007
COMP	FSA's Compensation Rules, part of its Handbook of Rules, in force on and after 1 November 2007

COND	FSA's Threshold Conditions, part of its Handbook of Rules, in force on and after 1 November 2007
CP	Consultation Paper
DEPP	FSA's Decision Procedure and Penalties Manual, part of its Handbook of Rules, in force on and after 28 August 2007.
DISP	FSA's Dispute Resolution, Complaints Rules, part of its Handbook of Rules, in force on and after 1 November 2007
DP	Discussion Paper
DTR	FSA's Disclosure and Transparency Rules, part of its Handbook of Rules, in force on and after 1 November 2007
EC	The European Commission
EG	FSA's Enforcement Guide, part of its Handbook of Rules, in force on and after 28 August 2007
ENF	FSA's Enforcement Manual, part of its Handbook of Rules, in force up to 27 August 2007
FIT	The FSA's Fit and Proper Test for Approved Persons, part of its Handbook of Rules, in force on and after 1 November 2007
FS	Feedback Statement
FSA	The Financial Services Authority
FSA CP 06/9	Organisational systems and controls, FSA Consultation Paper 06/9, May 2006
FSA CP 06/14	Implementing MiFID for Firms and Markets, FSA Consultation Paper 06/14, July 2006
FSA CP 06/15	Reforming the Approved Persons Regime, FSA Consultation Paper 06/15, August 2006
FSA CP 06/19	Reforming Conduct of Business Regulation, FSA Consultation Paper 06/19, October 2006
FSA CP 06/20	Financial Promotion and Other Communications, FSA Consultation Paper 06/20, October 2006
FSA CP 07/2	Review of the Enforcement and Decision making manuals, FSA Consultation Paper 07/2, January 2007
FSA CP 07/4	The Training and Competence Sourcebook Review, FSA Consultation Paper 07/4, February 2007

FSA CP 07/8	Quarterly Consultation No. 12, FSA Consultation Paper 07/8, April 2007
FSA CP 07/9	Conduct of Business Regime: Non-MiFID Deferred Matters, FSA Consultation Paper 07/9, May 2007
FSA CP 07/16	Consequential Handbook Amendments, FSA Consultation Paper 07/16, July 2007
FSA DP 07/1	A Review of Retail Distribution, FSA Discussion Paper 07/1, June 2007
FSA FS 06/1	Reviewing our Training and Competence Regime, FSA Feedback Statement 06/1, March 2006
FSA PM CASS	FSA's Client Assets Rules, part of its Handbook of Rules, in force up to 31 October 2007
FSA PM COB	FSA's Conduct of Business Rules, part of its Handbook of Rules, in force up to 31 October 2007
FSA PM ECO	FSA's Electronic Commerce Directive Rules, part of its Handbook of Rules, in force up to 31 October 2007
FSA PM GLOSSARY	FSA's Glossary of Definitions, part of its Handbook of Rules, in force up to 31 October 2007
FSA PM MAR	FSA's Market Conduct Rules, part of its Handbook of Rules, in force up to 31 October 2007
FSA PM SUP	FSA's Supervision Manual, part of its Handbook of Rules, in force up to 31 October 2007
FSA PM SYSC	FSA's Senior Management Arrangements, Systems and Controls, part of its Handbook of Rules, in force up to 31 October 2007
FSA PM TC	FSA's Training and Competence Rules, part of its Handbook of Rules, in force up to 31 October 2007
FSA PS 06/13	Organisational Systems and Controls: Common Platform for Firms, FSA Policy Statement 06/13, November 2006
FSA PS 07/2	Implementing the Markets in Financial Instruments Directive, FSA Policy Statement 07/2, January 2007
FSA PS 07/3	Reforming the Approved Persons regime, FSA Policy Statement 07/3, January 2007

