Society of Investment Professionals in Germany

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via Email

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Comments on CESR's Advice on Possible Implementing Measures of the Directive 2004/39/EC (MIFID) - Document 04-261b

Response by DVFA – Society of Investment Professionals in Germany

Dear Mr Demarigny,

DVFA – Deutsche Vereinigung für Finanzanalyse und Asset Management – is the Society of Investment Professionals in Germany with more than 1,100 members representing over 400 investment firms, banks, asset managers, consultants and counselling businesses. DVFA is a member of EFFAS, the umbrella organisation of European Analysts Societies, building a network of more than 14,000 investment professionals in 23 nations.

1. Nature of provisions of MIFID

In referring to CESR's Standards for Investor Protection – reporting requirement for serious breach of rules, the explanatory text to Section II draft advice to Art. 13 (2) – p.12 states that the imposition of such a requirement by Member States is not excluded by the provisions of the Directive on the minimum powers to be given to competent authorities.

This statement contains a view of the nature of the Directive's provisions with which we take issue.

The Directive, in its aim to foster a unified internal market in Europe for financial services, should create a level playing field in Europe. The present ISD (1993/22/EC) intended to facilitate cross border access to the markets but explicitly authorised in its considerants that

"a home Member State may, as a general rule, establish rules stricter than those laid down in this Directive, in particular as regards authorisation conditions, prudential requirements and the rules of reporting and transparency;"

MIFID does not contain such a general authorisation. This is no oversight but shows the intention to unify the requirements Europe-wide and only to allow in the areas specifically

mentioned in MIFID to either relax the requirement by optional exemptions or the permission to Member States to reduce or modify the requirements (Artt. 3, 5 No. 5, 9 No. 4 par. 2, 16 No. 3, 23 No. 1, 2 par. 2, 3 par.4 24 No. 3 and 4). It also explicitly provides whether and under which condition Member States may reinforce or add requirements to those established by MIFID. (Art. 23 No.6). Only to this extent „internal national discrimination“ of a Member State against its own firms is permitted.

Therefore, we do not agree with the approach of CESR that the national legislators or the competent authorities may introduce additional requirements to those provided for and authorised by MIFID. Provisions like “where permitted by national law” or similar formulas are the prerogative of the MIFID legislator, not of level 2 legislation or national legislators. The requirements imposed by the Directive are binding upon Member States unless the Directive provides specifically otherwise. We believe that this conclusion is beyond the jurisdiction of the Commission and/or CESR.

2. Conflicts of interests – Artt. 13 (3) and 18

Investment Research – Contents of Conflicts Policy

DVFA agrees with almost all of the principles outlined in the draft Advice Box 6 V. 15 and 16.

These requirements are in agreement with the professional requirements as laid down already in several codes of ethics, for instance the DVFA Code of Professional Conduct.

The issue of information barriers within an investment firm cannot be solved by a simple answer of yes or no. The structures and the size of the firms to be covered by the rules are too diverse. Furthermore, a simple prohibition of any information flow or exchange between different departments or sections of an investment firm is unrealistic. It is not advisable to create rules where one knows that they will not be observed by the industry, even if implicitly. This will create tensions between the firms and the regulators and will bind scarce resources to deal with such a permanent issue.

DVFA recommends to allow to those firms which maintain an in-house compliance function that information between the research department and other departments – e.g. corporate finance, M&A – be exchanged provided this exchange is monitored by or channelled through the compliance department in order to make sure that the exchange is necessary and not harmful to the investor. Where the size of the firm makes it impossible to insulate the different functions within the firm due to multifunctional activities of the staff, the only reasonable way to cope with the problem of potential or actual conflicts of interest is full disclosure of the situation to the capital market.

Our response to Question 6.3. is therefore that no requirement of an absolute information barrier should be introduced. It should be modified according to our above observations. We do agree with subsections ii, iii, iv and v for larger firms. We do not agree with the requirement for small firms with an in-house research function. Thus, DVFA would prefer the second option of No. 17. The wording of the warning should, however, be phrased differently. The answer to the question as to whether the research produced by a firm not having mechanism to avoid all conflicts is in the end after all an objective and fair product or service is open. The reader should decide by himself whether he/she still accepts the result as a fair and objective presentation. The reader should be warned that it might not be objective due to the potential or actual conflicts of interest. Reasonable people may still accept it as objective research despite the fact that the firm producing it had conflicts of interest.

