Comments of HVB Group

on

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

HVB Group welcomes the opportunity to comment on CESR's Draft Advice.

HVB Group is the second largest private-sector bank in Germany and together with Bank Austria Creditanstalt the undisputed market leader in Austria. With over 60,000 employees, 2,062 branch offices and over 9.8 million customers, we are Number One in the heart of Europe, meaning in our core markets of Germany, Austria and in the dynamic growth region of Central and Eastern Europe where we have positioned ourselves as a leading banking network. We focus on European retail and corporate customer operations, supplemented by customer-related capital market activities.

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Preliminary remarks

CESR has stressed in the draft technical advice that the advice should not be understood as a legal text, even if it is precise to facilitate its comprehension in the consultation phase. However, HVB Group is of the opinion that due to the nature, detailedness and extent of the advice presented, we must already today speak of it as a legal text, already inducing its passing without major changes. In the present advice, CESR has not pointed out any alternative for level 2 regulations. According to the Lamfalussy process, however, the Commission and not CESR submits proposals for implementation directives of the Securities Commission (ESC). CESR has "only" an advisory function in the procedure. As HVB Group understands it, however, this allocation of tasks presupposes that the Commission receives from CESR various options with the corresponding arguments concerning individual regulations which permit the Commission "to then examine the technical proposals [from CESR] "[1] and thereafter submit a legal text to the ESC.

According to the Lamfalussy process, advice from CESR is also supposed to contain a summary of the views of the market participants. This must be added to the final advice.

Quite apart from this, however, HVB Group would like to take advantage of the possibility to comment on the second CESR consultation paper on MiFID 2 and send the following remarks in this context:

1. Definition of "investment advice" (Article 4(1) No. 4)

For clarity's sake, the definition of "investment advice" there should also be a negative definition which expressly emphasizes that the "execution only" privilege is not lost if the investment firm sends marketing information to the client. It would be sufficient to call attention to Recital 30 of the directive.

As HVB Group sees it, the definition of personal recommendation cannot be based on *"a bilateral nature of relationship or a bilateral contract between the firm and its clients"* **(Question 1.2)**. Whether a bilateral contract or a bilateral nature of relationship exists, says noting about whether the investment firm has issued a personal recommendation. Rather, what counts is whether the recommendation *is suited to or based on a consideration of the client's personal circumstances*.

Only recommendation of specific financial instruments should be included in the definition of *"investment advice".* Generic recommendations **(Question 1.3.)** can possibly result in an investment decision by the client, but these recommendations are only an indirect cause and thus not to be equated with personal recommendations. General civil law of the member states offers sufficient protection here.

The same applies to recommending a particular broker, fund manager or custodian. In the final analysis, the recommendation here is only an indirect cause for possible investment business which may arise on the basis of this recommendation.

HVB Group believes that in defining personal recommendation, so far no attention has been paid to the fact that a personal recommendation can only be given to one individual, otherwise the recommendation would not be "tailored to each recipient's specific situation" but would instead only be the largest common denominator with reference to the needs of the persons to whom the recommendation was addressed.

A more exact distinction between recommendation and "marketing information" should be made to the extent that product information can be made known through general distribution channels. Without this distinction, there is a danger that mailings, for example, would also fall under the term *"investment advice"*. Mailings are not tested to see whether the financial instrument is considered *"as being suited to the client*". Not even if the investment firm selects the customers targeted by the mailing for marketing reasons on the basis of certain criteria such as place of residence, profession, income, age, and marital status and then e-mails them. With the definition submitted, the impression could arise that this selection reflects a consideration of the client's circumstances. Making matters more difficult is the fact that it cannot always be definitively said of every mailing that it is *"issued to the public*" because if the investment firm raises the criteria for the pre-selection, the hits in the selection are often very few and thus the criterion "the public" is no longer applicable.

Moreover, HVB Group does not agree with the view of CESR concerning overlaps in the definition. It must be possible to distinguish clearly between personal recommendations and other definitions. In so doing, the average retail client must be the yardstick.

