

4 April 2005

**CESR's draft technical advice on possible implementing measures of the
Directive 2004/39 EC on Markets in Financial Instruments - MiFID
Consultation (ref: CESR/05-164)
2nd set of mandates
March 4 – April 4 2005**

**Contribution by BNP Paribas
CESR's draft advice on "best execution"**

□ **Presentation of BNP Paribas**

BNP Paribas (www.bnpparibas.com) is a European leader in banking and financial services, with leading positions in Asia and an active presence in the United States. It is the first bank in terms of net income and market capitalisation in the Euro zone. The group has one of the largest international banking networks with a presence in 85 countries and 90,000 employees world-wide. BNP Paribas enjoys key positions in Corporate and Investment Banking, Private Banking & Asset Management, Insurance, Securities Services and Retail Banking.

□ **1. Introductory remarks**

1.1. We appreciate the consultation by CESR of the financial industry as a positive initiative and welcome the opportunity to express our views on the important implementation measures of the Directive on Markets in Financial Instruments ("MIFID").

We fully concur in the views expressed by the French Banking Federation (FBF), AFEI (the French Association of Investment Enterprises) and the European Banking Federation (EBF) in their responses to the present consultation.

□ 1. 1 *Timetable*

The consultation timetable of one month allocated to the present consultation is extremely short considering the importance of the items covered by CESR's draft technical advice. A more realistic timetable of 3 months would have been highly desirable to allow professional expertise to express fully their views.

In the case of "best execution" no prior consultation took place. Therefore, the deadline for comments should have been set within no less than 90 days.

We reiterate the Commission's view that "some speed in the process may have to be sacrificed in order to optimise consultation practices". Not to do so could only lead to consultation procedures becoming illusory or mock exercises. This is all the more timely following Commissioner McCreevy's announcement of a 6 month delay for MIFID's entry into effect.

In spite of the very short timetable, the responses to the present consultation have been provided by BNPPARIBAS ASSET MANAGEMENT.

2. *General comments*

In reply to the questions on Best execution we would like to stress the essential elements of the environment under general comments. In this process, we provide answers to the specific questions of the consultation and we also refer to our attached exhibits (Part 2).

In the discussion CESR introduces the term "indirect execution" in order to apply the „best execution“ requirements to investment firms which receive and transmit orders or provide the service of portfolio management. The MiFiD does not know this term, but rather defines quite clearly "execution" as acting to conclude agreements to buy or sell one or more financial instruments on behalf of clients.

This definition must be read in conjunction with Annex I Section A in which the "execution" of orders is listed as a separate category, besides „reception and transmission“ of orders and portfolio management. Therefore, CESR's approach is not covered by the MIFID. Neither the Commission nor CESR may alter the basic definitions and obligations tied to them.

Therefore, the approach should not be based on introducing a vague concept of indirect execution blurring the lines between services. In the normal set up of providing services of receiving and transmitting orders or managing portfolios, the client has relationships to one service provider, i.e. the portfolio manager. The portfolio manager's responsibility is to provide an aggregate service, it is thus both difficult to segregate the trading obligations from the other duties of the PM and potentially incomplete to overstress the pure best execution concept.

Nevertheless we do provide our analysis attached.

A) Markets evolution and regulatory influence:

- There are only three market types :
 - Auction markets (few participants little information) High level of margin of intermediaries
 - Price driven markets (numerous participants little information) average level of margin of intermediaries
 - Order driven markets (numerous information numerous participants) low level of margin of intermediaries or no intermediaries.
- > Historically, all markets evolve from auction to price driven to order driven (This is true in every industry unless a dominant buy or sell side exists).
- > Regulator helps to make the information level increase, thus to evolve toward efficient margin less market

B) Definition of trading in third party's asset management

Trading is the tactical part of the investment process (Process described Exhibit Part 2, pages 2 and 3).

There are two possible kinds of execution: decision orders and adjustment orders (Exhibit Part 2 page 4).

- A decision order corresponds to the manager's decision to amend exposure.

Execution serves to minimise market impact and maximise yield from the decision (Alpha).

- An adjustment order is an adjustment made necessary by a change in the benchmark, redemption, subscription, or an adjustment connected with cash level.

