The City of London Law Society
4, College Hill
LONDON
EC4R 2RB

The Committee of European Securities Regulators ("**CESR**")
11-13 avenue de Friedland
75008 PARIS
France

Via online response form at www.cesr-eu.org

17 September 2004

Dear Sirs

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

I. Introduction

1.1 This response is made by the Regulatory Law Committee of the City of London Law Society (the "**Society**"). The Society is the local Law Society of the City of London and represents City solicitors, who make up 15% of the profession in England and Wales.

1.2 Members of the Regulatory Committee advise a wide range of firms in the financial markets, including banks, brokers, investment advisors, investment managers, custodians, private equity and other specialist fund managers as well as market infrastructure providers such as trading, clearing and settlement systems.

1.3 Membership of the Regulatory Committee is personal, but members are partners in the following law firms:

Berwin Leighton Paisner	Lovells
Clifford Chance	Macfarlanes
CMS Cameron McKenna	Mayer Brown Rowe & Maw
Denton Wilde Sapte	Norton Rose
Freshfields Bruckhaus Deringer	SJ Berwin
Herbert Smith	Slaughter & May
Linklaters	Travers Smith Braithwaite

1.4 Between them these firms operate in the following jurisdictions, thus members of the Committee have exposure to legal issues affecting the whole of the international financial services community.

Abu Dhabi	Germany	The Netherlands	Thailand
Austria	Ghana	Oman	Turkey
Belgium	Gibraltar	Poland	Uganda
Botswana	Hong Kong	Romania	United Arab Emirates
Brazil	Hungary	Russia	United Kingdom
Canada	India	Serbia & Montenegro	United States
China	Italy	Singapore	Uruguay
Czech Republic	Japan	Slovakia	Uzbekistan
Dubai	Luxembourg	Spain	Vietnam
Egypt	Kazakhstan	Switzerland	Zambia
France	Morocco	Tanzania	

1.5 We welcome the opportunity to respond to CESR's first consultation on its advice to the European Commission (the "**Commission**") on possible implementing measures for the Directive on Markets in Financial Instruments (the "**Directive**").

1.6 This response focuses on CESR's advice on intermediaries.

1.7 We would be very happy to discuss this response with CESR. Please contact the chair of the Regulatory Law Committee: Margaret Chamberlain, Travers Smith Braithwaite, 10 Snow Hill, London EC1A 2AL. Telephone: 020 7295 3233. Fax: 020 7295 3500. E-mail: margaret.chamberlain@traverssmith.com.

II. Index

III. Observations

3.1 We make the following general observations, which are relevant to a number of topics.

Excessive detail at level 2 precludes proportionate application to different types of firm

3.2 We are surprised generally at the level of detail at which CESR has drafted its advice. We appreciate that CESR had a relatively short time to prepare the advice and it is helpful to see the detail of CESR's thought process. However, during the preparation of its final advice CESR will need to ensure that the detail does not preclude Member States applying regulation proportionately and flexibly to firms of different sizes and with different business models. CESR acknowledges, for example on pages 12 and 13 of the consultation, the need for flexibility and we would encourage it to review its draft advice with a view to ensuring that it is capable of being applied in a relevant and proportionate manner by Member States to different types of firm. For example, it would be disproportionate to apply a requirement for an "independent" internal compliance function under Article 13(2) to a small firm. Generally, in drafting its advice CESR seems to have had in mind larger firms, whose activities are related to regulated and similar markets, and those which deal with unsophisticated retail customers. The final advice will need to encompass a wider range.

3.3 The Directive covers a very wide range of markets; even within each Member States the markets in commodities will vary from those in securities, the exchange traded markets will vary from the OTC markets. A uniform and rigid set of rules at level 2 would therefore detract from the ability of the competent authorities to achieve fair treatment for customers of investment firms, in the context of each relevant market.

3.4 Level 2 should not give rise to a European rulebook – competent authorities at Member State level are required to consider cost benefit analysis and consult with their markets in implementing their rules and guidance, equally they are subject to the principles of local administrative law. Detailed legislation at level 2 would wholly undermine these safeguards for the regulated community.

CESR's preference for rules over guidance

3.5 The current approach leaves considerable doubt as to what is to be covered at level 3. For example, as far as outsourcing of investment services is concerned, level 2 should be confined to simple rules of broad application (for example that a firm may not, through outsourcing, displace its regulatory obligations) and guidance, for example acknowledging that outsourcing takes many forms. Even though CESR's draft advice on outsourcing runs to more than three pages of detailed rules, it will still not capture appropriately the wide range of businesses and activities that may be outsourced.

We suggest the use of the following tools to achieve proportionality and flexibility.

(a) High level principles of universal application (and we had understood this to be the purpose of level 1 legislation).

(b) Rules of clear application to particular categories of firm. In our substantive comments, we point out a number of instances where CESR's advice is well considered and has a good basis in policy, but where that policy justification does not extend to the same regulation for every type of firm.

(c) Authoritative guidance which elaborates upon the application to different types of firm of a particular rule.

Absence of exceptions

3.6 Given the level of detail adopted by CESR at level 2, greater thought must be given to identifying appropriate exceptions from particular rules: the greater the level of detail, the greater the need for detailed exceptions. These will enable local regulators to understand in which circumstances it is inappropriate to apply a particular provision. This is another way to ensure proportionate application to different types of firm.

Retail clients previously classified as intermediate customers

3.7 As a related point, it is important to bear in mind that the criteria in the Directive for classifying a professional client by reference to its size (set out in Annex II) will in many cases exclude relatively large corporations and sophisticated individual investors; thus many clients currently classified as "intermediate" customers may be retail customers within the Directive. Many investment firms, used to dealing only with professional clients under current rules, will find that their clients do not satisfy the size or other test in the Directive: those firms will therefore be subject to more onerous and potentially inappropriate regulatory obligations than they are today.

We welcome the fact that CESR has not included in its draft advice detailed rules applicable to investment firms when they deal with professional clients. However, CESR has approached provisions relating to retail clients as though all retail clients were private individual investors. Although the Directive only draws a distinction between professional clients on the one hand, and retail clients on the other, we believe that there is room within CESR's advice and level 2, further to distinguish between categories of retail client. Certain rules, for example those relating to the provision by an investment firm of detailed information during telephone calls, may be appropriate only where a client is a private individual investor who requires the greatest degree of investor protection. It would be proportionate, and would facilitate an appropriate use of regulators' time and resources, to tailor exceptions to those rules to other types of retail clients (for example some corporates).

Grandfathering and transitional arrangements

3.8 CESR's advice has the potential to require rewriting of IT systems, reorganisation of internal systems and processes and repapering of customer relationships and agreements. It is essential therefore that adequate grandfathering and transitional arrangements are agreed. They are most important in the context of client agreements and outsourcing arrangements. We suggest that an investment firm should be permitted to derogate for a prescribed period from implementing measures of the Directive in two circumstances.

(a) Where the investment firm has, in good faith, entered into a long-term outsourcing arrangement. It may be impossible to renegotiate the terms of the outsourcing, for example because the outsourcee is not prepared, commercially, to accept the contract subject to the new rules. It may be that the relevant outsourcee is the only person who can provide the service.

(b) Where the investment firm is already subject in its relevant Member State to rules which address the policy issues behind the relevant implementing legislation of the Directive. Where there are no such rules in the relevant Member State there would be no justification for applying transitional or grandfathering arrangements.

IV. Substantive response and answers to questions

Definitions

4.1 We refer to section 1 of CESR's consultation paper, beginning on page 7.

4.2 The definition of "relevant person" is of particular relevance to the rules on personal transactions (see in relation to Article 13(2), page 15, box 1, paragraphs 7 and 8 of the consultation).

The extension, in particular, of personal transaction and insider dealing rules to individuals employed by an outsourcee is a significant departure and will be inappropriate in many circumstances.

