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Working for the Investment Community

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By email to CESR at www.cesr-eu.org

Dear Sirs

Response to CESR on Advice on Possible Implementing Measures of the Directive on Markets in Financial Instruments (MiFID) – Section II Intermediaries

The Association of Private Client Investment Managers and Stockbrokers (APCIMS) is the organisation that represents those firms who act for the private investor and who offer them services that range from no advice or 'execution only' trading through to portfolio management for the high net worth individual. Our 217 member firms operate on more than 500 sites in the UK, Ireland, Isle of Man and Channel Islands and following the merger of EASD into APCIMS, increasingly in other European countries as well. APCIMS members have under management Euro 450Billion for the private investor and undertake some 13 million trades for them annually

We welcome the opportunity to respond to this consultation on behalf of our members. Due to the length and coverage of this consultation, together with the tight timescales under which we are all operating, we are providing the first stage of our response now and will follow this with the final response before the deadline of 17 September.

This response covers the following sections:

13(2) Compliance and personal transactions
13(4), (5) Internal systems, resources and procedures
13(6) Record keeping
13(7), (8) Safeguarding clients' assets
19(8) Reporting to clients

In preparing this response we have extensively consulted with our member firms both in the UK and other European countries. We have been keen to ensure that the issues that we raise and the answers to the questions posed by CESR are representative of as broad a range of intermediary firms as possible.

There are some important general observations that we would like to make at the outset.

1. A wide variety of financial firms and markets will be impacted by the proposed changes and there needs to be a clear recognition and understanding of the different models of investment firm operating throughout the EU. If CESR is too detailed in its measures

then this will inevitably result in unintentional constraints. Markets need to be allowed to develop and different business models will need flexibility to bring about the required change.

At all stages therefore, CESR should choose the less detailed and less prescriptive options.

2. In making its proposals and deciding on implementation measures, CESR should at all times keep in mind the costs to market participants of the changes and agree the least costly option.

3. Timescales are short and so CESR should agree both transition periods and grandfathering arrangements.

4. CESR measures should not have the effect of changing the intention of the Level 1 measures.

5. Where current requirements meet the intent of CESR measures, then a firm should be allowed to grandfather its existing arrangements. Otherwise the costs of implementing the new requirements will be borne by clients, without any corresponding increase in the protections afforded to them.

Costs

The proposed changes are going to lead to substantial costs, which will have to be borne by clients. Yet, as we show later, clients are already protected by very similar regulations, so it is critical that there are sensible transition rules to enable changes to be eased in with normal client communications or process changes.

It is not easy at this stage to assess the costs of CESR proposals, as firms cannot properly make judgments until they know the extent of the changes required. However, in some areas it is possible.

i) **Client Agreements.** A typical APCIMS-EASD member firm will have 15,000 clients and the range is from 5,000 to 120,000. If it is necessary to reissue new client agreements as a result of these Level 2 measures, then the cost of only sending out the new agreement for the average firm will be Euro 80,000. In addition, there will be associated legal costs and staff costs, which are estimated to double this figure. Therefore, the relatively simple change to a client agreement could cost our membership in excess of Euro 35million.

In this case it is critical that grandfathering arrangements are put in place to enable one-way notifications to clients in order to avoid these costs and the disruption to client services.

ii) **Safeguarding Client Assets.** Our member firms have established nominee companies for safeguarding client assets. The safekeeping is effected by sophisticated systems, frequent reconciliations within a rightly regulated environment. Systems have been built to meet current requirements. Any changes will therefore have a systems impact and so a cost impact. The current estimate for our community is that depending on the nature and extent of changes to the current safeguarding of client assets, it will range from Euro 5 million to Euro 15 million.

I hope these comments are helpful in the development of CESR's advice and should you have any further questions in this regard please do not hesitate to contact me. My email address is helenb@acpims.co.uk.

Yours faithfully

Helen Banks
Head of UK Regulation

APCIMS Comments on the Detailed Advice on Possible Implementing Measures of Directive on Markets in Financial Instruments (MiFID) – Section II Intermediaries

COMPLIANCE AND PERSONAL TRANSACTIONS

CESR Question 1.1

Must the compliance function in every investment firm comply with the above requirements for independence, or should this degree of independence only be required where this is appropriate and proportionate in view of the complexity of its business and other relevant factors, including the nature and scale of its business?

APCIMS Response

Whilst it is important to ensure that compliance is an independent function, it must be recognised that in small firms the individual or individuals responsible for compliance may also have some other function. APCIMS firms range from entities with around 5,000 clients up to firms with as many as 120,000 clients. While we agree that there needs to be proper Chinese walls, controls and procedures for the compliance function in the smaller firms, the rules must not be drawn so prescriptively that it prevents the compliance individuals from also undertaking other duties such as finance, complaints handling, anti-money laundering, training and competence and risk management.

