

MiFid - Transforming Regulatory Inflation into an Opportunity

by Charles-Henri Taufflieb, Partner, Trésofi by Sidetrade, and Chairman of the Compliance and Codes of Conduct Commission, EACT

The Financial Instruments Market Directive (MiFid) is perceived as a considerable constraint for companies and as a risk of less accountability on the part of banks regarding the rule of good conduct applicable to clients. But as the author of this article explains, it could also be an opportunity to optimise and secure the management of corporate financial risks.

The markets in financial instruments directive (MiFid), applicable since November 1 2007, has a strong impact on the relationships between banks and companies as regards the rules of good conduct relating to financial instruments

(foreign-exchange, interest rates, placement etc).

Until October 31 2007, investment service providers had a duty of information towards all their clients regardless of their size. These rules of good conduct were modulated on a case-by-case basis.

Since November 1 2007, the new regulations have brought about two major innovations - classification of all companies and adequacy and appropriate nature tests.

Classification of companies

As in London and New York, companies are classified into three categories with different good practice rules applied by

the investment service providers (banks and investment companies) - duty of information, warning, advice etc.

Non-professional clients benefit from the full duty of information for financial instruments. This status does not mean that the client is 'incompetent'.

Professional clients benefit from a simplified duty of information in comparison with non-professionals because "professional clients have the experience, knowledge and skills needed to make their own investment decisions and correctly assess the risks incurred" (Article L533-16 of the French Code Monétaire and Financier). The point to watch is the variable geometric nature of the duty of information as regards complex products. This ranges from simplified, lower, less - to in some cases - hardly anything, contrary to the regulations (Article 314-11 to 314-18 of the French AMF general rules [client information]).

Companies which meet two of the three following criteria based on the individual financial statements are automatically considered to be 'professional clients':

- balance sheet total equal to or exceeding EUR20 million;
- net turnover or net revenues equal to or exceeding EUR40 million;
- equity capital equal to or exceeding EUR2 million.

Complex process and legislative inflation

It took eight years to put together this 'monstrous, indigestible and formalist' legislation. Three directives, two orders, a European regulation, a law, two decrees, a complete revision of the AMF's general regulations and an instruction issued by the AMF, not to mention the documents drawn up by the investment service providers.

Companies are not actually financial market professionals in the same way as banks. The AMF points out (Monthly Review, December 2007) that when examining the balance sheets of CAC 40 companies, financial instruments on average account for 96% of total assets and 86% of liabilities for banks compared with 27% and 37% for commercial and industrial companies respectively.

The eligible counterparty only receives a straightforward order execution service without protection. Only the companies meeting the same quantitative criteria can opt in for this status.

It should be noted that regional authorities such as town councils, general councils and regional councils are not considered to be professionals or eligible counterparties.

Change of category. The investment service providers need to notify clients in writing of their classification bearing in mind that it is possible to change category afterwards. A professional client can become:

- 'a non-professional client' upon request and subject to the approval of the investment service provider or at the initiative of the investment service provider. Similarly, companies which want to benefit from a full duty of information for complex instruments (barrier options, accumulators etc.) can request to be considered for these products as non-professional clients, whilst remaining professional clients for plain products (forward, traditional foreign exchange etc):
- an eligible counterparty upon request or at the proposal of the investment service provider provided it receives expressed confirmation that the professional client accepts this status.

Conversely, the non-professional client may request to become a professional.

Adequacy and appropriate nature tests

The investment service provider's duty of warning to clients is formalised by two tests:

- assessment of the adequacy of investment advisory and portfolio management services, ensuring that the service meets the client's investment objective, that it is able to meet any risk connected with the transaction and that it has the experience and knowledge needed to understand the risks thereof. If the client does not provide the requested information, the investment service provider refrains from recommending the instruments or providing the service;
- assessment of the appropriate nature of the other services not affected by the first test. The investment services provider

Notifications sent to clients by the investment service providers

- Most banks (55%) have not notified classifications to their clients
- 45% did not state that it was possible to change status
- Classifications proposed by the banks: professional 43%, eligible counterparty 32% and non-professional 22%
- 27% request a change in status and 27% also refuse to be an eligible counterparty
- 25% of companies do not intend to respond to the banks' notifications
- Only 21% of companies accepted the proposed status.

Source: AFTE Survey: November 2007

checks whether the client has the experience and knowledge needed to understand the risks thereof.

If the investment service provider does not obtain the necessary information or considers that the instruments are not suitable, it must warn the clients. Logically, the tests are less restrictive for professional clients than for non-professional clients because the investment service provider can presume that the former has sufficient knowledge and experience to understand the risks arising from the investment services or transactions proposed.

Impact on relations between banks and companies

The MiFid moves away from a continental logic of rules of good conduct applicable to everyone to a formalisation of the relations between banks and clients, Anglo-Saxon style. In this respect, the confusion observed by companies in the notifications sent by the banks in France and several European countries, did not remove their apprehensions about this sensitive subject, as demonstrated in the Association Française des Trésoriers d'Entreprise (AFTE) survey (see box).

An opportunity to improve financial risk management

Based on our assignments and having actively played a part in drawing up the regulations, the recommendations we would make are as follows:

- review the procedures for managing foreign exchange, interest-rate and placement risks and strengthen the centralisation of these transactions subject to local regulatory constraints;
- integrate the content of the duty of information to the professional client as a criterion for choosing authorised banking counterparties;
- ensure that the general management defines and the audit committee validates a group position to be accepted based on the financial instruments used;
- do not omit to react to the notifications received from the banks;
- make an exhaustive list of all the notifications received by group companies located in the European Economic Area¹;
- do not sign documents blindly because the banks are not lawyers by divine right;
- refuse to be an eligible counterparty to avoid a total loss of protection;
- arrange for the approval of any change in the category of by a corporate proxy, with the option of delegating to the finance director and amending the banking powers accordingly;
- check that the legal documentation signed with the banks does not include any sensitive clauses which would not be in favour of the company (master agreements on financial

instruments, dealing room authorisations, questionnaires to assess professional competency etc);

- include the provisions made under MiFid in the chairman's report on internal auditing.

These new rules strengthen the formalism of relations between banks and companies for financial instruments. They provide an opportunity to review the manner in which financial risks are managed and the entities authorised to act on the markets, particularly for groups that do not centralise their foreign-exchange, interest-rate and placement transactions.

After the management stage of the notifications received from the banks, the MiFid therefore turns a constraint into an opportunity to optimise the management of financial risks and effectively secure the documentation with its banks, particularly by reducing the risk of the company being held liable in the event of a dispute. □

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Charles-Henri Taufflieb Partner, Trésofi by Sidetrade



Charles-Henri Taufflieb is a partner of Trésofi by Sidetrade, a French consulting company in treasury, finance and working capital. As chairman of the Compliance & Codes of Conduct Committee of EACT (European Associations of Corporate Treasurers), he has actively contributed to the drawing up of the MiFID regulations.

He was previously general manager and member of the board of AFTE (French Association of Corporate Treasurers), Usinor Sacilor's Deputy Group treasurer, Credit du Nord domestic treasurer and member of the board of the French Association of Bank Treasurers.

He has published many articles on corporate treasury, and is the co-author of technical booklets and books on treasury management.

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