Compliance and personal transactions (Art. 13(2))

Specific questions

5.1 **Question 1.1** - *Must the compliance function in every investment firm comply with the requirements for independence set out in paragraph 2(d), 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?*

Answer - The compliance function in every investment firm should *not* be required to be independent. The best solution is direct regulation of the individual within the firm responsible for compliance (whether or not an independent compliance function is required by virtue of the size and complexity of the firm's business). **Justification** - The proposal that the compliance function be independent and, in particular, that the individuals in the compliance function not be involved in the performance of the services or activities they monitor could have serious implications for small firms, not necessarily limited to sole practitioners. It has been suggested that investment firms should delegate the compliance function to, for example, compliance consultants. However, compliance consultants may not be willing to take on the formal role and associated liability. Nor, in our experience, is any lawyer, accountant or compliance consultant is in a position to adequately to fulfil the functions of an internal compliance function: they do not know enough about the business and they tend to operate by way of occasional reviews, rather than anticipating problems or addressing them as they arise.

There must be flexibility or unreasonable and disproportionate burdens will be placed on small businesses. For example, it would seem to be inappropriate to have an independent compliance function where the only investment activity of a sole trader or small firm is dealing as principal. As CESR points out, there are competition issues involved in placing unnecessary and unreasonable burdens on small businesses seeking to enter the market.

5.2 **Question 1.2** - *May deferred implementation of requirements for independence be based on the nature and scale of the business of the investment firm?*

Answer - It is not clear what is meant by "deferred implementation", presumably allowing firms a period of time before they create an independent compliance function depending on the size of the firm. If the question assumes a time limit after which all firms must, regardless of their size and other factors, have an independent compliance function then there should be no such time limit.

5.3 **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 and activities or should paragraph 9(b) be deleted and reliance be placed on the status and responsibilities of the outsourcing investment firm?*

Answer - Paragraph 9(b) should be deleted and reliance should be placed on the status and responsibilities of the outsourcing investment firm. **Justification** - A rule such as 9(b) could have a material impact on investment management structures

where a fund manager delegates to local sub-managers investment management in appropriate local jurisdictions. There may be no formal authorisation in the relevant jurisdiction, and often no formal relationship between any such regulator and the applicable EEA regulator. The proposal would have the undesirable effect of clients being asked to appoint fund managers in a non-EEA jurisdiction, with the EEA fund manager acting as delegate rather than the other way round. In the latter case the client would have far more protection. Moreover, no distinction is made between categories of clients - a sophisticated client should be permitted to appoint an EEA regulated investment firm provided it is informed that is that firm's business model to delegate certain investment management functions to local managers who are not authorised. More weight should be given to client consent. The position would be even worse if a rule such as 9(b) was extended to the delegation of other investment services, for example the execution of transactions as agent. What if the only counterparty or broker dealing in the relevant investment would not meet the criteria? Is instructing an agent to deal outsourcing?

Other comments on the draft advice

5.4 **Page 15, box 1, paragraph 3** - The draft rules suggest that senior management collectively, rather than specified individuals, are to be responsible for compliance. This may be politically necessary but it detracts from individual responsibility in members of senior management, which we advocate in paragraph 5.1 above.

5.5 **Page 16, box 1, paragraph 5** - We agree that the compensation provisions should apply only to investment firms when they deal with retail clients but we also suggest that it is disproportionate to require a complaints handling procedure in the case of non-retail clients. The whole of paragraph 5 should be restricted to retail clients or, ideally, to a sub-category of private individual retail clients who require these protections (please refer to paragraph 3.8 above).

5.7 **Page 16, box 1, paragraph 5** - The requirements in relation to personal transactions apply to all "relevant persons" (see our paragraph 4.2 above) who have access to price sensitive information or who are subject to conflicts of interest. We are concerned that there is no exception in the case of a sole trader whose regulated activities consist only of own account transactions.

Significant drafting points

5.8 **Page 17, box 1, sub-paragraph 7(d)** - This sub-paragraph is misnumbered - there is no sub-paragraph 7(c). More important, this sub-paragraph should expressly apply only to a person falling with sub-paragraph 7(a). In sub-paragraph 7(e)(ii) add "(except as aforesaid)" after the word "transaction" i.e. except in the proper course of its employment.

Obligations related to internal systems, resources and procedures (Arts. 13(4) and (5) second sub-paragraph)

Specific questions

6.1 There are no specific questions on this topic.

Other comments on the draft advice

6.2 Generally, we welcome an approach that is not too detailed and which is non-prescriptive. We agree with the general approach of placing the onus on the firm to ensure that its internal systems, resources and procedures are "appropriate and proportionate".

6.3 We have referred elsewhere, for example in paragraph 5.1, to the absence of responsibility attributed directly to individuals within a firm. The allocation of responsibilities would be much more straightforward, and the troubled requirement for "independence" could be dropped if the concept of an "approved person" were adopted. Direct regulation of individuals through the "approved persons regime" in the UK has had a marked positive impact because in our experience senior management do take their regulatory responsibilities more seriously as a result.

Significant drafting points

6.4 **Page 19, box 2, paragraph 1** - Other criteria should be added against which to measure systems, resources and procedures, such as whether they adequately protect against the firm being used to further financial crime.

6.5 **Page 19, box 2, sub-paragraph 1(b)** - CESR's advice should differentiate between those matters which are within a firm's control and which are reasonably practicable to address, and those which are not. Where, for example, business interruption is caused by an event such as a terrorist attack, a significant interruption to services may be unavoidable. Therefore, it may be preferable to couch this provision in terms of remedying the interruption "as soon as reasonably practicable".

6.6 **Page 19, box 2, paragraph 2** - Although not expressed as such, it seems to us that the principles set out in sub-paragraphs (a) to (f) are likely to be read as amounting to minimum standards which must apply to all firms, irrespective of their size or the nature of their business. We query whether they will be appropriate in all cases. In particular, the requirement to have "documented" decision making processes may be disproportionate in the case of a small firm.

6.7 **Page 20, box 2, sub-paragraph 6(a)** - We do not understand what is meant by "adequate search applications".

6.8 **Page 21, box 2, sub-paragraph 8(c)** - Provision should be made for the compliance and other relevant functions (see our comment about the different functions in paragraph 6.7 above) to have (a) unrestricted access to information and (b) sufficient resources.

In sub-paragraph 8(c)(4), it is unclear what is meant by the word "professionally" in "professionally competent". Is this a requirement to appoint a qualified accountant or other "professional" to the role of internal audit?

6.9 **Page 21, box 2, paragraph (c)(2)** - The reference to "the supervisory function" is unclear. Provision should be made here for swift reporting by the internal audit function in urgent cases.

Obligation to avoid undue additional operational risk in case of outsourcing (Art. 13(5) first sub-paragraph)

Specific questions

7.1 There are no specific questions on this topic.

Other comments on the draft advice

7.2 CESR comments that the draft technical advice on the first sub-paragraph of Article 13(5) "delivers principles to be applied by investment firms". We welcome CESR's stated objective of setting out principles to be applied in situations where investment firms outsource material operational functions and generally agree with, and recognise the need for, the principles set out in the draft advice.

7.3 However, by way of general comment, we suggest that:

(a) instead of imposing specific obligations on all investment firms, the principles give the competent authorities the rights or powers to implement and apply the principles in each jurisdiction in a flexible manner, as they are best placed to ensure the appropriate and proportionate application of the principles in consultation with the markets they supervise; and

(b) as currently drafted, some of the principles are too prescriptive (and are indeed referred to in the draft advice as "rules"), resulting in an approach that is in danger of hampering development due to a lack of flexibility.