Whoever would promote the idea that no reasonable person would honour a certificate of an outside auditor only because the auditor is appointed and paid by the firm audited? The same applies to research. It is, however, quite clear that the reader must have the possibility to

make his own judgement. Therefore, he must be prominently informed about actual or potential conflicts of interest.

Therefore the warning in 17 (a) should read: “The information and recommendation herein may not be objective investment research because it was not prepared...”

17 (b) unchanged

17 (c) should be rephrased: ”Any person to whom this research report may be directed should be aware that under the circumstances of its preparation and presentation this report may not constitute objective investment research.”

Response to Question 6.4.: The derogation should be available if an investment firm complies with the requirements of 17. Second Option and, due to its size and structure, cannot maintain sufficient information barriers.

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

3.1 Compliance

The compliance function can be defined as follows:

To assist in managing the risk of legal or regulatory sanctions, financial loss, or loss to reputation a firm may suffer as a result of its failure to comply with all applicable laws, regulations, codes of conduct and standards of good practice. Compliance risk is sometimes also referred to as integrity risk because the firm's reputation is closely connected with its adherence to principles of integrity and fair dealing.

The compliance function is one of the three elements of the broader concept of internal control:[1]

Internal control is defined as a process, effected by an entity's board of directors/trustees, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

Effectiveness and efficiency of operations.

Reliability of financial reporting.

Compliance with laws and regulations.

Art. 13 (2) treating compliance and personal transaction requires adequate policies and procedures and appropriate rules to ensure these functions. DVFA supports CESR's approach in providing for an appropriate calibration of the high level MIFID provision to the size and structure of investment firms. **To apply the compliance and internal control rules developed for banks and large investment banks would have the consequence to drive small investment firms out of business.**

The structure and size of firms providing investment services is quite different within the Member States. There is a number of States in which financial services of less complex structure (advice, portfolio management and receiving and transmitting orders) not involving the holding of client's assets are performed by small firms comprising one-person-firms to

[1] FRAMEWORK FOR INTERNAL CONTROL SYSTEMS IN BANKING ORGANISATIONS, Basle Committee on Banking Supervision, Basle, September 1998.

firms with few staff members, including the manager(s) of the firm. These service structures should not be destroyed by level 2 legislation which would introduce requirements which cannot be reasonably supported by the income and resources of these firms. Ways and means must be found to sufficiently safeguard investors' interest by simple, but nonetheless effective means of control.

CESR has invited comments on the appropriate calibration to be given to different circumstances. This raises two issues: What is a small firm? What are non-complex structures? These two elements should be combined in order to allow a significant simplification of the requirements.

Calibration of a "**small firm**": DVFA would put all firms with staff (including management) of not more than **15 individuals** (without outsourced functions) into this category. The number chosen is somewhat arbitrary and could be fixed differently. But in practical experience, firms up to this size have only flat hierarchies or none at all. Most staff members, if not employed in merely clerical or support positions, perform often multiple functions within the firm. Senior management and supervisory functions do not exist as separate functions. There is one general manager or two at the most. These firms do not have the earning potential to support the cost of a separate monitoring staff.

Categorisation of non-complex firms: DVFA is of the opinion that the **financial services of receiving and transmitting orders, of investment advice, and eventually also of portfolio management should be considered non-complex when performing these services separately**. Portfolio management thereby conceived as the combination of services to give investment advice (to themselves as representatives of the client) and to carry out this investment advice by placing the corresponding orders. Receiving and transmitting orders (introducing brokerage) in its pure form is rarely found. Usually it is combined with investment advice but without the power to carry out this advice at discretion without investor's instructions. These services are simple and straightforward. When and if these firms hold customer's assets or deal for themselves in the markets in which they serve their customers, the structures become much more complex. The potential of conflicts of interests is increased. Solvency and safeguarding customer assets become an issue.

The small and non-complex firms should not be required to install an independent compliance function or organisation. They should, however, be required to subscribe to the principles of proper compliance as for instance set forth in a code of conduct or code of ethics of a respective professional organisation. Such a code of conduct should include principles with respect to the proper treatment of client orders, executions of those, disclosure of eventual conflicts of interests, and references to the qualification of the individuals in charge of the business. Appraisals of that form would fit the set-up of smaller businesses and at the same time serve as foundation for compliance.