Execution's goal is used to minimise the divergence between the fund and its benchmark – Tracking.

In the first case (decision), the benchmark is the pre-trade price (price at the moment of the order's departure), eventually corrected by the effects of the market trend.

The manager chooses to buy or sell, among other things, according to the value of the security at the moment of decision.

- In the second (adjustment) case, the benchmark is the method of calculating the valuation of the fund (For a neutral decision, in particular at the moment of subscription or redemption; it is necessary to disburse what the fund share bearer pays or pay what is received from the market.

This can be an opening or closure price or any other method used.)

These two generic types split in two modes: absolute orders (One way order) and relative orders (Rebalancing, arbitrage, spreads) (Exhibit page 5)

To illustrate:

Buy order (Alpha quest) for 10 000 XYZ -> Absolute decision order

Sell order of those 10 000 XYZ to be replaced by an capital equivalent of ABC -> Relative decision order

Fund's first investment -> Absolute adjustment order

Fund's benchmark change or transition management (Buys and sells) -> Relative adjustment order

Trading is the tactical part of the investment process

It is a significant part of the “relative performance generation”. (Performance differential with benchmark or peer, i.e. marketed added value of any Asset manager)

For derivatives and OTC structured products the matter is slightly different: one has to store the proper time stamps to be able to recalculate the price from the information available on the underlying

C) Implementation of trading

Trading consists in implementing the investment decision.

The objective of good trading is to optimize alpha or minimize tracking.

To achieve that, trading looks for the best possible price.

A short term market price is a function of bid/ask spread and short term trend risk.

The short term trend risk (volatility) is managed in managing information and time.

The bid ask spread is managed in managing liquidity. (Exhibit Part 2 page 6))

Thus it is a conceptual error to confuse a “price” given by a market maker and price quality.

The market maker offers immediacy, i.e. liquidity. But immediacy is NOT asset management: the immediate price is not always the best possible price. It is rather a fortuitous price.

An asset manager is supposed to bring to its customer the best possible price. To this end the asset manager has to manage time and information on the short run for the execution purpose EXACTLY as to manage time and information on the long run for the investment purpose.

Trading is completely integrated in the investment added value, thus in the performance. Trading is completely the responsibility of the asset manager.

This added value can be monitored (Exhibit Part 2 pages 7 – 8 – 9)

D) Monitoring

- It is possible to quantify the processing ability of a venue or intermediary (Volume, delays)
- It is NOT possible to quantify the trading ability of a venue or intermediary unless the trading is totally delegated to this venue or intermediary. (This means delegating part of the asset management, customer should then be advised of the subcontractors existence) (ref question 30 page 19)

3. Detailed comments

Please find herewith answers to CESR Individual Questions.

Page 19 question 30

a) It is not possible to aggregate comparative data of venues or intermediaries offering inducements with those that are not offering the same, as the inducements are of completely different nature. (As far as the inducements are not concerning the specifics of the trade)

b) Firms have to negotiate/evaluate the cost of trading in relation with venues or intermediaries. Then the cost of inducement is any % or cent paid above this base cost.

“Pure execution” orders can be segregated; market practices already do that for basket trading on equity, plus a sufficient quantity of agency only pure execution venues or intermediaries do exist to allow for comparison.

But: the very cost of execution is also a function of the purchasing power of the fund or mandate manager. This purchasing power can partly benefit to the final customer.

Page 24 question 56

This can be possible if the venue offers pure agency or direct market access to all asset classes and products traded by the firm with the essential condition that the firm has small AUM, thus low market impact and low purchasing power (Splitting a purchasing power is completely inefficient as the sell side has to manage its resources and does it in its time allocation to margin generating customers.)

Page 25 question 65

Even though a minimal trading setup should be required to guarantee compliance, the human and IT needed costs can be inefficient if the firm's volumes are very low and if the portfolio manager's schedule or process allows him to have proper care of the short term trend risk.

Page 27 question 82

We do monitor our executions with internal tools and external auditors.

Execution quality is a buy side responsibility.

A better price source outside of an asset manager's providers network can exist, the cost of sourcing it can alleviate the interest in using it. The intermediaries or venues choice are part of the added value of the investment manager. It is managed by a broker selection process.