7.4 All of the draft rules are mandatory where there is outsourcing within paragraphs 1 and 2, subject to paragraph 5. This is in stark contrast with the outcome of other work where it has been concluded that investment firms must be permitted a flexible approach to the management of outsourcing in their businesses, not least because outsourcing takes many forms.

7.5 There is a significant and unwelcome overlap between CESR's draft advice and the work of other international organisations. For example, the Basel Committee published its report "Outsourcing in Financial Services" in August 2004 and The Committee of European Banking Supervisors has just closed its April 2004 consultation: "The High Level Principles on Outsourcing". Investment firms must not find themselves subject to overlapping (and possibly contradictory) requirements from different regulators in relation to the same outsourcing.

7.6 We therefore suggest that, in place of detailed rules at level 2, this topic be the subject of high level principles and/or guidance at level 3. The draftsperson of the guidance will be able to draw on the work of the Basel Committee and CEBS.

7.7 In this context, the concept of responsibility imposed on individuals within a firm would again be helpful. One individual might take responsibility for outsourcing by the firm, which would obviate the need for detailed rules.

7.8 Please refer to Schedule 2, which is a mark-up of box 3, which begins on page 23 of the consultation document. Our comments on the amendments are in the following paragraphs.

Significant drafting points

7.9 **Page 23, box 3, paragraphs 1 and 2** - There is a lack of clarity in the scope of these provisions, which are too prescriptive and unduly restrictive. We are not sure how the words "which could otherwise be undertaken by the firm itself" should be interpreted? Any firm *could* provide additional services itself: for example, an investment manager could become a broker (albeit that this would be a costly change to its business model); when it appoints a broker is this an example of outsourcing within paragraph 1?

It would be helpful if CESR defined "outsourcing" by way of high level principle as to what is or is not critical, leaving the detail to competent authorities to prescribe in a proportionate and appropriate way in the light of the individual circumstances of the markets and investment firms in their jurisdiction. As a practical matter, outsourcing must be by reference to the services which an investment firm has agreed to provide to its clients.

Principles, or guidance, must take account of disclosure and investor consent. Where a client has willingly entered into a relationship with a service provider whom it knows will delegate the whole, or substantially the whole of its functions, to an identified delegate or class of delegates, this should be permitted without prescriptive rules.

This problem with scope illustrates why the topic would be better suited to high level principle or to guidance at level 3.

In paragraph 2, we suggest the removal of the reference to an investment firm's reputation, as this goes beyond the first sub-paragraph of Article 13(5).

7.10 **Page 23, box 3, paragraph 3** - It clearly cannot be assumed that the outsourcing arrangements described in this paragraph would be material in every case. It may be true for a large number of good-sized investment forms, but not necessarily so for small independent investment advisers, for example. As a result, with the materiality test set out in paragraph 2, we suggest the deletion of this paragraph in its entirety to avoid unnecessary confusion and uncertainty.

7.11 **Page 23, box 3, paragraph 4** - We are uncertain as to the intended scope of and application of this provision, which purports to provide relief from the draft rules where outsourcing is intra-group. In any case, it should be left to the competent authority to decide how to treat material intra-group outsourcing as the topic is better suited to high level principles and/or guidance at level 3.

7.12 **Page 23, box 3, paragraph 5** - With the description of outsourcing and the materiality test above, it is unclear why the particular arrangements set out in sub-paragraphs (a) to (e) have been chosen. Although sub-paragraph (c) is intended to carve out material outsourcing arrangements where the outsourced services are

provided by an appropriately authorised service provider, the provision as currently drafted does not necessarily have this effect. On balance, though, we believe that a non-exhaustive list of tests for materiality, appropriately drafted, would be helpful.

7.13 **Page 23, box 3, paragraph 6** - The way this provision is cast evidences some confusion between the regulatory and contractual effects of outsourcing. We assume that CESR is not attempting to change the contractual position of parties to an outsourcing agreement. We suggest deletion of the last sentence as it is legally uncertain and does not add to this provision. The principles behind this sentence should be dealt with under Article 13(4) and the second sub-paragraph of Article 13(5), regarding systems and controls requirements, since if an investment firm outsources its functions so that it is left as no more than a shell, it is likely to fail to meet the systems and controls requirements.

7.14 **Page 24, box 3, paragraph 7** - This provision should be recast to give each competent authority the right to require prior notification and other information, if deemed necessary. It should not take the form of an obligation on investment firms.

7.15 **Page 24, box 3, paragraph 8** - Again, this provision should not take the form of an obligation on investment firms. It appears that the second sentence is intended to clarify the obligation set out in the first sentence but, as currently drafted, it operates as a separate obligation. Given the variety of potential outsourcing arrangements, it is likely to be difficult to assess compliance with this provision as a rule. Accordingly, it would be better to devolve this to the competent authorities.

7.16 **Page 24, box 3, sub-paragraph 9(a)** - This provision is too prescriptive: it appears to be more about systems and controls than outsourcing. An outsourcing policy may be advisable for an investment firm but it is not clear why a small investment firm outsourcing on a one-off basis would require a policy before entering into such an arrangement.

7.17 **Page 24, box 3, sub-paragraphs 9(f) and (g)** - This provision should not be drafted as an obligation on investment firms, but as a right of the competent authority. This would enable each competent authority to implement these principles in a proportionate and appropriate manner, taking into account the variety of markets and investment firms within its jurisdiction. Furthermore, this provision should not be as prescriptive as currently drafted but should take the form of a non-exhaustive list of matters the competent authority may have regard to in determining compliance with the principle set out in paragraph 8.

Record keeping obligation (Art. 13(6))

Specific questions

8.1 **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?*

8.2 **Answer** - There should not be a separate obligation because it is contrary to concepts of due process and because it would be disproportionate. Would it follow that a competent authority would assume that there had been a breach unless the investment firm could prove otherwise? There must be a significant doubt as to what records an investment firm might keep in order to demonstrate its compliance. Ultimately, it is impossible to prove a negative.

We appreciate that this an example of an issue which has, for some time, been the subject of CESR standards. Whilst we appreciate that CESR standards were the subject of consultation, CESR will acknowledge that, given the volume of change to law and regulation in the financial services sector in recent years, none but the largest firms will have had the resources to consider CESR's past consultations in the same detail in which they must now consider draft rules which will bind on them directly. Firms will have assumed that CESR standards had been reflected in local law and regulation. It is in this context that it is appropriate to reopen the debate on matters which CESR may have considered closed.

We also believe that CESR's draft advice may go beyond the mandate set by the Commission.

8.3 **Question 4.2** - *What should the nature of the record keeping requirement be in relation to i) capital markets 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, financing, dividend policy etc?*

8.4 **Answer** - CESR should not attempt to be too prescriptive at level 2. The question relates to a very wide range of business from wholesale to classic retail private investment, such that no appropriate detailed requirement could ever be set. The only practical and proportionate rule would require an investment firm to keep records of substantive investment advice given to retail customers who are individual private investors (see paragraph 3.8 above).

Other comments on the draft advice

8.5 We have no comments on this topic outside our responses to CESR's specific questions.

Significant drafting points

8.6 We have no comments on the drafting in relation to this topic.

Safeguarding of clients' assets (Arts. 13(7) and (8))

Specific questions

9.1 **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 subdeposit 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?*

9.2 **Answer** - There should be no such requirement. There is advantage in retaining flexibility, not least because of the frequent and legitimate use, for example, of unregulated nominees and solicitors' client accounts. There are factors other than its regulated status which bear on the suitability of a potential depository, for example, its financial standing.