As for the ongoing surveillance of conduct, non-complex and small firms should then be permitted to perform the compliance function by cross monitoring of their activities, i.e. a staff member not involved in the particular operation could monitor this activity regardless of whether he/she is carrying out similar operations for other clients. To be specific: If introducers, advisers or portfolio managers serve different customers or customer groups, they should be entitled to monitor each other's compliance. An individual of a one-man firm should be able to monitor him-/herself by a time deferred formalised rechecking of his/her previous activities and/or to outsource some control functions. Outsourced functions should not be required to be performed on an "ongoing" (see CESR Advice 4 (a)) basis. Cross monitoring is possible on an ongoing basis. Outsourced monitoring, however, will normally be closer in frequency to a partially outsourced internal audit which is performed periodically in relation to the volume of transactions.

Response to Question 1.1. Independence of the compliance function should adopt a more flexible form in small, non-complex firms.

Response to Question 1.2. Under the premise of the above response, the issue of deferral becomes moot. With requirements tailored to the size and structure of the firms, the firms should be able to comply with the requirements when MIFID enters into force. In those Member States, in which ISD has been implemented, most of such proportionate requirements are met by the firms in question.

The goal should be that a small non-complex firm should not have a higher relative time investment and cost burden for its compliance function than the other firms

3.2 Personal transactions

The issue of conflicts of interests by personal transactions as one key point of compliance is especially relevant for a firm dealing on own account. Small and non-complex firms do not deal on own account.

This leaves the problem of personal transactions by the relevant persons in the investment firm. Level 2 legislation should permit these firms to avoid a costly compliance structure in this area by simply following a policy of not permitting personal transactions in those areas in which the firm renders services to their customers.

The preconditions for own-dealings by officers of those firms could be met along the same lines as described above, i.e. by subscribing to codes of conducts, or similar. The compliance of these could then be monitored in the external audit.

4. Internal control mechanisms, procedures for risk management – Art. 13 (5)

4.1 Internal control

We can refer to our responses regarding compliance. Since compliance is a subcategory of the wider concept of internal control, the statements on the compliance function in small investment firms is equally applicable to internal control mechanisms.

4.2 Risk assessment

Investment firms providing investment advice, portfolio management, and reception and transmission of orders have a limited risk profile as long as they do not hold client assets and do not deal on own account.

Their risk lies in malpractice, i.e. giving wrong or unsuitable advice, breaching portfolio management guidelines agreed with the investor, making errors in transmitting orders. The avoidance of malpractice in this meaning is the main objective of the conduct of business rules and regulations. If these rules and regulations are properly observed by the investment firm, the risk of malpractice is essentially under control. In comparison to the risks of solvency, the operational risks of the small investment firms with limited license do not require additional organisational measure for risk assessment and control. Good conduct means risk avoidance. The observance of rules and regulations of good conduct will be fostered by qualified training of the firm’s staff. To promote and/or provide such training is a genuine service of professional organisations for their member firms.

5. Client agreement – Art. 19 (7)

The Draft Advice on retail agreements for portfolio managers provide under 10 c) that the portfolio manager must indicate a benchmark against which the performance of the portfolio will be compared.

DVFA sees, especially for retail clients, a certain problem in this requirement, depending on how the term "benchmark" is understood. Institutional clients may and do agree with their portfolio managers more or less complex benchmarks. For retail clients, simple benchmarks like common indices are problematic in times when markets become very volatile. On the other hand, this does not mean that the portfolio manager be completely unfettered. The client agreement must, therefore, clearly take into account the risk and financial profile and the investment goals also of retail clients. It shall also define the categories of instruments, restrictions in volume and other parameters of interest. These parameters must be part of the written management guidelines which, in turn, form part of the agreement. Those guidelines can and should be formulated in a manner which is transparent to the retail client.

DVFA, therefore, suggests, to allow portfolio managers to interpret the term "benchmarking" such that it also allows for a specification of the risk/return goals of the investors and of other parameters relevant for proper management of the assets, but without necessary reference to a specific index benchmark, or combinations thereof.

(10) c) should be supplemented by

"The client may explicitly choose not to have his/her portfolio compared to a benchmark but to determine the investment goals and parameters in management guidelines."

Yours sincerely,

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Chairman of DVFA