The definition should therefore be as follows:

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[1] See "FINAL REPORT OF THE COMMITTEE OF WISE MEN ON THE REGULATION OF EUROPEAN SECURITIES MARKETS" page 28 – *"The Commission, without prejudice to its right of initiative under the Treaty, would then consider this technical advice.*"

(1) „Personal recommendation" means any information given to one specific person including a value judgment or opinion or any other express or implicit recommendation whether to

a) buy, sell, subscribe for, exchange, redeem, hold or underwrite one or more specific financial instruments or

b) to exercise, or not to exercise, any right conferred by one or more specific financial instruments to buy, sell or subscribe for one or more specific financial instruments, or

c) to carry out any other transaction relating to one or more specific financial instruments

that is held out, either explicitly or implicitly, to the recipient as being suited to, or based on a consideration of his personal circumstances.

(2) A recommendation is not a personal recommendation if

a) additional clients are to be encouraged by the investment firm through the same information to behave as indicated above under (1) a) to c) and the investment firm makes it clear in the information that it is not making a personal recommendation or

b) an average client could have recognized that the information sent does not constitute a personal recommendation.

2. List of Financial Instruments (Art. 4 – Annex I Section C)

On the whole it is a good idea that, in contrast to the American regulation, no conclusive list for "commodity" is proposed. Nevertheless HVB Group does not think it helpful to use the proposed definition. In particular the distinctions made in Box 2 paragraph 3 about commodities are not logical. Cotton, for example, could also be considered an agricultural product. An abstract definition should suffice.

3. General obligation to act fairly, honestly and professionally and in accordance with the best interests of the clients (article 19.1)

The HVB Group agrees with the proposals on portfolio management **(Question 3.1)**. From our view no further issues should be addressed under Article 19(1).

4. Suitability-Test (Art. 19, paragraph 4)

An adequate investment advice or a portfolio management service is not possible on the basis of the assumption that the client has no knowledge and experience, the assets provided by the client are his only liquid assets and/or the financial instruments envisaged have the lowest level of risk if the client is not able to or refuses to provide any information either on his knowledge and experience, his financial situation or its investment objectives to the firm. One might assume in favor of the client – and this is what the CESR question implies **(Question 4.1)** – that he has the worst prerequisites for investing. The investment firm would however thus insert assumptions into its suitability test which would not produce a sound result. However, investment advice presupposes that the client's recommended course of action is based on an analysis of his real personal and not just assumed cirumstances. This means that if a client follows the "recommendation" given under these circulmstances he is not protected by Art. 19 paragraph 4 but instead in the area of application of paragraph 5 or 6 of Art. 19. This is also logical if one wishes to see investment advice as a core service by investment firms.

The converse conclusion cannot be drawn, namely that this assumption gives a reasonable observer of the type of the client or potential client the impression that the “recommendation” is not suited to or based on a consideration of his personal circumstances, because seen purely objectively, the "recommendation" for the client can be tailored to the client’s specific situation.

So far it is also unclear how the acting investment advisor or portfolio manager of the investment firm must behave when he learns about major changes in the situation of a professional client **(Box 8 No. 5)**. For retail clients, investment advisors must request additional information from the client. However, this must not apply to professional investors since they do not need such protection. If this is not clearly stated in the advice, we can expect that the national, unharmonized civil law systems imply such an obligation for the professionial investor as well and thus substantiate liability of the investment firm.

In addition, it should be noted that the extent of the information to be obtained from the client depends on the range of financial instruments the securities company can offer the client. These problems have not yet been taken into adequate account in the advice.

Moreover, **No. 8 in Box 8** is not formulated precisely. No clear distinction was made between investment advice and asset management. With asset management, the company is obligated to continuously analyze the client's portfolio. The client pays an extra fee for this. In

contrast, with Investment advice, the investment firm acts only prior to the investment decision. The client's portfolio is not continually monitored.

Box 8 No. 8 should thus be supplemented to read as follows:

“However, the obligation to ongoing monitoring of the client's portfolio is not demanded.”

Finally, HVB Group does not believe it would be a good idea if for investment advice and "execution-only" business there are two different procedures for obtaining information. An analysis sheet (see attached sample) in which the customer is asked to provide the necessary information) should be designed so that it meets the requirements not only of paragraph 4 but of 5 and 6 as well.

5. Appropriateness test (Article 19 paragraph 5)

As HVB Group sees it, Article 19 paragraph 5 presents the "execution–only“ regulation for financial instruments which must be classified as complex financial instruments in the meaning of paragraph 6 of Article 19.

CESR believes the investment company should define suitable parameters with regard to testing whether securities or services are appropriate for the customer. HVB Group welcomes this approach but the parameters must be selected in such a way as to ensure a good cost-benefit ratio from the service.