We note that this is an area where CESR has used the existing Standards for Investor Protection and in this instance we believe that these go beyond the requirements of the level 1 text in Article 13.2. We question the level 2 advice in respect of the independence of the compliance function and believe that the draft implementing measures do not fit with the legislation which simply requires "adequate policies…….to ensure compliance of the firm". We believe that the requirement for "adequate policies" does allow a degree of flexibility which firms need when staffing for their business needs.

With respect to the budget and remuneration of the compliance function, typically the compliance function is remunerated in a manner separately from that of front office staff. However, firms often operate a bonus "pool" linked to the overall performance of the company. We consider it wholly appropriate that compliance staff should be able to benefit from that bonus pool in order to attract the necessary high calibre of staff and to secure their full participation in the overall performance of the business, on the basis that an effective compliance function works to enhance the business. We would therefore propose that compliance should not be excluded from such arrangements but that the targets which they have to achieve for participating are not linked to the financial performance of the individual business teams of the investment firm.

Furthermore, we do not agree with the requirement in point 4(c) in which the compliance function should report annually to any external auditors. This would tend to alienate the compliance function from the rest of the business and we consider their responsibility is to report the results of monitoring to the firm's governing body. The external auditors must take the responsibility to review whatever records they deem necessary in the forming of an audit opinion.

The requirements in the UK which are set out in the Financial Services Authority's Systems and Controls module of the rulebook are similar to the level 1 text, and they also provide guidance that "a compliance function should be staffed by an appropriate number of competent staff which are sufficiently independent to perform their duties objectively". We provide at Annex 1 examples of the types of compliance arrangements in different types of firms which we believe provide firms with sufficient flexibility for professionally qualified compliance staff able to ensure the competence and compliance of the firm.

CESR Question 1.2

May deferred implementation of requirements for independence be based on the nature and scale of the business of the investment firm?

APCIMS Response

We have in part answered that above. Size of the business is clearly important when considering changes, as it is well known that the costs of regulatory change affect small firms significantly more than large firms. We have given estimates above of the cost implications of bringing about certain changes and this supports a case for delayed implementation, where clients are already sufficiently protected. Wherever possible, existing arrangements should be grandfathered if they currently operate satisfactorily and are subject to national regulators' supervision. In addition, transition periods are also enormously helpful when implementing change. For a private client firm, deferring the implementations of these requirements could well be useful and we would suggest that, firstly, this is allowed and, secondly, that authority be given to national regulators to decide to whom such a deferral applies in conjunction with the industry and how it should be implemented.

CESR Question 1.3

Should the current text of CESR Standard 127 be retained or should its scope be extended to the outsourcing of all investment services activities or should paragraph (b) be deleted and reliance place on the status and responsibilities of the outsourcing investment firm?

APCIMS Response

The approach of the CESR Standard 127 to the outsourcing of a portfolio management service is to emphasise the regulatory status of the service provider. It also requires formal arrangements to be in place between the regulators involved in a cross-border outsourcing arrangement where the service provider is a non-EEA investment firm. We believe that it is inappropriate to restrict the potential for outsourcing arrangements in this way, when the key issue is how well they are managed by the outsourcing firm.

We would therefore propose that the firms themselves bear the responsibility for the functions that they outsource and that the guidance in b) should be deleted. It should be a business decision whether a firm outsources a particular function or not and to which service provider, rather than one for regulators to decide. However, we also recognise the regulators' responsibility in this area and that the national regulator should satisfy itself that the firm has proper systems and controls in place governing both the in-house activities and that which it has outsourced.

As a general comment, although we understand CESR concern that outsourcing arrangements should be put in place in a proper and ordered manner, care needs to be taken not to be over prescriptive in its requirements. We would see this issue as primarily a Level 3 responsibility.

INTERNAL SYSTEMS, RESOURCES AND PROCEDURES

CESR Proposals

Obligations relating to internal systems, resources and procedures: Article 13 (4) and (5), second sub-paragraph.

APCIMS Response

We note that the general principle set out in 1 a) relates all guidance in this section to the nature scale and complexity of the firm's business and consider this to be of key importance in determining the systems to be put in place. Likewise, we are concerned that the concept of "reasonableness" is introduced throughout CESR's proposed advice in this area as well as elsewhere. For example, in the business continuity planning embodied within general principle 1(b), whilst a large firm may well have complete emergency backup in a second site, smaller firms will have much simpler arrangements such as, for example, using the premises of an alternative firm on a temporary basis.

In addition, we note that CESR is proposing to require a set of principles relating to accounting systems and controls. We would be very concerned if this made the assumption that firms have separate audit committees as, again, this is a structure only relevant for a large entity. Also, such principles are already part of the accountants' responsibilities in the UK and to include them as a mandatory requirement in regulation will present a costly duplication.

