APCIMS

Working for the Investment Community

CONSULTATION PAPER RESPONSE

CESR TECHNICAL ADVICE TO THE EUROPEAN COMMISSION IN THE CONTEXT OF THE MIFID REVIEW

INVESTOR PROTECTION AND INTERMEDIARIES

ASSOCIATION OF PRIVATE CLIENT INVESTMENT MANAGERS AND STOCKBROKERS (APCIMS)

The Association of Private Client Investment Managers and Stockbrokers (APCIMS) represents firms acting on behalf of investors[1]. Member firms deal primarily in stocks and shares as well as other financial instruments for individuals, trusts and charities and offer a range of services from execution only trading (no advice) through to full portfolio management. They operate on more than 500 sites in the UK, Ireland, Isle of Man and Channel Islands, employing over 30,000 staff. Around £365 billion of the wealth of these territories is under their management.

We set out below our response to the questions in the CESR consultation document on investor protection and intermediaries, which forms part of CESR's technical advice to the European Commission on the MiFID Review.

Part 1: Requirements relating to the recording of telephone conversations and electronic communications

Before responding to the questions posed in the CESR document, APCIMS would like to offer some general comments on the subject of recording based on UK experience.

As CESR is aware, the FSA has imposed a recording requirement on UK investment firms since March 2009. APCIMS was strongly opposed to the introduction of the FSA's COBS 11.8 recording régime; we believed that for firms servicing retail clients the costs involved in systematically recording telephone and electronic communications were disproportionate to the benefits likely to accrue either to the firms themselves or to the regulator. In addition, in relation to market abuse prevention (the main rationale behind the introduction of the UK régime), we believed that recording, rather than deterring market abuse, would result in those determined to profit from inappropriate behaviour ensuring that their activities took place via non-recorded communication channels.

[1] APCIMS has around 190 members, of which about 130 are private client investment managers and stockbrokers and the rest are associate members providing relevant services to them.

More than a year after implementation of the UK régime, and with the FSA now proposing that its requirements be extended to cover mobile phones, APCIMS remains unconvinced of the mooted benefits of recording. The fact that, during the last 15 months, many APCIMS firms have not received any requests for information from the FSA in pursuit of its market abuse enquiries would seem to call into question whether the considerable costs incurred to implement the COBS 11.8 requirements were justified. Furthermore, we do not believe that the other rationales which CESR cites in paragraph 17 – namely, the settling of client disputes and the supervision of conduct of business compliance – are such as to justify the costs involved. APCIMS member firms receive very low levels of client complaints, with the bulk of such complaints revolving around issues of service administration and investment performance rather than the details of specific orders. As regards conduct of business compliance, while recorded data may be useful in terms of providing proof of breaches, it is an extremely resource-intensive way of monitoring in-house activity and firms are likely to have more focused procedures and systems which aim not only to risk manage the activities of their staff but also to identify breaches more efficiently.

Question 1. Do you agree with CESR that the EEA should have a recording requirement? If not, please explain your reasoning.

Notwithstanding our general opposition to the recording of telephone/electronic communications, APCIMS believes that, given how many Member States have already made use of the Article 51(4) discretion to introduce their own recording requirements, the time may have now come for a more harmonised approach to be adopted across the EU. The fact that widely varying regimes currently exist across the different Member States (as described in Annex 2) must be problematic for firms seeking to operate from a number of different bases and must militate against the efficient company-wide management of their communications systems. From a level playing field perspective, it also seems unreasonable in respect of business occurring across national borders that one competent authority may effectively rely on cooperative arrangements with other regulators to seek recorded data from their firms without imposing like requirements on their own.

Question 2. If the EEA is to have a recording requirement do you agree with CESR that it should be minimum harmonising? If not, please explain your reasoning.

While we note that a minimum harmonising obligation is likely to achieve far greater support amongst CESR members than a maximum harmonising one, such an approach is unlikely to be particularly beneficial for firms operating across a number of Member States. Although firms operating in Member States that have recording requirements that extend beyond the CESR proposals are unlikely to derive much benefit from the dismantling of any "excess" requirements given that they have already incurred the costs of putting relevant recording systems, procedures and controls in place, a genuine attempt at harmonising requirements would be beneficial for firms seeking to establish branches in other Member States in future.

Finally, given that other elements of the CESR paper talk about the need for maintaining consistency with current MiFID standards, we do not see why a recording requirement should not be maximum harmonisation like the Directive itself, thereby preventing regulators from needlessly

"gold plating" requirements without having to go through the control mechanism provided by Article 4.