Page 28 question 87

We have been sending since 2000 a semi - annual questionnaire to our intermediaries inquiring on possible changes.

Page 31 question 110

- a) It is the cost of acquisition or of development of a sound OMS (A sound OMS logs the trade details.) as a weak alternative the log can be requested to the custodian.
- b) The brokerage fee is the client's money. The purchasing power, however, is an investment firm's asset. Publishing the company's purchasing policy may thus allow for pressures on its purchasing power by the various providers.
- c) No. There are no clues of other industries having to release their provider's list and policy to final customers.
- d) Reporting venues and intermediaries details to customers can become a very costly and counter-efficient process, as it implies a possible judgement or discussion by the final customer of the procurement policy of the firm, knowing that this policy is in itself a very complex management. The list and details should be available upon request for regulators to allow for traceability (This process exists in other industries).
- e) No. This question would imply the description of the entire market structure.
- f) The less liquid the market, the most informative the procurement network. Publicity of it would reveal part of the added value or the investment firm.

Page 32 question 115

Detailed information should be available for regulators only. Traceability is obviously mandatory.

The structure (procedure) of the error handling policy only should be made available to consultants and clients. Just like other industries.

Page 34 question 126

No comment

No answer: not in the scope of third party's money management

Conclusions

It is essential to understand that the provider's mix of an asset manager is proprietary and constitutes potentially a competitive advantage; it is also an outcome of the asset's manager's purchasing power thus any release of information outside regulatory authorities creates a potential weakness of the asset's manager's procurement. (Ref question 110 page 31)

Should you have any questions regarding the above comments, please do not hesitate to contact either M. Bernard COUPEZ, Director, BNP PAM at Bernard.coupez@bnpparibas.com, tel.: 33 1 58972990 or M. Amaury de TERNAY at amauryde.ternay@bnpparibas.com, tel.: 33 1 5897 2333, who will be happy to be of assistance in these matters.

Very Sincerely,

Hubert de VAUPLANE
HEAD OF LEGAL DEPARTMENT

CORPORATE & INVESTMENT BANKING
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Florence SIREL
GROUP LEGAL DEPARTMENT