9.3 **Question 5.2** - *Should a requirement be imposed that the records of the investment firm must indicate for each client the depository with which the relevant clients' 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 paragraphs 11(c) and 13(b)?*

9.4 **Answer** - There should be no such requirement: records and reconciliations should be performed at the aggregate level. To maintain records at the level of individual clients would (in England at least) expose a firm and its clients to the artificial and complicated rules of tracing (such as first-in, first-out) in the event of insufficiency of the fund of assets. These result in arbitrary discrimination between clients: a matter of luck. Firms and clients generally agree that commercial best practice is to favour loss allocation based on a pro rata sharing. It is inconsistent with fungible holdings, which support pro rata division of losses, to inject a degree of non-fungibility by requiring that firms record individual entitlements. No useful purpose would be served by additional record keeping which might be commensurate to the additional cost: particularly since it is open to a client, as a matter of commerce and of contract, to require that its entire holding be placed with a particular nominated depository and kept as a discrete pool on a separate trust. To impose the requirement would therefore be a restriction on the client's freedom of contract.

9.5 **Question 5.3** - *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 all to exclude or limit its responsibility for loss of the investment directly arising from its failure to exercise 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 and periodic review of the depository?*

9.6 **Answer** - Both options (a) and (b) are unacceptable because they are both disproportionate and would give rise to systemic risk.

CESR should think very carefully before prescribing any position on the extent of an investment firm's liability. At its simplest, it would be objectionable because it would restrict an investment firm and its clients' freedom to contract. There are also issues of fair treatment: why should a custodian (which provides only ancillary services and is not therefore an investment firm) be permitted to exclude or limit its liability, but an investment firm may not?

If CESR insists on setting rules in this area, then a variation of option (a) would be preferred. Limb (i) of option (a) should be deleted because the extent of a firm's liability is properly a matter of contract, particularly in the professional market. A similar rule might instead apply only to a firm when it deals with retail clients who are private individual investors (see paragraph 3.8), but again this should only be if CESR identifies a way in which their rights are not sufficiently protected by unfair contract terms legislation. In the context of the wide definition of "depository" used by CESR to refer both to (a) clearing systems and settlement systems, and (b) custodians and nominees, an investment firm should certainly not be required to be responsible under such a rule for depositories which are clearing systems and settlement systems.

There are two more technical points: (1) it is unclear what is meant by "directly arising": is this an attempt to distinguish between direct, indirect, special and consequential loss? In England, at least, this is a vexed issue; and (2) it would, in any case, be necessary to adopt an appropriate definition of "group" for these purposes. The Investment Services Directive adopted the accounting definition, which is to be preferred to alternatives, for example that in the UK Financial Services and Markets Act 2000, which draws on the concept of a "participating interest".

Other comments on the draft advice

9.7 CESR's draft advice is generally more detailed than necessary. Please refer to our comments in paragraph 3.2 above.

9.8 **Page 35, box 5, sub-paragraph 5(c)** - The information requirements in this sub-paragraph are particularly detailed and disproportionate to professional or wholesale clients. Their scope should be confined to retail clients who are private individual investors (see paragraph 3.8).

9.9 **Pages 35 and 36, box 5, sub-paragraph 8(b)** - Query to what extent this requirement is achievable. CESR already makes reference to "market practice". Please refer to our answer to Question 5.2 in paragraph 9.4 above.

9.10 **Page 38, box 5, sub-paragraph 13(b)** - We will welcome elaboration of this rule at level 3.

Significant drafting points

9.11 **Page 34, box 5, sub-paragraphs 4(a) and (b)** - In English law, at least, the word "guarantee" carries particular legal significance. It would be preferable use the word "ensure".

Conflicts of interest (Arts. 13(3) and (18))

Specific questions

10.1 **Question 6.1** - *Should other examples of methods for managing conflicts of interest be referred to in the advice?*

10.2 **Answer** - Yes, provided that the list of measures is stated to be examples, rather than measures which must be taken. Disclosure and express consent should be added as examples of a way to manage conflicts, on its own or in conjunction with other techniques. For example, in the UK corporate finance market, introducers (companies, venture capitalists, accountants and managers) widely expect banks to adopt a multi-bid policy, whereby different teams in the bank promote different deal structures. These teams are typically separated by information barriers. In addition, some banks have (in order to discharge possible duties under English common law) adopted policies whereby the different introducers are informed (a) from the outset that the bank operates a multi-bid policy and (b) when an actual conflict arises.

10.3 **Question 6.2**

(a) *Should paragraphs 8(a) to (f) (or the final list of measures for managing conflicts of interest adopted in response to question 1) be stated as examples of arrangements that may, depending on the circumstances referred to in paragraph 5, be effective methods of providing an appropriate degree of independence in respect of persons engaged in different business activities?*

(b) *Alternatively, should there be a requirement for an investment firm to include these measures in its conflicts policy to the fullest extent possible unless it is able to demonstrate that it has implemented alternative arrangements for effectively preventing conflicts of interest from adversely affecting the interests of clients?*

(c) *If the answer to question (b) is yes, which of these measures should be subject to the requirement referred to in that question?*

10.4 **Answer** - Of the two alternatives only the first (10.3(a)) would be acceptable. Firms should be in a position to decide for themselves which would be appropriate measures depending on the factors set out in paragraph 5. It should be clarified that the list is not exhaustive, so that other methods of managing conflicts may, in certain circumstances, be effective too. The contents of the list in paragraph 8 are in some cases also very vague and therefore unsuitable as a list of prescriptive requirements. This would also be impractical in the case of small firms or those which involve reporting lines across different activities.

10.5 **Question 6.3**

(a) *Is it appropriate for an investment firm that publishes or issues investment research to maintain information barriers between analysts and its other divisions?*

(b) *If so, which divisions should be separated by information barriers in order to prevent analysts' research from being prejudiced?*

10.6 **Answer** - It may be. But this should be left open to the firm's judgement. It has obligations to adopt a policy for managing conflicts under Part II. Establishing information barriers is just one of the techniques for managing conflicts, and its appropriateness must depend on the criteria set out in paragraph 5.

10.7 **Question 6.4** - *Should the derogation from the requirements in paragraph 16(f)(i) to (v) be available if:*

(a) *the investment firm complies with the requirements in paragraphs 17, 18 and 19 of the first option set out below; or*

(b) *the investment firm complies with the requirements in paragraph 17 of the second option set out below?*

10.8 **Answer** - If non-independent research is to be permitted then the second of the two alternatives would have to be adopted. The first option (especially coupled with the requirements for disclosures for "research recommendations in the Market Abuse Directive) is too onerous. Investment research may, as a result, become much more expensive than it currently is, or the regulations may encourage firms not to issue any investment research at all, so depriving the markets of information.

What is the objection to non-independent research as long as users are aware of the fact? Counterparties and clients should be able to assess information on the basis of "where it came from". The objective of rules on conflicts of interest must be to prevent firms from misleading clients: to the extent that the client knows that what it is getting is not independent research there is no issues.

There is also the general question as to whether it is necessary for the draft rules to be so prescriptive generally. There seems no reason to effectively ban non-independent research. Some markets may be so small as to fail to attract independent research.

Other comments on the draft advice

10.9 Care should also be taken to distinguish between obligations and guidance. We welcome CESR's stated objective of setting rules that can be of universal application. If CESR wishes to make the measures appropriate for all firms, it would be best to adopt guidance rather than prescriptive rules.

10.10 CESR comments that a balance needs to be struck between the conflicts of interest measures that fall under Articles 13 (3) and 18 and those best dealt with under other articles. This seems a sensible approach. In addition, CESR says that the conduct of business provisions in the Directive and various provisions of the Market Abuse Directive (MAD) relevant to conflicts of interest, in particular in relation to the execution of orders, front running and disclosures to be made in research recommendations are meant to be complementary. Again, this approach is encouraging. CESR should consider the cumulative effect of the Directive and MAD very carefully, especially in the context of research recommendations.