Question 3. Do you agree that a recording requirement should apply to conversations and communications which involve:

- **the receipt of client orders;**
- **the transmission of orders to entities not subject to the MiFID recording requirement;**
- **the conclusion of a transaction when executing a client order;**
- **the conclusion of a transaction when dealing on own account?**

Question 4. If you do not believe that a recording requirement should apply to any of these categories of conversation/communication please explain your reasoning.

The investment activities which CESR proposes should be covered by a recording requirement mirror those to which the FSA currently applies its COBS 11.8 requirements and, as a consequence, most APCIMS firms would find themselves to be already operating in line with any new MiFID requirement. There is however, one area of difference between the proposed EU and current FSA régimes which could draw currently unaffected UK firms within scope: while the market abuse focus of the FSA regime means that recording is mandated in respect of *qualifying investments admitted to trading on a prescribed market* (e.g. equities, bonds and derivatives), the CESR proposals relate to all financial instruments covered by MiFID (including units in collective investment undertakings). In the UK, this is likely to mean that many smaller firms (known as "independent financial advisers" or IFAs) whose business is largely restricted to advising retail clients on various types of investment product (life policies, pensions, insurance etc) will be drawn into the recording régime because of their involvement in collectives.

Given that the bulk of APCIMS members operate in the same retail client environment as IFAs (albeit with a market-facing, direct investment bias as opposed to a product-orientated approach), they would generally take the view that firms operating in the same space as them should be subject to the same requirements. However, while APCIMS favours a level playing field operating in circumstances where fundamentally different types of firms compete across certain investment types or for certain types of clients, we do wonder whether requirements which end up drawing into the régime firms that are primarily focused on the distribution of non-MiFID products may be disproportionate.

Question 5. Do you agree that firms should be restricted to engaging in conversations and communication that fall to be recorded on equipment provided to employees by the firm?

While many firms already have procedures in place which ban their staff from using privately-owned phones for undertaking business activities, we do not believe that the use of equipment owned/provided by the firm should be mandated by regulation. APCIMS is aware that some of its firms allow individuals working for them to communicate with clients using equipment which is not owned/provided by the firm; this most commonly occurs in scenarios where individuals are not actually employees but are self-employed contractors. The FSA's current rules accommodate such

scenarios by requiring recording of communications sent or received on equipment that is either provided by the firm or *the use of which by an employee or contractor has been sanctioned or permitted by the firm* (COBS 11.8.5R(2)). We believe that this flexibility needs to be retained if EEA-wide recording rules are adequately to cater for the many different types of business/organisational structures operating in the market.

Question 6. Do you agree that firms providing portfolio management services should be required to record their conversations/communications when passing orders to other entities for execution based on their decisions to deal for their clients? If not, please explain your reasoning.

APCIMS does not agree that firms providing portfolio management services should be required to record their conversations/communications when passing orders to other entities for execution. As CESR is aware, the UK recording régime provides exemptions for discretionary investment managers in respect of communications with firms that are themselves subject to the recording obligation; in addition, communications with firms that are not subject to the recording obligation need not be recorded where they are made *on an infrequent basis and represent a small proportion of the total telephone conversations and electronic communications made*. We believe that these exemptions not only take account of the unnecessary duplication that recording by discretionary managers would involve but also reflect the fact that, in a discretionary environment, firms do not receive orders from clients and there is consequently no evidence for regulators to glean vis-à-vis market abuse. Furthermore, in the context of the CESR paper, given that no orders are received, it is unlikely that telephone taping would assist with the resolution of client disputes.

Consequently, APCIMS supports the indications provided in the CESR consultation to the effect that portfolio managers should not be subject to the recording requirement paper when passing orders to other firms for execution regardless of whether such firms are EEA firms which are themselves subject to recording requirements or non-EEA firms which may not be.