EUROPEAN LAW
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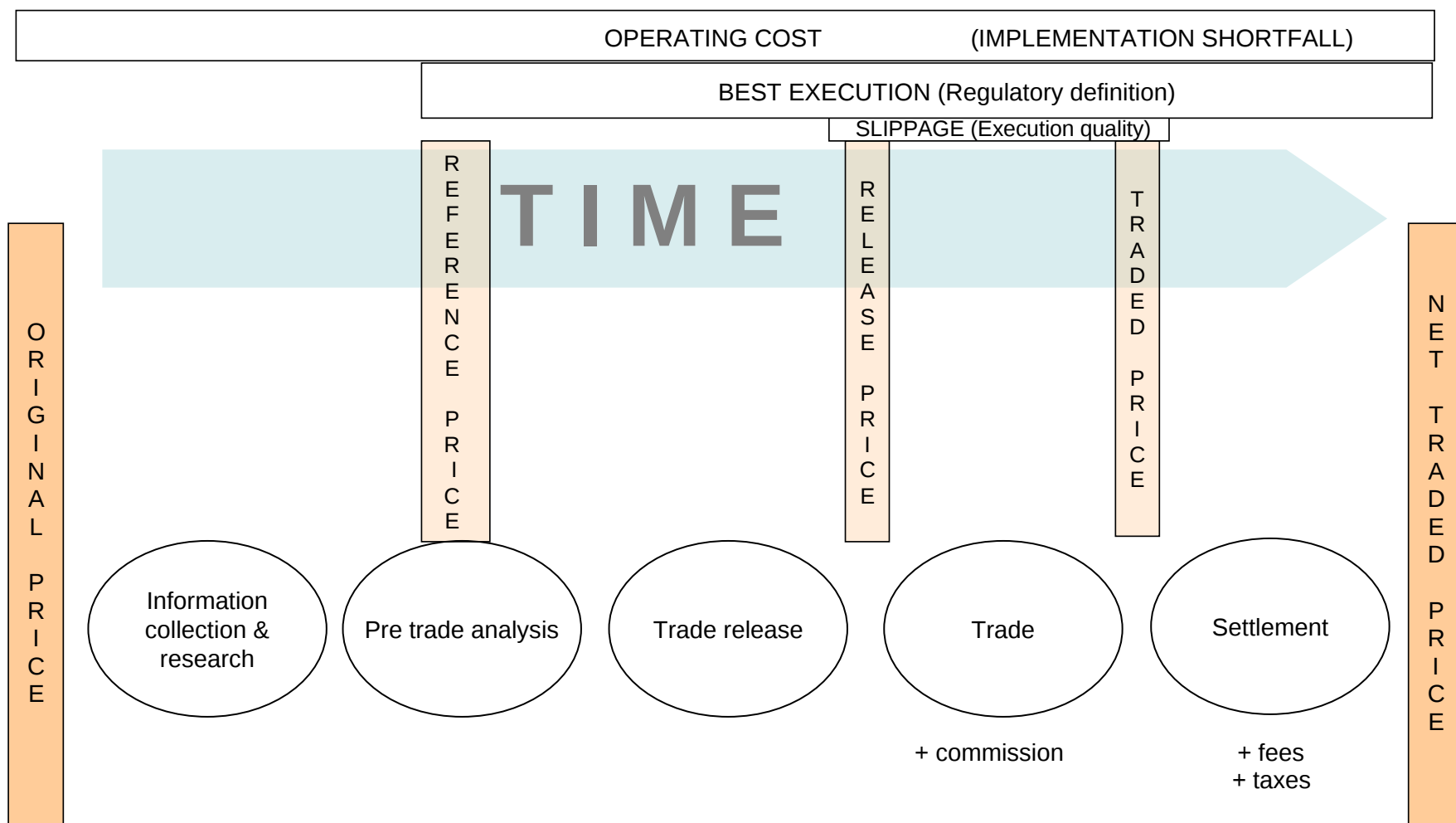
Exhibit Part 2