10.11 CESR's draft definition of "investment research" (set out on page 8) refers to the ancillary service in Annex I of the Directive and therefore catches "general recommendations". If is not appropriate to subject general recommendations to the same standards as those applied to what is generally understood to comprise investment research. The definition is also different from the definition used in the Market Abuse Directive, which is not helpful in achieving a unified regulatory regime for investment research.

10.12 **Page 43, box 6, paragraph 1** - To the extent that paragraph 1(a) refers to any situation where the firm stands to profit or avoid a loss to the detriment of the client it covers all profit making activities. It would certainly include genuine principal trades with a firm's client where there is no advisory or fiduciary relationship: this is clearly not the intent and the drafting should be clarified.

In relation to sub-paragraph 1(c), in particular, CESR's advice is too detailed: this should properly be left to level 3.

10.13 **Page 44, box 6, paragraph 4** - It is not possible to both prevent and manage a conflict of interest. Conflicts are prevented by eliminating them or by not acting for a client or for own account, or they are managed using various techniques, such as setting up information barriers or disclosure and consent.

10.14 **Page 44, box 6, sub-paragraph 5** - Another example might be added: "the level of sophistication of the investment firm's clients". The less sophisticated the client, the more likely that conflicts of interest will damage its interests. The conflicts policy of a firm which deals with professional investors or eligible counterparties should not have to be the same as the policy of a firm that deals mainly with retail investors.

In the final sentence, after the words "structure and business or the other", add "relevant". CESR's explanatory text says that an interest arising in relation to non-investment business would be relevant only where it leads to a conflict that arises in the course of the provision of an investment or ancillary service. This test should apply also in relation to investment businesses; hence the suggestion for referring to "relevant" members of the group. Competent authorities may be able to provide further guidance on when a group member would be relevant for these purposes.

10.15 **Page 44, box 6, paragraph 6** - CESR's draft advice provides that arrangements must to the fullest extent practicable include effective methods of providing an appropriate degree of independence in respect of the persons engaged in business activities involving a conflict of interest. The exact meaning of this is unclear, for example, in the context of proprietary trading. How does it extend beyond an obligation to provide "fair treatment"? This is the language which we would prefer.

The provision is, in any case, too prescriptive. Having identified conflicts of interest, it must be possible for the firm to choose how to prevent or manage those conflicts. For example, when dealing with a client that is an "eligible counterparty" or "professional investor", it should be possible to manage the conflict of interest using disclosure and consent, as opposed to setting up information barriers, as the

phrase "appropriate degree of independence" suggests. In other words, there should be circumstances in which the firm may continue to act if the client expressly consents to the firm acting where it knows that the firm is not independent.

10.16 **Page 44, box 6, paragraph 7** - There is a specific requirement that as far as possible there be separation of persons engaged in proprietary trading, portfolio management and corporate finance, unless the firm can demonstrate that it has implemented effective alternative arrangements. We believe that the requirement might be better phrased as "information barriers between those persons". Nevertheless, we think that separation or information barriers would be problematic for proprietary trading because separating proprietary traders from the rest of the firm's activities would mean that they could not have adequate exposure to the market nor properly control the risk they were taking in the context of the exposure of the investment firm as a whole. In many cases, particularly in relation to the activities of proprietary trading and portfolio management, an obligation of disclosure to, and obtain consent from, clients should be sufficient protection. Please refer to our comments in the preceding paragraph.

10.17 **Page 44, box 6, sub-paragraph 8(b)** - The concept of "separating supervision" requires clarification, since there will come a point at which supervision comes together in senior management. We suggest reference to "direct" supervision.

10.18 **Page 45, box 6, sub-paragraph 8(c)** - The effect of this method of managing a conflict of interest would be to prevent the payment of bonuses by reference to the overall performance of the firm. This is presumably not CESR's intention, and the drafting should be clarified.

10.19 **Page 45, box 6, paragraph 9** - We question why inducements must reasonably assist the investment firm in the provision of services, even if they do not lead to a conflict of interest. We suggest that an investment firm should be permitted to offer or receive inducements which do not assist the investment firm in the provision of services even if there is a conflict, provided it obtains its client's consent.

In any case, the term "inducement" (used also in paragraphs 10 and 11) should be defined: does it extend beyond receipt of soft commissions? If the term goes beyond soft commission arrangements, an ongoing disclosure policy in relation to all forms of permitted inducement would seem extremely difficult to implement.

10.20 **Page 45, box 6, paragraph 11** - The obligation in sub-paragraph (a) is fine in relation to new clients, but CESR should clarify how firms are to deal with existing clients. Will all existing clients have to be "repapered" and, if so, when? We suggest that there might be reference to "materiality", as in page 45, box 6, paragraph 4.

There should be an exception to this rule where: (a) the client is habitually resident overseas and has requested the investment firm not to inform the client of inducements; or (b) the investment firm has information from which it is reasonable to conclude that the client does not wish to receive the information.

10.21 **Page 46, box 6, paragraph 12** - We consider this obligation to be super-equivalent to the Directive and outside the mandate set by the Commission. If there is a need for this level of protection, it should be confined to retail clients, and only those who are private individual investors (see paragraph 3.8 above).

10.22 **Page 46, box 6, paragraph 15** - This rules as drafted applies to all investment research, not only investment research which purports to be impartial. Its scope should be narrowed. Please refer to our comment on non-independent research in paragraph 9.8 above.

10.23 **Page 47, sub-paragraph 16(f)(ii)** - After the words "analysts must not be", insert the word "directly". At some level in the organisation , there will be individuals responsible for divisions or teams who have clients with conflicting interests. There should be no bar on senior management fulfilling this role. This is consistent with CESR's comment that regulators should not require firms to disaggregate their business.

10.24 **Page 47, sub-paragraph 16(f)(iv)** - Presumably analysts could become involved in such activities if they were not also producing independent research in relation to the relevant issuer. In other words, can CESR clarify that firms may still be able to "bring analysts over the wall"?

Significant drafting points

10.25 We have no comments on the drafting of this advice, other than those which are issues of substance, referred to above.

Fair, clear and not misleading information (Art. 19(2))

Specific questions

11.1 There are no specific questions on this topic.

Other comments on the draft advice

11.2 The mandate to CESR recognises the need to take account of other relevant provisions of Community law. We are very concerned that Community law on marketing communications is increasingly imposing detailed requirements on communications with potential customers using significantly different definitions of the type of person who is to be protected or type of communication covered. For example the concept of an offer to the public, and express exclusions from that concept, in the Prospectus Directive are radically different from the proposed provision in the draft advice definition that information is issued to the public if it is designed for, directed at and/or addressed to "a number" of people, with the only express exclusion being that information directed at one specific person or group of persons acting jointly is not regarded as addressed to the public.

We believe that aspects of this definition have been drawn from recent UK legislation and regulation which should not be applied across the Community as they are not consistent with any general understanding of an advertisement or marketing communication. Applying the definition as it currently stands means that a communication which is made to even two people may be regarded as made to the public and therefore have to comply with the more detailed provisions applicable to public advertising.

Even if the reference to the "public" in a marketing communication is not made entirely consistent with the Prospectus Directive we recommend that:

(a) it should refer to a substantial (e.g. more than 100) number of people in the Community;

(b) it should be made clear that information is not to be regarded as "designed for, directed at and/or addressed to" people if it is clear on the face of the information or from surrounding circumstances (e.g. procedures at the relevant firm relating to responses to the advertisement) that such people, even if they actually receive the information, are not its intended audience. Clarification of this point in the definition would also help to alleviate the concern expressed in paragraph 11.6 below on Box 7 sub-paragraph 3(a).

11.3 We agree with the explanatory text setting out why almost all the detailed provisions in Box 7 should apply only to retail communications. However we believe that the same reasoning justifies a more limited application of the detailed provisions (though not, of course, the general obligation to be fair, clear and not misleading) because such detailed mandatory provisions are only necessary for communications with a very uninformed consumer audience (such as individuals acting otherwise than in the course of their business, which would be consistent with other

Community marketing law), not for all of those falling within the MiFID definition of retail clients.