6. "execution-only" (Article 19 paragraph 6)

HVB Group supports the approach of CESR, namely to define the attribute "non-complex instruments“ only in an abstract manner. A final and thus always incomplete list (due to the fact that circumstances change so fast) does not provide enough legal security for the customer or the investment firm.

On the other hand, we do not support CESR’s interpretation that all derivatives have to be considered as complex instruments according to the scheme and purpose of the restrictive preconditions of Article 19. Article 19 paragraph 6 mentions the term “derivative” only in connection with bonds or other securitised debt *(“bonds or other securitised debt that embed*

a derivative"). Furthermore you can read in Article 19 paragraph 1 g) (UCITS - Directive 85/611/EEC) that investments of a unit trust or of an investment company can consist solely of financial derivative instruments. Since Article 19 paragraph 6 treats UCITS as un-complex instruments not all derivatives have to be considered as complex instruments.

With the question of whether an instrument is non-complex, CESR should pay more attention to the economic effect of the financial instrument **(Question 5.1.)** since the Level 1 Text clearly emphasizes this. Article 19 with the gradation paragraph 5 und 6 aims to protect the retail client from complex financial instruments and provide sufficient information about these instruments. In listing *"shares …, money market instruments, bonds or other forms of securitised debt (excluding those bonds or securitised debt that embed a derivative), UCITS and other non-complex financial instruments"* the legislators focused exclusively on the economic risk of an investment. Apparently the legislators assume that the average retail client is capable of assessing the risk, for example, involved in UCITS but not those involved in derivative products. However, some UCITS are also complex legal and financial instruments. Nevertheless, their risk can be assessed very simply. This legislative assessment must naturally also be reflected in the definition of non-complex instruments.

In addition, products such as index certificates on the DAX or Euro STOXX should be classified as "non-complex". Particularly because these products can be compared with stocks and UCITS, the area of application in Art. 19 paragraph should be opened.

The definition of "non-complex instruments" should therefore be as follows:

(1) Non-complex instruments shall mean all ~~non-derivative~~ financial instruments:
a) that are frequently transferable, redeemable or otherwise realisable at prices that are frequently available,
b) that do not involve any actual or potential liability for the client that exceeds the amount of his contribution [including any commitment that represents a genuine contribution to the acquisition costs of the financial instrument]" and
c) where the financial risk of the financial instrument for an average retail client are comparable to those in the list in Art. 19 paragraph 6.

The prerequisite "*at the initiative of the client*" should also be met when there is a lapse of time between the personalized communication from or on behalf of the firm a action on the part of the client (such as buying securities).

Finally, HVB Group does not believe that unfair business-to-customer practices imply that the service was not provided "at the initiative of the client." The circumstance “at the initiative of the client” would then be misinterpreted. Such an assumption is not reasonable.

7. Transaction executed with eligible counterparties (Article 24)

In the advice to Art. 24 CESR lists a number of obligations for investment firms auf, which cannot be assumed from the legal text nor are they compatible with the protection idea behind the norm..

Art. 24 paragraph 2 does not constitute an obligation for investment firms to inform their eligible counterparties about their status in the implementation phase of the directive **(see Box 11 paragraph 1)**. Nor is the investment firm obliged to inform an eligible counterparty that it can request to be treated as a client in order to secure a higher degree of protection and that it is the responsibility of the entity to make such a request. CESR advice is inconsistent here since eligible counterparties have the same (eligible) position as investment firms. They do not require protection or special information.

Nor can the obligation be assumed from the legal text that the investment firm is obliged to document whether an eligible counterparty requested higher protection level (either as a professional client or a retail client). The same applies to the obligation required by CESR regarding written confirmation to the client.

Demands for acceptance of other eligible counterparties is correctly defined **(Question 6.1.)**. No additional criteria are necessary.

8. Definition of Systematic Internaliser

To the extent that CESR in the scope of Box 14 Number 2 establishes that the investment firm must announce giving up its activity as systematic internaliser in the same publication in which it publishes its quotes, it must be remembered that this kind of publication will not receive adequate attention. For this reason HVB Group believes that this information should be shown on the investment firm's website.

Furthermore, we do not see why interests of third parties could be affected if the systematic internalization is given up. There is no good reason why relinquishing an activity should be announced in advance.

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