RECORD KEEPING OBLIGATION

CESR Question 4.1

Should there be a separate obligation for the investment firm to be able to demonstrate that it has not acted in breach of its obligations under the Directive?

APCIMS Response

We do not believe that an investment firm should have to demonstrate that it has not acted in breach of their obligations under the Directive. We believe that this reversal of the burden of proof would set a dangerous precedent. The burden of proof should rest with the investment firm to demonstrate that it has complied with the obligations under the Directive.

CESR Question 4.2

What should the nature of the record keeping requirements be in relation to (i) capital market business such as equity IPOs, bond issues, secondary offerings of securities; (ii) investment banking business such as mergers and acquisitions; and (iii) general financial advice to corporate clients in relation to gearing and financing, dividend policy, etc?

APCIMS Response

There are already substantial record keeping requirements within the advice – a list of which is appended. We do not believe that the nature of the record keeping requirements in relation to the given activities should differ from general principles of good record keeping and should be for the firms to decide.

SAFEGUARDING OF CLIENTS' ASSETS

CESR Question 5.1

Where the jurisdiction in which financial instruments have to be held regulates the holding and safekeeping of financial instruments, should investment firms be required to sub-deposit their clients' financial instruments with such institutions in all cases or are there cases in which overriding considerations to the contrary mean that it would be permissible to use an unregulated depository?

APCIMS Response

We consider that if should be permissible to use an unregulated depository, given an acceptable standard of performance and the express permission of the client, however this should be viewed as an exception.

CESR Question 5.2

Which appropriate systems and controls an investment firm has to put in place to ensure that only financial instruments belonging to clients who have given their consent are used in those arrangements?

APCIMS Response

It is unusual for our member firms to lend clients' stock. However, where this is the case we consider that the current regulations imposed by the FSA are sufficient to control this activity. That is, where financial instruments are held on a pooled basis, a firm must have in place adequate systems and procedures in order to identify that only the assets of clients who have consented to stock lending are used. This can be achieved through the use of a competent accounting system. CESR should not require that lendable stock must be separately registered. This would cut across all the efficiencies and economies of pooling client stock and client transactions.

CESR Question 5.3

Should a requirement be imposed that the records of an investment firm must indicate for each client the depository with which the relevant client's assets are held, or is it sufficient that the investment firm should maintain records of the amount of each type of asset held for each client and of the amount of each type of asset held with each depository and ensure that the aggregate figures correspond with each other in accordance with paragraph 11c and 13b?

APCIMS Response

APCIMS member firms typically operate what is known as a pooled nominee. This is a nominee company set up by the firm at arms length, with its own directors and within a strong regulatory framework. The nominee company then undertakes safekeeping of the clients' assets. These

assets are completely segregated from the firm in every respect and are protected under UK law, which recognises the claims of the beneficial owner of the assets. Firms are required to keep records of the amount and value of each client's assets held in their nominee, to reconcile the nominee on a monthly basis and to report to the client every six months. That report will give the name of the nominee company in which the assets are held.

We appreciate that there are a variety of arrangements which fall within this general description. In addition, if, for example, the client has investments in companies quoted on exchanges in other European countries, requirements may well be to hold those assets in a certain way and in a certain type of depository within that country. As such, we believe that the practical variabilities mean that the CESR minimum requirements for an investment firm to maintain records of the amount of each type of asset held for each client, the amount of each type of asset held with each depository and that the aggregate figures correspond, is both appropriate and practical.

CESR Question 5.4

If the client's assets may be held by a depository on behalf of the investment firm, should: (a) the investment firm be (i) prohibited from purporting to exclude all limited responsibility for losses directly arising from its failure to exercise all due skill, care and diligence in the selection and periodic review of the depository; and (ii) required to accept the same responsibility for a depository that is a member of its group as it accepts for itself; or (b) must the contract between the investment firm and the client state that the investment firm will (i) in any event be wholly liable for any losses the client suffers where the investment firm is directly or indirectly linked to the depository; and (ii) be liable in whole or in part according to the circumstances for any such losses unless the investment firm shows that it has exercised all due skill, care and diligence in the selection period review of the depository?

APCIMS Response

Firms have a contractual responsibility for their clients' assets when they are in their firm's nominee (depository). They are required by the regulator to exercise due skill, care and diligence and, where the depository is other than their own, to take reasonable steps to assure themselves that it is satisfactory. In addition, firms take out insurance typically against fraud, theft and, when available, professional indemnity insurance. All insurance is limiting in some form and it would therefore be surprising if CESR made requirements which have the affect of preventing firms taking out insurance in this way. However, should CESR decide that an investment firm was prohibited from limiting its responsibility for losses, then this would impact directly on its lack of ability to take normal prudent steps through insurance.