11.4 Explanatory text on page 50 of the draft advice indicates only that the advice is without prejudice to the Prospectus Directive. We recommend that, rather than impose an additional regime on top of that Directive, any advertisements produced in accordance with that Directive should be excluded from the detailed draft advice in Box 7.

11.5 **Page 50, box 7 generally and, in particular, paragraphs 3, 4 and 8** - In our opinion, CESR's advice goes into far too much detail for a clause which generally requires absolute compliance (rather than indicating factors which might be relevant to assessing compliance). For example, having established that communications must give a fair and adequate description of benefits balanced against risks, it is unnecessary to go on to state that key items (whatever this might mean) contained in the information must be given due prominence (paragraph 3(b)), that warnings must be given in a way that does not disguise them (paragraph 3(c)), and that the communication does not omit information required to ensure it is fair, clear and not misleading (paragraph 3(d)). All of these requirements are unnecessary embellishments on the requirement that the communication must give a fair balance between benefits and risks. We recommend deleting all of paragraph 3. Further, we do not understand what paragraph 4 means or what firms might do to ensure compliance with it.

11.6 **Page 50, box 7, sub-paragraph 3(a)** - CESR proposes requiring that information must be "likely to be understood by the average member of the group to whom the communication is directed or addressed".

First, this requirement should be without prejudice to any of the other mandated requirements related to communications. As an example of the importance of this caveat, in our opinion, explanations of the potential credit risks of any guarantor (required by page 58, box 8, paragraph 10) are either unlikely to sufficiently describe the risk as to be fair or are unlikely to be understood by the average member of any widely-drawn group if they are fair.

Second, we do not understand why the communication must be likely to be understood by the average person in the group to whom the communication is directed. It could be that a communication relating to a particularly sophisticated product is widely distributed, on the basis that the suitability requirements set out elsewhere in the Directive would require the firm only to deal with investors for whom the product was suitable (or who were otherwise exempt from this requirement). If the average member of the group to whom the communication is directed must be able to understand it, this would prevent any widespread communication related to any sophisticated product. We recommend deleting 3(a) and think that the Directive's objectives will be better served by the broad fair, clear and not misleading requirements than any "average recipient" requirements.

11.7 **Page 51, box 7, sub-paragraph 7(b)** - CESR proposes that the competent authority may consider factual claims as inaccurate if the evidence demanded by the competent authority is not furnished or is "deemed insufficient" by the competent authority. It is not appropriate for a breach to be established because information

provided is deemed insufficient by the competent authority. To do so would mean that, even if the competent authority was wrong in considering the information insufficient, a breach would have occurred. In fact, firms should have recourse to an appeals process to consider whether the information is sufficient or not. We would recommend redrafting (b) as follows:

"Consider factual claims as inaccurate if the evidence demanded in accordance with (a) is insufficient to outweigh any evidence of inaccuracy."

11.8 **Page 51, box 7, paragraph 8 -** This sets out a detailed list of requirements for communications. These may not all be appropriate in all circumstances. For example, describing the absence of a right of withdrawal may not be appropriate when the financial instrument is not of a type where a right of withdrawal exists. Only sub-paragraph 8(a)(ii) is limited by "unless such a reference would be inappropriate" wording. We suggest similar wording at the start of paragraph 8. We would redraft paragraph 8 as follows:

"Where appropriate taking into account the financial instrument and/or investment service involved, when an investment firm makes...."

11.9 **Page 52, box 7, paragraph 13 -** We do not understand why it is automatically inappropriate for a firm to use simulated historic returns as part of the information provided to retail clients. Simulated historic returns may be an appropriate part of the information to be provided to a retail client. Investment firms would still be under an obligation to ensure that the communication as a whole was clear, fair and not misleading, notwithstanding the inclusion of a simulated historic return. We would delete paragraph 13.

11.10 **Page 52, box 7, paragraph 14(b)(iv)** - It is not appropriate to require firms to state figures in the local currency in all circumstances. For example, if a UK-based client entered into a €/US$ currency swap, there would be no point in setting out the figures in £, nor including any reference to local currency risk. We would delete paragraph 14(b)(iv).

Significant drafting points

11.11 We have no comments on the drafting of this section of the advice, other than points made above.

Information to clients (Art. 19(3))

Specific questions

12.1 There are no specific questions on this topic.

Other comments on the draft advice

12.2 As a general observation, we believe that CESR has gone much further in its draft advice than is contemplated by Article 19(2). We also note that the impact of the rules will be particularly powerful because of the broader definition in the Directive of "retail client". There is no mention of tailoring the information to the client's objectives and we believe that this would be helpful.

12.3 **Page 56, box 8, paragraph 4** - The draft rules are incredibly detailed and complicated. Paragraph 4(b) sets out the information to be given "subject to the explicit consent of the retail client or potential retail client", which suggests that more detailed information could be given if the client does not consent to the "short-form" details set out in paragraph 4(b). It is difficult to think what the more detailed information might be. As a practical matter, how is a client to give explicit consent if the investment firm has not already told them what information it proposes to withhold? Nor will a firm necessarily know at the beginning of a call what product or service it might provide: particularly if the retail client calls the firm, as opposed to vice versa. A similar rule would be more appropriate under Article 19(2): fair, clear and not misleading information.

12.4 **Page 57, box 8, sub-paragraph 4(b)(iii) and sub-paragraph 7(c)** - These rules require information to be given about the total price to be paid by the retail client to the investment for the financial instruments and/or investment services, including all fees, commissions, expenses and all taxes paid via the investment firm relating to the transaction. It is difficult to give all this information at the outset before services are provided, especially taxes and commission which are subject to frequent change. A firm could provide no more than an estimate or in some cases give a general description of the type of costs that arise. This should be explicitly acknowledged.

12.5 **Page 57, box 8, sub-paragraph 4(b)(iv) and sub-paragraph 7(c)** - These rules require notice of the possibility that other taxes or costs may exist that are not paid via the investment firm or imposed by it. Depending on the product, this should be a general warning about capital gains tax or inheritance tax, otherwise it will be a disproportionate burden on the firm. The rule should be clarified.

12.6 **Page 58, box 8, sub-paragraph 7(g)** - This rule requires information on any limitation on the period for which the information provided is valid. This will be a burden as, in practice, this may mean that firms update the standard terms of business at more regular intervals in order to satisfy this provision.

12.7 **Page 58, box 8, sub-paragraph 8(b)** - This rule requires that if various other investment firms are to be involved in a transaction or investment service, there should be an estimate of the other fees available. We appreciate that this is designed

to make the costs as transparent and competitive as possible, but it is likely to be a "guesstimate" and is also likely to confuse the client. The rule should be deleted.

12.8 Although there is provision for information about withdrawal (at paragraph 4(b)(v) and 7(f)), oddly there is no provision about termination of the service agreement between the investment firm and the retail client.

12.9 There are no exceptions from the draft rules for client information. Please refer to our general comment in paragraph 3.7 above. The equivalent UK rule is subject to various exceptions, which allow some investment business to take place where terms of business and client agreements are not required. For example, bringing about execution-only transactions or customers entering into transactions through a direct offer financial promotion. No such carve-outs are provided in CESR's advice, which would mean that the full information requirements would be applied to situations such as execution-only transactions. This is disproportionate.

12.10 **Pages 58 and 59, box 8, paragraphs 12 and 13** - There should also be a proportionate exception from these rules where a retail client is ordinarily resident outside the EEA and the firm has taken reasonable steps to determine that the client does not wish to receive the notice.

12.11 CESR might consider providing that competent authorities may set a standardised format for particular types of disclosure, which would alleviate some of the burden on firms.