Question 7. Do you think that there should be an exemption from a recording requirement for:

- **firms with fewer than 5 employees and/or which receive orders of a total of €10 million or under per year; and**
- **all orders received by investment firms with a value of €10,000 or under.**

In paragraph 49, CESR refers to the possibility of *an exemption from a recording obligation on the grounds of proportionality for smaller investment firms or offices providing investment services which receive few telephone orders.* While we appreciate the rationale behind this suggestion, it is difficult to envisage the criteria against which such an exemption could be assessed. The specific limitations proposed by BaFin and the FMA appear somewhat arbitrary and beg the question as to what would happen to firms that breached such limits either on an exceptional basis or more frequently as their business grew: would they be expected to equip themselves for recording immediately upon first breaching the limits? Would they be given a period of grace? Would regulators monitor the activities of such firms to ensure that they were not taking advantage of the exemption when in fact they had no right to do so? How would regulators safeguard against firms sidestepping the requirements by effectively

dividing orders into smaller lots? Furthermore, is it possible that these limitations might operate against a client's interests, e.g. a firm that abided by the *€10,000 or under* order limit more to protect its exemption than with a view to whether a larger transaction might actually be more in keeping with a client's circumstances?

Question 8. Do you agree that records made under a recording requirement should be kept for at least 5 years. If not, please explain why and what retention period you think would be more appropriate.

APCIMS does not agree that records made under a recording requirement should be kept for at least 5 years. While we agree that it is appropriate for such records to be kept in accordance with the conditions specified in Article 51(2) of the MiFID Level 2 Directive as regards accessibility and protection against manipulation, we do not believe that it would be proportionate for the standard MiFID record retention period of 5 years to be imposed in this instance.

As CESR is aware, the FSA's COBS 11.8 regime requires firms to retain records of telephone/electronic communications *for a period of at least 6 months from the date the record was created.* For UK firms, a ten-fold increase in the recording period would almost certainly result in some firms having to buy additional storage media and allocate more space for the safekeeping of the resulting CDs/tapes and may, for those firms whose existing systems are operating close to capacity, necessitate investment in completely new technology. In addition, given the rapidity with which telecommunications technology develops, it may well be that equipment which is used/recorded now is obsolete in 5 years time with the result that firms would be put to the expense and inconvenience of maintaining duplicate recording, storage and retrieval systems for their old and new communications structures.

Firms have also expressed concerns about the fact that the process of searching recorded material becomes more difficult the longer the period that elapses between recording and retrieval. In the UK, where a record retention period of 3 years was originally proposed, firms suggested that unless the FSA was able to define its data requests with some considerable degree of specificity (which does not currently seem to be the case), firms would be required to devote a great deal of staff time to tracking down, isolating and collating the required data.

Consequently, while APCIMS acknowledges that a 5 year retention period would secure consistency with MiFID, we do not believe that a desire for regulatory symmetry is an adequate rationale for imposing additional costs on firms. In paragraph 53 of its consultation, CESR states that *it is likely that most issues requiring access to previous telephone conversations/electronic communications will arise in a shorter time period.* We believe that that recognition should inform CESR's proposals and should ensure that the retention period is set as the minimum that can reasonably be considered as likely to meet regulatory objectives, always taking into account *the practice of competent authorities to require investment firms to hold recordings for longer where the recordings may be relevant for an investigation*. Provisions that enable regulators to require firms to hold certain specified data beyond the standard record-keeping period provide flexibility for regulators without imposing disproportionate requirements on firms as a matter of course.

Question 9. Are there any elements of CESR's proposals which you believe require further clarification? If so, please specify which element requires further clarification and why.

The main area of CESR's proposals that requires further research and clarification relates to the benefits that are considered likely to flow from the introduction of a EEA-wide recording requirement. The benefits identified at a very high level in paragraphs 57 and 58 are, we believe, too tentative and unsubstantiated to provide a reasonable justification for the imposition of considerable costs upon investment firms. Paragraph 58 states: *Most CESR members believe, largely based on their supervisory experience, that the benefits are significant.* Given that recording is undertaken by a large proportion of the countries whose regulators are CESR members, it should be possible for CESR to collate more detailed and specific information about the benefits that competent authorities have identified as arising from their individual recording regimes. For cost-benefit analysis to be accorded any value by those subject to regulation, requests to investment firms for quantitative estimates of costs (as per questions 11 and 12 below) have to be balanced by credible assessments of benefits.

Question 10. In your view, what are the benefits of a recording requirement?

For firms, the benefits of recording telephone/electronic communications are marginal; while such records may occasionally be useful for resolving trading disputes with market counterparties or for providing corroborative evidence of breaches that have been identified through other means, they are an extremely resource-intensive monitoring tool for day-to-day conduct of business compliance and are, consequently, more likely to be used for random spot-checks than for systematic risk monitoring.