FSA PS 07/6	Reforming Conduct of Business Regulation, FSA Policy Statement 07/6, May 2007
FSA PS 07/14	Reforming Conduct of Business Regulation, FSA CP 07/14, July 2007
FSA PS 07/15	Best Execution, FSA Policy Statement 07/15, August 2007
FSMA or 2000 FSMA GEN	The Financial Services and Markets Act 2000 FSA's General Provisions, part of its Handbook of Rules, in force on and after 1 November 2007
GLOSS	FSA's Glossary of Definitions, part of its Handbook of Rules, in force on and after 1 November 2007
GN	Guidance Note
GR	Guidance Release
IOSCO	The International Organisation of Securities Commissions
ISD	The Investment Services Directive 1993, 93/22/EEC
JMLSG Guidance Notes	The Guidance Notes issued by the Joint Money Laundering Steering Group, January 2006
LC	The Law Commission
Level 1 Directive	MiFID
Level 2 Directive	Commission Directive 2006/73/EC of 10 August 2006 implementing MiFID
Level 2 Regulation	Commission Regulation (EC) 1287/2006 of 10 August 2006 implementing MiFID
LIBA	The London Investment Banking Association
LIFFE	The London International Financial Futures Exchange
LME	The London Metal Exchange
LSE	The London Stock Exchange
MAR	FSA's Market Conduct Rules, part of its Handbook of Rules, in force on and after 1 November 2007
MiFID	The Markets in Financial Instruments Directive of 21 April 2004, 2004/39/EC
MLRO	Money Laundering Reporting Officer
MTF	Multi-lateral Trading Facility
1939 LDRs	The Licensed Dealers Conduct of Business Rules, 26 July 1939, SI 1939/787
1960 LDRs	The Licensed Dealers (Conduct of Business) Rules 1960, SI 1960/1216

1983 LDRs	The Licensed Dealers (Conduct of Business) Rules 1983, SI 1983/585
1986 FSAct	The Financial Services Act 1986
OEIC	An open-ended investment company
PERG	FSA's Perimeter Guidance Manual, part of its Handbook of Rules, in force on and after 1 November 2007
PFI	The Prevention of Fraud (Investments) Act 1939, re-enacted in 1958
PN	Press Notice
PR	Press Release
PRIN	FSA's Principles for Businesses, part of its Handbook of Rules, in force on and after 1 November 2007
Prospectus Rules	FSA's Prospectus Rules, part of its Handbook of Rules, in force on and after 1 November 2007
PS	Policy Statement
RAO	The Financial Services and Markets Act 2000 (Regulated Activities) Order 2001, SI 2001/544, as amended, including by the FSMA 2000 (Regulated Activities) (Amendment No. 3) Order 2006, SI 2006/3384
Reader's Guide	FSA's Reader's Guide: an introduction to its Handbook of Rules, August 2007
REC	FSA's Recognised Investment Exchanges and Recognised Clearing House Rules, part of its Handbook of Rules, in force on and after 1 November 2007
SIB	The Securities and Investments Board
SUP	FSA's Supervision Manual, part of its Handbook of Rules, in force on and after 1 November 2007
SYSC	FSA's Senior Management Arrangements, Systems and Controls, part of its Handbook of Rules, in force on and after 1 November 2007
TC	FSA's Training and Competence Sourcebook, part of its Handbook of Rules, in force on and after 1 November 2007
2005 FPO	The FSMA (Financial Promotion) Order 2005, 2005/1529
TRUP	Transaction Reporting User Pack, Version 1, FSA, July 2007
UCIT/UCITs/UCITS	Undertakings for Collective Investment in Transferable Securities

Contents

<i>Preface</i>	xiii
<i>List of acronyms</i>	xiv

Part I	Evolution of capital markets regulation, FSA and the European single market	1
1	Introduction	3
2	FSMA and the single market	8
2.1	Evolution	8
2.2	Up to the 1930s	9
2.2.1	The secondary market and the London Stock Exchange	9
2.2.2	Primary market new issues	10
2.3	The Prevention of Fraud Acts	12
2.4	The Financial Services Act 1986	15
2.4.1	Reform of securities regulation	15
2.4.2	Self-regulation?	17
2.4.3	Rules and principles	19
2.4.4	A complete (functional) regulatory regime	22
2.5	FSMA	27
2.5.1	The statutory objectives	33
2.5.2	Conveyance structure	36
2.5.3	Annual report	37
2.5.4	Practitioner input and consultation	38
2.5.5	Enforcement	39
2.5.6	Complaints commissioner	43
2.5.7	Accountability to Treasury	44
2.5.8	The rulebook	45
2.6	European Union directives	53
Part II	Licensing and rule application	61
3	Licensing	63
3.1	Analysing the application of regulations	63
3.2	Regulated activities	64