Significant drafting points

12.12 **Page 59, box 8, paragraph 15** - There is a typographical error in the second line: delete "(?)".

Client agreements (Art. 19(7))

Specific questions

13.1 There are no specific questions on this topic.

Other comments on the draft advice

13.2 We believe that CESR's draft advice is unduly prescriptive. Our comments on Article 19(3) (information to clients) are equally applicable in this context. As a general matter, rules should be caveated "where appropriate" or "where reasonable", with the onus on the firm to assess appropriateness and reasonableness. For example, sub-paragraph 4(j) is inappropriate to an advice service. Others are inappropriate when investments are purchased through "off the page" advertisements, for example sub-paragraphs 4(g) and 4(i).

13.3 There should be exceptions from the requirement to provide a client agreement, for example, in respect of execution-only business with the client's consent.

13.4 In certain rules, for example **page 63, box 9, paragraphs 10(c) and 13**, CESR's advice strays into commercial provisions, which should properly be left to contract.

13.5 In the absence of grandfathering provisions, firms may well have to "repaper" all their clients, at great expense.

13.6 Provided that retail clients who are individual private investors (see paragraph 3.8 above) are offered an agreement complying with matters set out in box 9, all clients should be permitted to require alternative terms: some clients insist on using their own terms.

Significant drafting points

13.7 We have no particular drafting points on this topic.

Reporting to clients (Art. 19(8))

Specific questions

14.1 **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?*

14.2 **Answer** – Investment advice may be given in written form, or via electronic means, or orally. Insofar as advice is given in written form, the client will, by definition, have an adequate record of that advice. Insofar as advice is provided by electronic means, it is generally capable of being reduced by the client to written form or otherwise stored for later review.

The question therefore essentially relates to oral advice. Should firms be under an obligation to produce a written record for the client of any oral advice that may be given? We believe it is unnecessary, in this instance, to distinguish between retail clients and other clients. In all cases, we believe such a requirement would be unduly burdensome. It would impose on a firm a requirement, following any form of conversation with a client, to analyse which elements of that conversation, if any, constituted investment advice and then to reduce that element to writing and send it to the client. There will, of course, be circumstances in which that approach constitutes good and sound business practice and where it may be requested by the client. For small firms in particular, however, we believe that the administrative burden would be significant and would outweigh any likely advantage to the client.

We are also uneasy about the possibility that a subsequent written "record" of this kind could be used by unscrupulous advisers, under cover of the fulfilment of a legal requirement, to produce self serving and sanitised records of their own advice. Any client who did not review such a written record upon receipt and make an immediate complaint would be at greater risk than if the record had not been produced.

Our conclusion, therefore, is that any such requirement may be onerous and expensive for good firms and their clients (particularly small, good firms) and is unlikely to offer effective protection against those whose advice is defective, as the latter are unlikely to repeat the defects in writing.

Other comments on the draft advice

14.3 **Page 66, Box 10, Paragraph 1** – There are important exceptions to any general requirement that a firm should provide contract notes and confirmations. In many cases, the client does not wish to receive day-to-day communications about the individual transactions that a discretionary fund manager, for example, may have undertaken on the client's behalf. The client may prefer to receive aggregated information on a periodic basis. In rare cases, retail clients may, for legitimate reasons, prefer to collect even such periodic information from their bank, broker or fund manager, at the time of their own choosing, rather than have it delivered.

In addition, for small investors it may be uneconomic to require a discretionary manager to provide contract or confirmation notes on an individual basis. In these

cases, clients will frequently agree to accept aggregated periodic statements only, rather than be charged the additional expense that may be involved in delivering individual contract notes.

The latter point is less important if paragraph 1 is intended to concern itself exclusively with direct customer orders, rather than including those made on a discretionary basis on the client's behalf by a fund manager. If that is the intention, the position should be clarified but the need for exceptions, to cover the remaining circumstances described above, will still stand.

14.4 **Page 66, Box 10, Paragraph 2** – This paragraph, and the following paragraphs, are subject to the general comments made in relation to paragraph 1 above. In addition, it may be important to convey the thought that the information itemised in this paragraph represents the aggregate of information that the client may receive from a number of sources. Also, information that may be necessary in respect of an execution-only transaction or direct customer order, e.g. the settlement details described at sub-paragraph (k), may not be necessary in respect of a discretionary transaction, where settlement will take place upon instructions of the manager.

14.5 **Page 67, Box 10, Paragraph 3** – There are circumstances where it may be permissible for an order to be executed over a period of more than one business day, e.g. a large aggregated order in relation to an illiquid security. In these circumstances, it may be unhelpful to notify the non-fulfilment or partial fulfilment of the order, unless the client needs to be notified for settlement purposes.

14.6 **Page 67, Box 10, Paragraph 4** – The place to which confirmations, statements or other information may be dispatched must be subject to client instructions – see paragraph 1 comments above.

14.7 **Page 67, Box 10, Paragraph 5** –This is a useful exemption from the need to provide a contract note or confirmation but confining the exemption to the circumstance where the contract note or confirmation would "duplicate" a contract note or confirmation provided by someone else may be too narrow. We assume that the intention is that it should be sufficient if the essential details of the transaction are to be provided by someone else promptly and that this is therefore a matter of language rather than substance.

14.8 **Page 68, Box 10, Paragraphs 13 and 14** - The obligation set out in paragraph 13 is required to be carried out "immediately" whereas the obligation set out in paragraph 14 is required to be carried out "as soon as possible". It is doubtful if any meaningful distinction is intended and they should be conformed. It may be that both obligations should be carried out "as soon as reasonably practicable".

14.9 **Page 68, Box 10, Paragraph 16** – In sub paragraph (a) periodic valuations will not normally include performance measurement, unless this has been specifically agreed with the client. It is doubtful whether performance measurement should be a universal requirement. Unless there is specific and detailed agreement as to the parameters, the fund manager may choose whichever benchmarks will favour its performance and the result is at best likely to be unhelpful to the client. A

straightforward valuation at the beginning and end of the period is more helpful than an unconstrained performance assessment.

14.10 **Page 68, Box 10, Paragraph 18** – The requirement for the investment firm or fund manager to disclose all information on any remuneration received from a third party that is attributable to services performed for a retail client is likely to be too prescriptive. It should probably be confined to fees and commissions attributable to dealings in securities in the portfolio. Other indirect remuneration e.g. acquiring securities of a company in respect of which a subsidiary or affiliate firm has acted as sponsor or corporate finance adviser on a securities issue, should be the subject of disclosure as a conflict of interest but is not a matter in respect of which the client is entitled to a detailed account.

14.11 **Page 69, Box 10, Paragraph 20** – Again, the level of detail required by this paragraph may be too prescriptive in many cases. A client may neither choose, nor wish to pay for, three-monthly statements. In many cases in the retail sector, it is common for periodic statements to be sent once a year. It is doubtful whether the administrative costs involved in a change to six-monthly or three-monthly reporting will produce a consumer benefit for the many retail clients who will pay that cost.

Significant drafting points

14.12 We have no particular drafting points on this topic.

Best execution (Art. 21)

15.1 Our response to this section of CESR's consultation will follow by the extended deadline of 04 October 2004.

Client order handling (Art. 22(1))

Specific questions (Consultation page 84)

16.1 **Question 1** - *Do you agree with the definition of prompt, fair and expeditious execution of an order from a client? Do you think that it is exhaustive? If not, can you suggest any elements to complete this concept?*

16.2 **Answer** - CESR's advice offers no such definition, and we agree that it should not.

16.3 **Question 2** - *Do you think that the details of the orders included under paragraph 2 of the draft technical advice should apply also to professional clients?*

16.4 **Answer** - No. The details are far too prescriptive to be useful and we doubt they are appropriate for level 2, even for retail clients.