1- Process

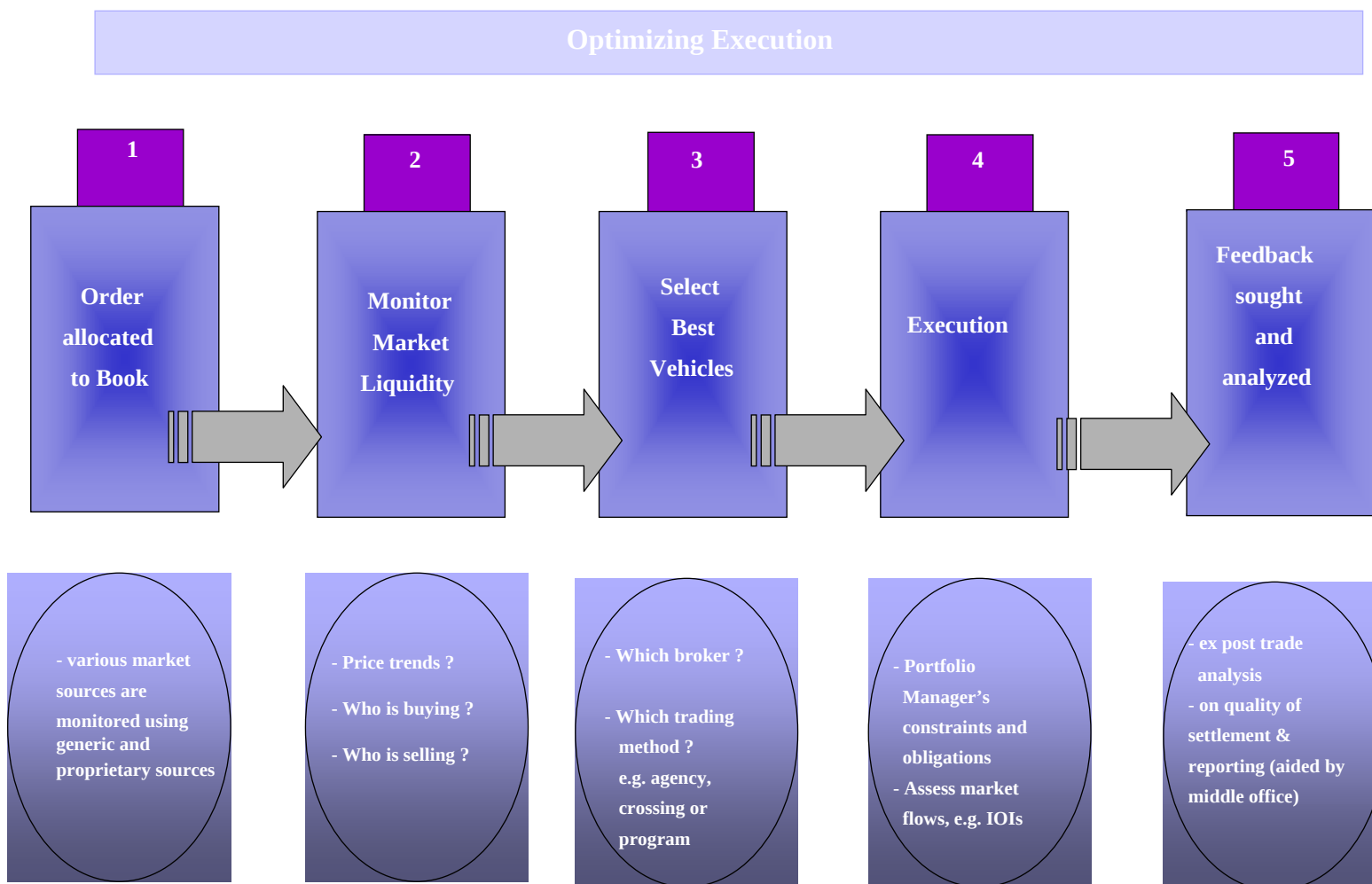
2 – What to measure

3 – How to measure

BEST EXECUTION OPERATING FLOW



BEST EXECUTION PROCESS



> Decision Order :

- > PM amends market's exposure or private mandate management



Execution shall minimize market impact
and maximize alpha

> Adjustment Order :

- > Benchmark change, massive redemption, fund creation, transition..

