One Silk Street
London EC2Y 8HQ
Telephone (44-20) 7456 2000
Facsimile (44-20) 7456 2222
Group 4 Fax (44-20) 7374 9318
DX Box Number 10 CDE
Direct Line 020 7456 4939
Direct Fax 020 7456 2000
rob.moulton@linklaters.com

Committee of European Securities Regulators
11-13 Avenue de Friedland
Paris
France

19 January 2005

Our Ref Rob Moulton/SM

Dear Sirs

CESR's Advice on Possible Implementing Measures of the Directive 2004/39/EC on Markets in Financial Instruments - Consultation Paper October 2004

This letter is addressed to CESR by Linklaters, an international law firm with EU offices in Amsterdam, Berlin, Bratislava, Brussels, Budapest, Cologne, Frankfurt, Lisbon, London, Luxembourg, Madrid, Munich, Paris, Prague, Rome, Stockholm and Warsaw. We provide regulatory and compliance advice to a variety of market participants. Our clients have actively followed MiFID's progress and, having advised a number of clients on the negotiations over the Directive, we continue to advise clients on the implications of CESR's consultation process.

In our opinion, the second Consultation Paper takes a more sensible approach to the distinction between doing business with professional and private customers than had been the case with the first Consultation Paper. This alone has reduced the number of comments we have to make on the second Consultation Paper.

Our comments are, again, based on our own experience of advising our clients on the implications of changes to regulations, but is our own and not provided on behalf of any particular client.

We are happy to discuss any of these points in more detail and, should you wish to do so, please call Rob Moulton on + 44 207 456 4939.

Yours faithfully

Linklaters

1 Intermediaries

1.1 Definition of Investment Advice

Number	Page	Para or Q.	Comment
1	9	*"Recommendations"*	CESR proposes that recommendations on the timing of an investment decision should be considered as investment advice. Presumably, this applies where the customer has already taken the decision to invest, and the advice solely relates to timing. We can understand why, in the example which CESR uses, recommending that a client should wait until the end of the month before buying shares in a particular company should be caught as advice. This is because the investor is being advised <u>not</u> to deal at the current moment in time. However, CESR needs to make it clear that the activity of being a broker does not amount to advice simply because the broker is given some discretion as to timing. For example, it would be common for a fund manager to pass an order for execution to a broker and ask that broker to time the resultant transactions to minimise market impact. For example, the dealer might be asked to buy 1 million shares over a set period of time. As currently defined by CESR, advising the customer as to the correct period of time (for example, a sufficient period of time to enable, on average, 3 million shares to be traded, to make sure that this transaction of 1 million shares did not have an undue market impact) would be caught. Similarly, exercising a discretion as to when, during that period, to execute orders in order to minimise market impact would also potentially be caught as defined. In our opinion, CESR should make it clear, in its reply to the responses to the Consultation Paper, that this type of advice on, and discretion as to, timing is not caught.
2	12	Q 1.3	CESR plans to include advice on asset allocation as "investment advice" for the purposes of the directive. We do not think that such advice should be included. It is not possible to act on such advice without either seeking further advice or deciding to enter into an execution-only transaction, so we do not see why it needs to be caught. Further, concluding that advice on asset allocation is investment advice would hinder the production and distribution of valuable economic analysis carried out at a sector or asset-type level.
3	15	Box 1, 1	CESR's definition of "personal recommendation" could be improved because the general provision (i.e. the part outside (a) to (c)) does not refer to financial instruments. If (a) to (c) were removed (and the definition needs to make sense if they are removed because of the use of the word "including") then the sentence would read as follows. "Personal recommendation means any information given to a person that is held out, either explicitly or implicitly, to the recipient as being suited to, or based on a consideration of, his personal circumstances".