3.2.1	‘Investments’	65
3.2.2	‘Investment activities’	79
3.2.3	Activities in and/or from a UK place of business	86
3.2.4	Activities into the UK and the overseas persons exclusion	86
3.2.5	Excluded activities	88
3.2.6	The ISD/MiFID override	90
3.2.7	By way of business	92
3.2.8	A licence is required	92
3.3	Process and criteria	94
3.4	Passporting	94
3.5	Non-EEA firms	96
4	The application of FSA MiFID rules	98
4.1	Methodology	98
4.2	Rules of application	98
Part III	The firm’s infrastructure	111
5	Systems and controls	113
5.1	Evolution of FSA’s approach	113
5.2	Systems and controls rules	117
5.2.1	Overall requirement	118
5.2.2	Apportionment of responsibility	121
5.2.3	Control functions	123
5.2.4	Employees	125
5.2.5	Outsourcing	128
5.3	Senior management responsibility	132
5.3.1	Registration as an Approved Person	132
5.3.2	Rule responsibilities	135
5.4	Approved Persons	139
5.4.1	Registration as an Approved Person	139
5.4.2	Rule responsibilities	140
5.5	Record-keeping	140
5.6	FSA’s risk assessment methodology	142
6	Conflicts of interest	146
6.1	Differences in interests and conflicts of interest	146
6.2	The general law of fiduciaries	146
6.2.1	A fiduciary relationship	146
6.2.2	A conflict of interest	148
6.2.3	Solutions	153
6.3	Regulatory rules	158
6.3.1	The general rule	158
6.3.2	Inducements	166
6.3.3	Soft commission and bundling	171

6.3.4	Investment research	178
6.3.5	Corporate finance securities issues	189
6.3.6	Churning	191
6.3.7	Personal account dealing	191
6.3.8	Polarisation	193
7	Client property	194
7.1	Client assets and custody	194
7.1.1	Protecting the client's assets	194
7.1.2	Application of the custody rules	199
7.1.3	Procedures	203
7.2	Client money	208
7.2.1	Protecting the client's money	208
7.2.2	Defining client money	211
7.2.3	Procedures	216
Part IV	Conduct of business	223
8	Client classification and client documentation	225
8.1	Regulatory policy	225
8.2	'Clients' for regulatory purposes	226
8.2.1	The definition of 'client'	226
8.2.2	Clients acting as agent	229
8.3	Client categorisation	230
8.3.1	Private customers and retail clients	231
8.3.2	Intermediate customers and professional clients	231
8.3.3	Market counterparties and eligible counterparties	239
8.4	Terms of business	241
8.4.1	The requirement	241
8.4.2	Content	243
8.4.3	Form	249
8.4.4	Amendments	249
8.4.5	Standard terms and exclusion clauses	250
8.4.6	Enforcement	251
8.4.7	One-way and two-way notifications	251
9	Principles of conduct	254
9.1	The FSA's 11 Principles	254
9.1.1	Policy	254
9.1.2	Application	257
9.2	Treating the customer fairly	259
9.3	The MiFID Principle	264
10	Marketing investments	265
10.1	The different regulatory regimes	265