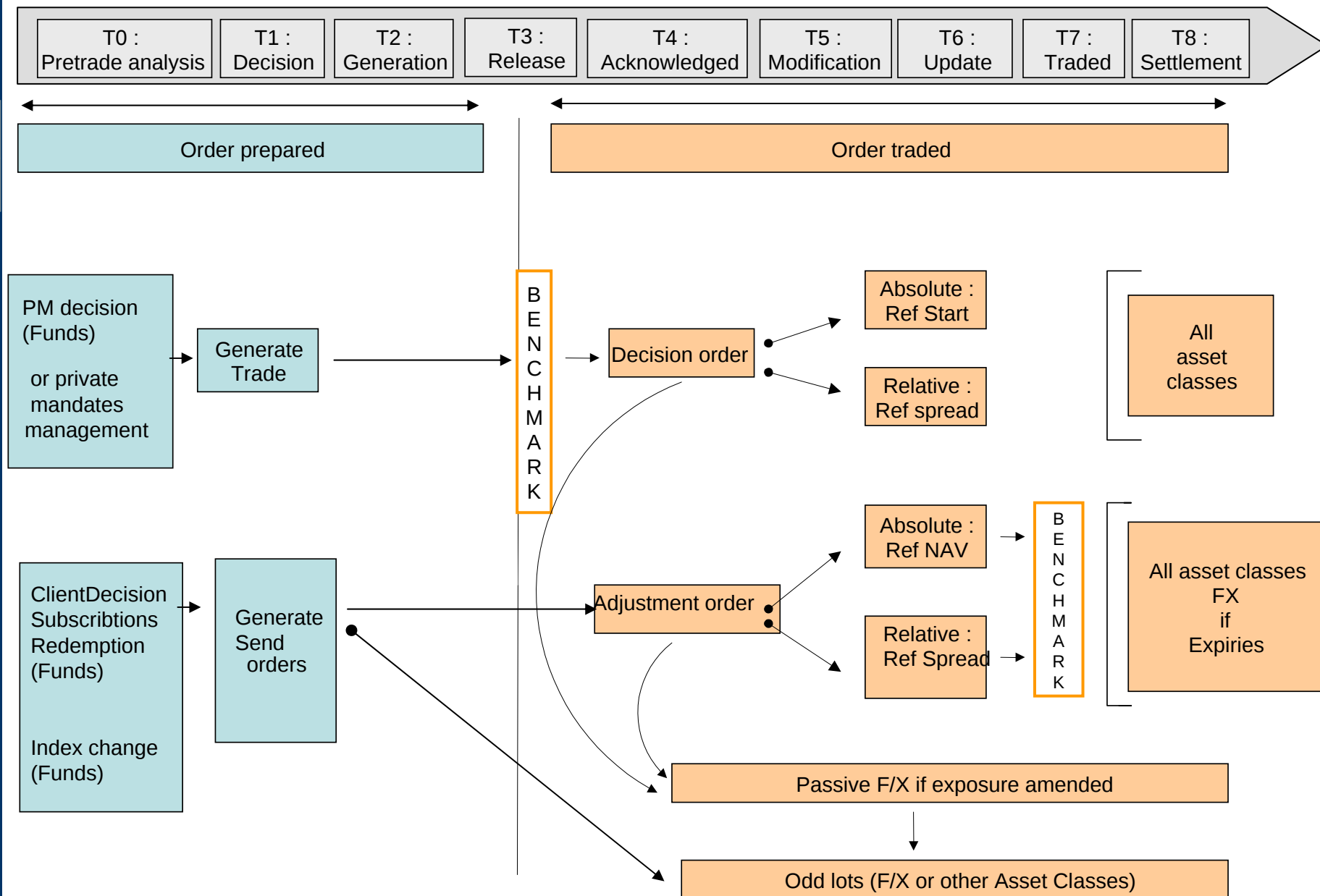


Execution shall minimize divergence between
portfolio and benchmark => minimize tracking error