16.5 **Question 3** - *Which arrangements should be in place to ensure the sequential execution of clients' orders?*

16.6 **Answer** - The guiding principal should be fairness, rather than sequential execution. Sequential execution will generally be fair, but clients may agree different treatment and should be treated accordingly. Freedom to contract different treatment should be preserved for all types of client.

16.7 **Question 4** - *Do you agree with the reference in paragraph 7 of the draft technical advice to prevailing market conditions that make it impossible to carry out orders promptly and sequentially?*

16.8 **Answer** - It is unnecessary. The principle, which is quite reasonable, is that clients should be told whenever it is impossible to carry out their orders according to their instructions.

16.9 **Question 5** - *Do you think that the possibility that the aggregation of client orders could work to the disadvantage of the client is in accordance with the obligation for the investment firm to act in the best interest of its clients?*

16.10 **Answer** - Yes, there is no inconsistency between this practice and the general principle. It can be in general in the best interests of a firms clients to aggregate orders, even though on occasion some clients may be disadvantaged in particular cases. Whether or not an aggregation will benefit each client involved cannot always be known in advance. It is important that firms adopt aggregation policies with the right intentions.

16.11 **Question 6** - *Do you think that the advice should include the conditions with which the intended basis of allocation of executed client orders in case of aggregation should comply or should this be left to the decision of each investment firm?*

16.12 **Answer** - This should be left to the competent authorities, who may decide such matters in consultation with the markets they supervise.

16.13 **Question 7** - *Do you consider that CESR should allow the aggregation of client and own account orders? Do you think that other elements (i.e. in respect of the*

arrangements in order to avoid a detrimental allocation of trades to clients) should be included?

16.14 **Answer** - A general principle that firms should not place themselves at an unfair advantage over their clients would be sufficient.

16.15 **Question 8** - *Do you think that paragraphs 15 and 16 of the draft technical advice should only apply to retail clients?*

16.16 **Answer** - Yes and possibly only to a sub-category of retail clients (see paragraph 3.8 above).

Other comments on the draft advice

16.17 CESR should highlight the principles on which prompt, fair and expeditious execution of client orders depend. The level of detail of CESR's advice, however, goes beyond principles. CESR's advice is as prescriptive and sometimes more detailed than existing rules of competent authorities.

16.18 Further, we think that CESR may have exceeded its mandate, which is very specific. CESR is required to advise on "conditions" and "situations" set out in paragraphs (1) and (2) of the mandate.

"DG Internal Market requests CESR to provide technical advice on possible implementing measures by 30 December 2004 on:

(1) the conditions with which the order handling procedures and arrangements that investment firms have to set up shall comply in order to obtain prompt, fair and expeditious execution of client orders.

(2) the situations in which or types of transaction for which investment firms may reasonably deviate from prompt execution so as to obtain more favourable terms for clients.

To respond to these requests CESR should take into account the retail or professional nature of the client."

16.19 We suggest CESR's advice needs to address these questions, which are focussed on the procedures and arrangements which firms are to be required to put in place. It would be better to ensure that the level 2 measures are addressed to competent authorities and set out the main areas of principle which those competent authorities should focus on, in assessing a firm's "procedures and arrangements". If more detail is required, it should be framed in a permissive way, so that competent authorities may be permitted to "have regard to" specified factors in considering a firm's procedures and arrangements.

16.20 Please refer to the Schedule 1, which is a mark-up of box 11, beginning on page 81 of the consultation document. Set out in the following paragraphs are comments on the amendments. As a general observation, CESR's advice is framed throughout this section as direct obligations on the investment firm, and should be recast as a set of rules and principles for competent authorities to apply in setting rules for firms.

This will enable the competent authority to implement at level 3 on a proportionate, appropriate and flexible basis.

16.21 **Page 81, box 11, paragraph 1** - As framed, this appears to be a comment on the scope of Article 22(1), which appears to be outside the scope of CESR's mandate to advise. It is neither a "condition", nor a "situation" of the kind referred to in numbered paragraphs (1) and (2) of CESR's mandate. The same comment can be made in relation to many other paragraphs in this section.

The point in sub-paragraph (a) is, in any event, open to a variety of interpretations. It seems reasonable, however, that in determining whether a procedure is fair, the competent authority should consider the position of orders against investment management decisions.

16.22 **Page 81, box 11, paragraph 2** - This rule is prescriptive and descends to a dangerous level of detail. The Directive covers a very wide array of markets and details of possible orders in those markets will change and develop as those markets develop. The appropriate level of detail for some orders might be more than is included in CESR's advice - it might be less for others: the competent authority is best placed to decide. Imposing an obligation at level 2 of this nature could have far-reaching implications for firms established IT systems with little regulatory advantage gained.

16.23 **Page 81, box 11, paragraph 3** - The manner in which firms trade with clients from their own book vary from market to market. The implications even within a jurisdiction vary from exchange to exchange - the consequences for clients on the London Metal Exchange differ from those on other markets. The competent authority is best placed to decide how to ensure fair treatment for clients, given the peculiarities of any local market. This is an issue better dealt with in the rules and principles dealing with conflicts of interest (to which it is highly relevant) and client agreements.

16.24 **Page 81, box 11, paragraphs 4 and 5** - It would be better to replace these paragraphs with a general principle to the effect that "competent authorities should ensure that the procedures and arrangements of investment firms provide for fair dealing, and should have particular regard to practices such as front running or dealing ahead".

Unless the advice in paragraphs 4 and 5 addresses the competent authority, it will be unclear. What is "improperly"; what are "better conditions"? Competent authorities must be free to impose requirements on firms which clarify this in the context of the markets which they supervise.

"Relevant persons" do not include affiliates.

In paragraph 5, CESR's advice raises more questions: in particular, how is "investment research" to be defined? This has been a matter of acute debate in the UK, particularly with regard to the application of this rule to the commodity and fixed income markets.

Competent authorities should be free to impose rules to specify what is and what is not "proper", after appropriate consultation with their markets.

Furthermore, the interaction of rules of this nature with other rules dealing with Chinese walls and conflict management would need to be carefully considered by each competent authority in order to ensure coherent and consistent legislation at level 3.

16.25 **Page 82, box 11, paragraph 7** - The requirement to execute substantially subject to the exceptions in paragraph 7 is not helpful, since the catch-all "otherwise in the interests of the client" is so wide as to make the rule empty. The principle must be that client orders are treated fairly and in due turn and competent authorities should be able to implement that principle in their respective markets.

16.26 **Page 82, box 11, paragraph 8** - UK practice does not currently impose this requirement in respect of "market counterparty" orders. There is no reason why firms should be required to give experienced professional firms this risk warning.

16.27 **Page 82, box 11, paragraph 9** - It would be more appropriate to require firms to keep a written policy on allocation and to allocate accordingly.

16.28 **Page 82, box 11, paragraph 12 to 14** - These requirements descend to an inappropriate level of prescriptive detail for level 2 advice. CESR's advice should be to implement level 2 as a general principle of fair allocation, leaving it to competent authorities to outline that principle, as appropriate, at level 3. It is too strong to require firms not to allocate in a way which is detrimental to any client - this may be impossible to achieve in some situations. It is better to require firms not to place the clients at an unfair disadvantage compared to the firm or particular clients.

16.29 **Page 82, box 11, paragraph 16** - The requirement in paragraph 16 is too prescriptive for level 2 and is better dealt with by setting up an adequate information principle, which competent authorities would be able to implement at level 3.

Significant drafting points

16.30 We have no comments on the drafting of this section, other than those referred to above.

We hope you find the above comments helpful. Please do not hesitate to contact us if you would like further elaboration or information.

Yours faithfully

M. Chamberlain

Margaret Chamberlain
Chairman
City of London Law Society Regulatory Committee