Many UK firms hold all client stocks in a third party custodian, usually a first class international bank, chosen after a due diligence process and reviewed annually. In such cases a total loss is unlikely. Most firms will accept responsibility if their negligence causes a loss but exclude losses caused by the outright failure of the bank. This seems to us appropriate.

We therefore consider that Option (b) put forward by CESR is more appropriate than Option (a) and will make it clear to clients what the extent of the firm's responsibility is. In addition, the necessary due skill, care and diligence referred to within that paragraph should be for national regulators to decide and implement as appropriate.

REPORTING TO CLIENTS

CESR Question 10.1

What type of reporting requirements relating to the provision of investment advice should be included in the advice to the Commission? When should such requirements apply and what concrete requirements should be imposed?

APCIMS Response

We agree with much of the proposed draft Level 2 advice, although we would like to emphasise the importance of client choice in the type and frequency of information received. It does not act in the best interests of clients or firms to have onerous and unwanted reporting requirements. We do have some specific concerns with respect to the section on the periodic information for portfolio management clients.

In respect of the portfolio management services provided by our member firms, there are two very distinct levels of service. In regard to the more basic service, the performance evaluation requirements are wholly inappropriate and would increase costs to clients significantly, without any discernable benefit.

The following detailed points have been discussed at length with the FSA in regard to the regulatory regime operating in the UK, and agreement reached on a more pragmatic approach:

Point 16(a) of the advice suggests that periodic statements to clients receiving portfolio management services should include valuations at the beginning and end of the reporting period. We believe that it is impractical for firms to provide this information and that it would lead to a significant increase in costs to the client.

We would also suggest that the wording of point 16(d) is changed to "information on any remuneration received from a third party or details of its calculation basis". This would give a more practical basis to enable firms to comply with the requirements, while still providing clients with relevant information.

We consider the requirements under point 18 to be overly onerous for our members because of a dependence on the way in which information is received from third parties, depending on the interpretation of the term "relevant" in this context. For example, the usual basis for the reporting of trail commission and the difficulty in splitting out the relevant information has led to the FSA agreeing to disclosures in more general form.

ANNEX 1

Examples of compliance arrangements in APCIMS firms

Case 1

A small independent stockbroker run as a partnership with 10 staff and 650 clients. Clients receive either advisory or discretionary services. The 10 staff are 3 partners, 2 fund managers, 3 secretaries, 1 bookeeper and 1 compliance officer. The compliance function is not independent and the compliance officer is the money-laundering officer. The compliance officer is also authorised to give investment advice and performs this function on a daily basis. The compliance officer reports to the senior partner. The compliance function has an annual external audit by a leading professional firm of accountants. The compliance officer is paid on a salaried basis and receives a bonus according to the performance of the firm. The firm outsources its IT, HR and clearing and settlement arrangements.

Case 2

A UK branch of a French company under German ownership, this firm provides execution-only online services to 30,000 clients. Subject to UK Conduct of Business rules, but with authorisation determined by the French regulators. There is a total of 100 staff and there is an independent compliance and internal audit function with 5 staff (with responsibility for all legal and regulatory matters, money laundering reporting, staff training and risk management). The compliance officer reports directly to the senior management of the UK branch and is an FSA approved person. The compliance function is subject to external monitoring by the group compliance and internal audit functions, with a further reporting line to the Group Compliance Office in Germany. The compliance team receive discretionary performance related bonuses on a similar basis to other staff.

Case 3

A UK subsidiary of a continental European bank, this firm provides broking and corporate finance services to corporate and institutional clients in the UK and overseas. Broking services include the provision of financial advice, corporate broking, private equity, research, sales, trading and market making. There are 4 executive directors and a total of 100 staff.

The director of operations and finance is also the compliance officer and money laundering reporting officer. The compliance officer reports to the CEO. The compliance officer is paid on a salaried basis and receives a bonus according to the performance of the firm. The compliance function is audited by external auditors and the internal audit department of the parent bank.

Case 4

A UK firm which is a member of a non-EU group. This firm provides discretionary and advisory portfolio management for individuals, families, charities and trusts. The firm has about 20,000 clients and has £6 billion funds, under management. It has 328 staff of which 142 are controlled functions. The Head of Compliance has a staff of five people reporting to him. He reports direct to the CEO and also has a reporting line to the Group Compliance Officer. He is the Money Laundering Reporting Officer. All compliance staff are salaried with the level

comparable with those generally paid in the industry for a similar type of firm. Discretionary bonuses are paid, by reference to the overall profitability of the firm and are determined by a Remuneration Committee. They are not transactional based, but some variation to the general level will be determined by exceptional performance.