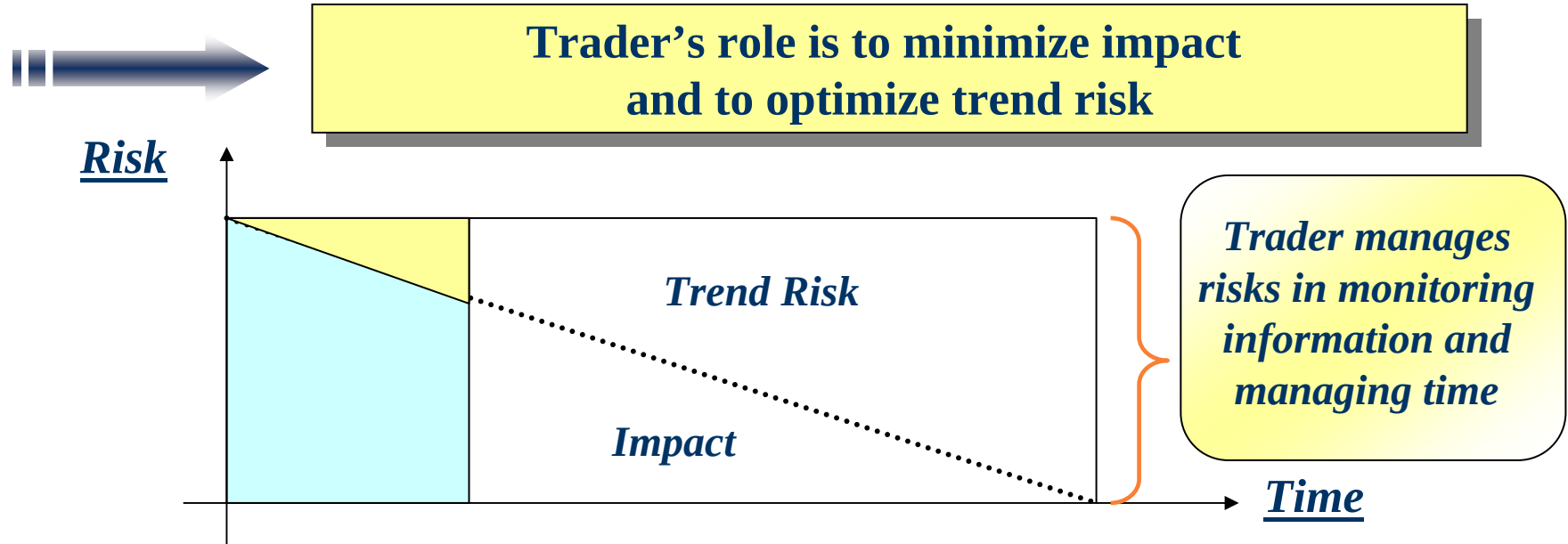


Trading contributes to performance

TRADING FLOW CHART



- > Trend risk is function of trading delay (can be positive or negative)
- > For small orders, risk is bid or ask. Time is not a factor.

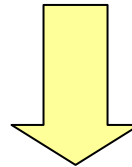


- > To design a measure, one needs :
 - It is neither gamable, nor subject to arbitrage
 - It is objective and justifiable
 - It is readable and usable
 - It has sufficient rusticity
 - It is information neutral
 - It takes into account market asymmetry
 - To have the relevant data and timestamps

> What are the needed data ?

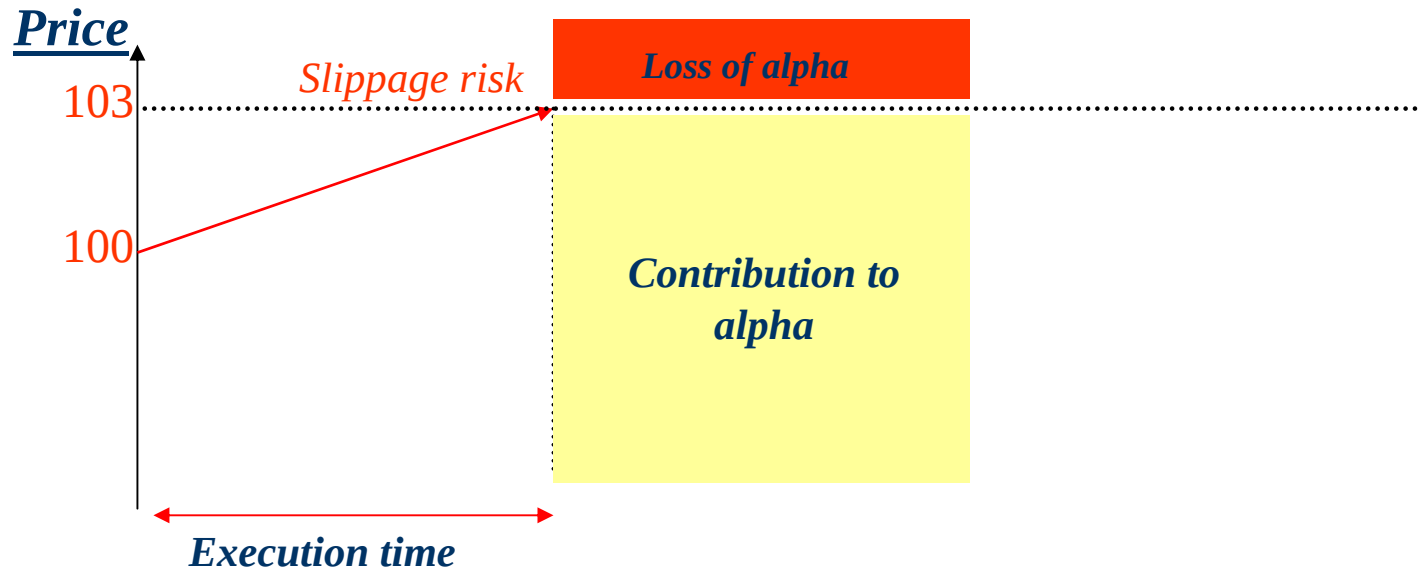
- S = order size
- t = time stamps
- L = Liquidity
- P = Pre trade price
- E = Execution price

$$R = f(S, t, L, P, E)$$



Ability to assess true added value of trading

Example : Buy order



Not gamable, no arbitrage, measures contribution to performance