Number	Page	Para or Q.	Comment
			In our opinion, the words "relating to one or more [*specific*] financial instruments" need to be added between the word "person" and "including" in the first line. Further, given that (c) contains a "catch all" provision (as it contains the words "any other transaction") it should either proceed, or replace, (a) to (b). In summary, we would redraft this section as follows. "*Personal recommendation*" means any information given to a person relating to one or more specific financial instruments that is held out, either explicitly or implicitly, to the recipient as being suited to, or based on a consideration of, his personal circumstances, including a value judgement or opinion or any other express or implicit recommendation to carry out a transaction relating to one or more specific financial instruments, whether that transaction is to (a) buy, sell, subscribe for, exchange, redeem, hold or underwrite one or more specific financial instruments or (b) exercise, or not exercise, any right conferred by one or more specific financial instruments to buy, sell or subscribe for one or more specific financial instruments.

1.2 Suitability Test for Investment Management and Investment Advice

Number	Page	Question/ Para.no	Comment
4	41	Top paragraph	The end of this paragraph makes reference to the fact that an investment firm does not need to obtain information on the client's experience with execution-only services if it does not intend to offer this service to the client. In fact, firms do not need to obtain information on the client's experience with execution-only services at all under paragraph 19(6) of the Directive. The inclusion of execution-only services as an example in relation to the suitability test is unhelpful and CESR should confirm that execution-only services are not caught by Article 19(4) at all.
5	43	4	CESR states that, when gathering information for the purposes of the suitability test, the firm shall be able to rely upon the information provided by the client unless it is manifestly inaccurate or incomplete. We do not think that the use of the phrase manifest inaccuracy is helpful. It is not clear to whom the inaccuracy must be manifest, and we would delete this reference. In relation to incompleteness, an investment firm is entitled to rely upon the fact that a customer has not provided information, provided that the firm has not invited the client to not provide the information (see box 8(3)). A firm should be able to rely upon a refusal to provide information by a client as indicating no

Number	Page	Question/ Para.no	Comment
			knowledge in this area. The same issue arises on page 47 of the CESR paper, in box 9, para 4.
6	43	5	The first paragraph of (5) states that, when providing advice or acting as portfolio manager for a retail client, firms must take reasonable care to keep the client profile under review and, where investment advice is provided on an occasional basis, firms must undertake a review of the profile whenever the retail client seeks advice. The second paragraph in (5) states that the retail client must be advised that he should inform the investment firm of any major changes to the details provided. It goes on to state that, if the firm becomes aware of a change, it must ask for more information on that change. These paragraphs are thoroughly confused. The first seems to make it the firm's obligation to keep the client profile updated. The second seems to put the onus on the client to update the firm. Firms should be able to agree with retail clients that the firm will act upon the basis of information provided, and that if the information has changed the retail client should inform the firm. It will be a disincentive to the provision of expert services to retail clients if firms are constantly required to update the information that they hold on clients, rather than being able to rely upon clients to update that information. After all, the client is in the best position to know whether the information they provided has changed or not.

1.3 Execution-only

Number	Page	Question/ Para.no	Comment
7	50	Q 5.2	In CESR's approach to analysing when a service is provided at the initiative of the client, CESR goes into considerable detail on the concept of "undue influence". In our opinion, this is totally irrelevant. Rules relating to the management of conflicts of interest should address the extent to which firms must avoid exerting undue influence over clients. For the purposes of whether business is execution-only or not, in our opinion, there is sufficient detail included at Level 1 and in the recital to cover this area, and no CESR guidance is needed.