10.2	Securities	265
10.2.1	Transferable securities	268
10.2.2	Offer to the public	268
10.3	Misleading etc marketing	270
10.4	Marketing by unlicensed persons	272
10.4.1	Marketing up to the end of the 20th century	272
10.4.2	The FSMA regime	276
10.5	Marketing by licensed persons	282
10.5.1	Full disclosure	282
10.5.2	Specific disclosures	289
10.5.3	Real-time promotions	293
10.5.4	Electronic Commerce Directive	293
10.5.5	Distance marketing	296
10.5.6	Collective investment schemes	298
11	Advising clients	306
11.1	General Law	306
11.2	The Regulated Activity	307
11.3	Execution-only services	318
11.4	Appropriateness	320
11.5	Margin Lending	324
11.5.1	Consumer Credit	324
11.5.2	Securities Regulation	324
12	Improper behaviour in dealing and executing orders	326
12.1	Introduction	326
12.2	Insider dealing	326
12.2.1	An individual	327
12.2.2	Territorial jurisdiction	327
12.2.3	Inside information	329
12.2.4	Connection	331
12.2.5	Dealing	332
12.2.6	Encouraging	332
12.2.7	Disclosure	333
12.2.8	Defences	333
12.3	Market manipulation	336
12.3.1	Act or course of conduct	336
12.3.2	False or misleading impression	337
12.3.3	In the UK	338
12.3.4	Purpose	339
12.3.5	Inducing	339
12.3.6	Reasonable belief	339
12.3.7	Defences	339
12.4	A principle of conduct and the need for an administrative remedy	343

12.4.1	An administrative offence	345
12.4.2	The burden of proof	345
12.4.3	Intention	346
12.4.4	Affected persons and certainty	347
12.4.5	Multiple jeopardy	347
12.5	The market abuse regime	347
12.5.1	‘Behaviour’ in relation to an exchange	349
12.5.2	Territorial ambit	350
12.5.3	Misuse of information	350
12.5.4	False or misleading impression	360
12.5.5	Distortion	364
12.5.6	The reasonable and regular user	371
12.5.7	Requiring or encouraging	373
12.5.8	Safe harbours	374
12.5.9	Mitigating factors	374
12.6	The Principle	375
12.7	The future	376
13	Dealing and executing orders	378
13.1	Transactions	378
13.1.1	Pre-transaction	378
13.1.2	The order to deal	378
13.1.3	The decision on how to deal	379
13.1.4	Executing transactions	380
13.1.5	Own account dealing	388
13.2	Best execution	391
13.2.1	Policy	391
13.2.2	When the best execution obligation applies	391
13.2.3	Achieving best execution	398
13.3	Systematic internalisers	407
13.3.1	Introduction	407
13.3.2	The Investment Services Directive	408
13.3.3	MiFID	409
13.4	Reporting	413
13.4.1	Trade reporting	413
13.4.2	Transaction reporting	415
13.4.3	Reporting to clients	417
14	Exchanges and MTFs	418
14.1	Regulated markets	418
14.2	Multi-lateral trading facilities (Alternative Trading Systems)	418
14.2.1	The need for separate regulation	418
14.2.2	Regulatory standards	419
14.3	Clearing services	422

Part V	Application of rules to particular businesses	423
15	Corporate finance	425
15.1	Regulatory status	425
15.2	Infrastructure rules	425
15.3	Conduct rules	426
15.3.1	Conduct rules	426
15.3.2	MiFID	427
16	Broker–dealers	429
16.1	Regulatory status	429
16.2	Infrastructure rules	429
16.3	Conduct rules	429
16.3.1	Securities and derivatives broking and dealing	429
16.3.2	Energy and oil markets	429
16.3.3	Stocklending	430
17	Asset managers	432
17.1	Portfolio managers	432
17.1.1	Regulatory status	432
17.1.2	Infrastructure rules	432
17.1.3	Conduct rules	432
17.2	Collective investment schemes	432
18	Trustees	434
18.1	Trustees of collective investment schemes	434
18.2	Custodians	434
18.2.1	Regulatory status	434
18.2.2	Infrastructure rules	434
18.2.3	Conduct rules	434
18.3	Other trustees	434
18.3.1	Regulatory status	434
18.3.2	Infrastructure rules	435
18.3.3	Pre-MiFID conduct rules	435
19	Retail intermediaries	438
19.1	Stockbrokers	438
19.1.1	Regulatory status	438
19.1.2	Infrastructure rules	438
19.1.3	Conduct rules	438
19.2	Packaged product intermediaries	438
19.2.1	Regulatory status	438
19.2.2	Infrastructure rules	438
19.2.3	Conduct rules	439
	<i>Bibliography</i>	440
	<i>Index</i>	441

PART I

Evolution of capital markets regulation,
FSA and the European single market