Number	Page	Question/ Para.no	Comment
8	51	Box 10, Definition of “non-complex instrument”, preamble	The definition of a “non-complex instrument” (which is important because firms cannot provide execution-only services in complex instruments) excludes all derivative financial instruments. In the Directive, Article 19(6) it is made clear that, for example, securitised debt (excluding bonds which embed a derivative) are non-complex. This makes it clear that products which do not “embed” a derivative, but which are themselves a derivative, can be non-complex. If Article 19(6) had intended to exclude all derivatives, it would have said so, and would not have needed the “embedded derivative” caveats in relation to securitised debt and bonds. Therefore, this drafting is ultra vires the Directive and CESR should delete the words “non-derivative”.
9	51	Box 10, Definition of “non-complex instrument”, (b)	CESR should understand that some types of derivative product are relatively simple and could only be used to manage a customer’s risk, rather than to expose a customer to risk. For example, a small corporation (which will be a private customer for the purposes of the Directive) might face a currency risk because they import products from the US. That customer might want to enter into a currency forward transaction in order to eliminate currency risk. Such a company might previously have managed a similar risk and might want to go for a cheap, execution-only service in order to manage its existing risk, rather than to pay for a more expensive advised service. Such a customer will be denied the opportunity to deal in the simple derivative product for the purposes of risk management on this basis by CESR’s implementing advice, either through the use of the words “non-derivative” in the preamble in Box 10 or as a result of (b), as such derivative contracts would involve the potential for loss. However, any loss on the derivative is not relevant to the client (given their corresponding gain on the movement of the currency rates) as it is held to hedge a pre-existing risk.

Number	Page	Question/ Para.no	Comment
10	51	Box 10, Definition of "non-complex instrument", (c)	CESR states that, for an instrument to be non-complex, it must be possible to provide information on that product which is easily accessible, and likely to be understood by, the average retail client. Recent analysis in the UK suggests that investors have a very poor understanding of financial products – for example, in a recent UK survey by the IFS in the UK, 79% of people did not correctly identify the meaning of the term APR (Annual Percentage Rate) in relation to a loan.[1]As defined, we wonder whether anything except for a deposit account would pass CESR's test. We do not think such an objective test is helpful in this area and would encourage CESR to delete (c), relying instead upon the general requirement that communications be fair, clear and not misleading. In any event, the understanding of an "average" retail client is irrelevant in relation to execution-only business. Only the understanding of those clients to whom the service is provided should be relevant.

1.4 Transactions Executed with Eligible Counterparties

Number	Page	Question/ Para.no	Comment
11	56	Opt-out Regime	CESR's advice on undertakings that are not eligible counterparties, but agree to be treated as such, requires the investment firm to obtain a statement from the client in writing and in a separate document from the contract that he is aware of the consequences of losing such protections. The Directive, in Article 24(3) merely requires "the express confirmation from the prospective counterparty that it agrees to be treated as an eligible counterparty". The requirement that this be in a separate document and in writing is ultra vires the Directive. Firms ought to be able to comply with the requirements of the Directive rather than these additional requirements. In particular, CESR's approach seems to envisage that eligible counterparties do not read the contractual documents which are sent to them, and we do not agree with this analysis.

[1] Institute of Financial Services Report on Financial Illiteracy in Britain, 18 August 2004.

2 Markets

2.1 Scope of the Rule – Definition of Liquid Market

Number	Page	Question/ Para.no	Comment
12	64	Explanatory text, final paragraph	CESR seems to be influenced in its consideration of the definition of liquid market by the fact that defining this on an EU-wide basis might mean that there were no liquid shares in the smallest markets. We do not understand why this is a problem. If a share is not liquid as defined, there is no point in treating it as if it were liquid. Indeed, the Directive takes precisely this approach, and seems to envisage that there may be markets where there are no liquid shares, and there may be markets where there are many liquid shares. The pre-trade transparency requirement applies to firms anywhere in Europe who are dealing with liquid securities. Therefore, we do not understand why the fact that some markets may have no liquid shares should have any influence on CESR's considerations, nor is it envisaged in the Directive that it should do so.

2.2 The Determination of Standard Market Size

Number	Page	Question/ Para.No.	Comment
13	70	2^{nd} paragraph	CESR's advice on the definition of standard market size has been keenly awaited as, in order to differentiate between the impact of pre-trade transparency requirements in retail and institutional markets, it is important that standard market size is not defined in such a way as to affect the provision of liquidity to institutional markets. In particular, the analysis of the correct approach for pre-trade transparency measures should not be influenced by any considerations relating to post-trade transparency (i.e. delayed reporting). The rationale for permitting firms to delay reporting is completely different from the rationale for requiring firms to provide pre-trade transparency and they should be dealt with on a separate basis. The references, under the heading "Basis for Calculations", to Articles 30 and 45 suggest that CESR may (in contrast to the open approach taken in the first consultation) be tending towards a common definition for both pre and post trade purposes. This will be a serious mistake. It is important to get the level right for both pre and post trade transparency requirements, and this must mean different definitions.

Number	Page	Question/ Para.No.	Comment
			Worryingly, at the Open Hearing in Paris, CESR representatives claimed that firms cannot internalise a share which has not yet had its Standard Market Size determined. We would be grateful if CESR could now confirm that this view is incorrect. Under the Directive, there are no restrictions on a firm's ability to internalise, although there are obligations which arise when firms do so, such as to offer pre-trade transparency if they wish to deal below any Standard Market Size that may have been determined.

2.3 Obligations of a Systematic Internaliser

Number	Page	Question/ Para.No.	Comment
14	76	Top paragraph	CESR states that an obligation of a systematic internaliser must be to publish quotes "100% of the time during the firm's normal trading hours". In our opinion, it is impossible for firms to state categorically that they will be able to quote in this way, because an IT failure might prevent them from doing so. We think that wording to make it clear that firms must take reasonable steps to act in this way is appropriate, and would reword this paragraph as follows. A quote is published on a regular basis when a systematic internaliser takes reasonable steps to publish a quote throughout its normal trading hours as a systematic internaliser.
15	76	Access (c)	CESR refers to its work on the first set of mandates which stated that the "easily accessible" test was unlikely to be met simply by publication on the firm's own website. We refer you to our response on the first set of mandates, which pointed out that this approach was ultra vires the Directive, which clearly contemplates proprietary means as an acceptable method of publishing quotes. We do not think it is helpful for CESR to merely state that publication on a website is not "easily accessible" if CESR cannot state a proprietary method which would amount to an "easily accessible" means of providing this information. Further, accessibility is relevant to those entitled to execute against the published quote (i.e. a firm's clients) and firms commonly make services, such as research, available to their clients in a readily accessible manner.

Number	Page	Question/ Para.No.	Comment
16	78	3	CESR proposes that systematic internalisers should only be allowed to withdraw quotes when trading of a security on a regulated market is suspended. This is far too narrow. Trading in securities is very rarely suspended, as usually the ability of investors to execute transactions on order-driven markets (where both sides of the trade must want to deal) is maintained unless there is a fear that information on the security has not yet been made public, when a short suspension might be used to protect investors until the position is clarified. However, in a quote-driven market, it is unfair to force systematic internalisers to continue to quote if there is one-way trading i.e. just buying or selling (as the market maker is not fulfilling their role of balancing buying and selling interests and offsetting any resultant risk). We suggest that 3 be redrafted as follows: Systematic internalisers may withdraw quotes whenever market conditions prevent them from balancing buying and selling interests, or it is otherwise improper to require them to continue quoting. Systematic internalisers must resume quoting as soon as possible when these circumstances cease to exist.

2.4 Order Handling

Number	Page	Question/ Para.No.	Comment
17	82	Box 20	CESR has provided advice on the definition of a portfolio transaction. This is important as the requirement to execute orders at the quoted price without the opportunity for price improvement is waived where transactions are portfolio transactions (see article 27(3), para 5). CESR's definition requires the transaction to be "traded as a single lot against a specified reference price". This is merely a sub-section of the business which is currently carried out under the heading of portfolio transactions. Some portfolio transactions are executed on an agency basis over a period of time without reference to a specific price, where the price given to the client is the price at which the transaction is executed by the firm. CESR has interpreted "orders which are subject to conditions other than the current market price" to mean both market and limit orders. This is ultra vires the directive which refers to "current market price". A limit order is an order other than at the current market price. Both "limit" and "market" orders are defined in the Directive, and CESR's descriptions are therefore unhelpful. CESR should not reopen the wording which was settled at Level 1 after lengthy debate.