As per our response to question 9 above, it would be extremely useful for investment firms to have a clearer and more detailed understanding of the benefits of recording as perceived by regulators. When the FSA first proposed the introduction of a recording requirement in CP07/9 in May 2007, the weakness of its benefits assessment was one of the areas most challenged by industry. Ten months later, after industry had provided the FSA and its consultants with a great deal of specific cost data, the FSA could still produce very little evidence for the likely benefits of its proposals and confirmed the recording requirement with the less than satisfactory conclusion that *it is not possible to place a monetary value or benefits. Nor is the FSA able to estimate the additional number of successful enforcement cases which will result from the rules.*

Question 11. In your view, what are the additional costs of the proposed minimum harmonising recording requirement (for fixed-line, mobile and electronic communications)? Please specify and where possible please provide quantitative estimates of one-off and ongoing costs.

Given the press of regulatory projects in which APCIMS member firms are currently engaged, we have not approached firms with a view to assessing the incremental costs they are likely to incur if the CESR proposals are implemented in their current form. We would, however, like to sound a note of caution about the reliability of cost estimates drawn up by regulators which are, in our view, usually aimed more at illustrating the reasonableness of regulatory proposals than at establishing their true costs to and impact upon industry. In putting forward its recording proposals, the FSA estimated that between 55,000 and 70,000 individuals were likely to be within the scope of its rules

and that, allowing for the fact that the majority of phone lines in major investment banks were already recorded, approximately 11,000 to 14,000 additional lines would need to be recorded for the first time. Between the publication of its original consultation and its confirmed rules, the FSA's cost estimates for the recording of these additional lines rose (a) for one-off costs of installing relevant hardware/software from £3m-£4m to a revised "best estimate" of £9m-£14m and (b) for on-going annual costs associated with storage/maintenance from £3.5m-£4.5m to a revised "best estimate" of £6m-£11m. Notwithstanding these significantly increased costs and its inability to produce any useful estimation of benefits, the FSA's proposals were confirmed.

Question 12. What impact does the length of the retention period have on costs? Please provide quantitative estimates where possible.

Please see our comments in response to question 8 above.

Part 2: Execution quality data (Art 44(5) of the MiFID Level 2 Directive)

As with the telephone taping section of this paper, APCIMS wishes to offer some general comments related to execution quality data and market fragmentation prior to answering the specific questions in the CESR document,.

We made the point in our January 2009 submission in response to CESR's call for evidence on the impact of the MiFID on the functioning of secondary markets that (i) the costs of implementing the MiFID had fallen disproportionately on smaller agency brokers of the kind represented by the APCIMS membership and (ii) these firms had experienced few or none of the countervailing benefits derived by larger intermediaries from their facilitated cross-border operations because they were too small to have any such operations. Moreover it was not clear that imposition of new MiFID-related rules on APCIMS' firms, which already had a pattern of enduring client relationships derived from excellence of client care and service, had improved either investor protection or the market operations of the firms in favour of the clients.

CSR recognised concerns about the lack of discernible benefits of the MiFID for smaller agency brokers in its feedback statement of July 2009, particularly the third bullet point of paragraph 153. Many of these concerns related to market fragmentation and the detrimental effect of this on pre- and post-trade data available in relation to on-market equity trading. This had brought extra costs and increased difficulty of establishing that in executing trades the best outcomes had necessarily been achieved for the client because of uncertainty about whether prices on all possible execution venues had been fully ascertained. In turn this was because the relative costs to the smaller firms of accessing all the data feeds necessary to ensure certainty was prohibitive and largely offset the gains from greater competition which has resulted in the lowering of trading fees, narrower spreads greater liquidity, and reduced clearing costs. These problems have been particularly acute in London where fragmentation due to the proliferation of execution venues and price competition has been most keenly felt.

In the light these experiences of post-MiFID execution quality data APCIMS believes that CESR should take very careful account in its advice to the Commission of the likely costs of the different policy proposals in its current paper that are designed to underpin or improve data quality. It is important in particular to be aware of where such costs might disproportionately fall. Firms will do

all they can to implement efficiencies to absorb additional regulatory costs but in the APCIMS sector there will inevitably be some costs that are passed on to the retail consumer of financial services. This extra burden can only be justified if it brings clear regulatory benefit and as noted above that has not been an obvious gain for our firms and their clients from the MiFID hitherto.

We note from paragraph 87, the second bullet point, that CESR is conscious of the difficulties experienced by smaller investment firms in relation to accessing data and analytical tools, and from the preceding bullet and footnote 13 of the need to take the full complexity of different market structures into account. We hope that this recognition of diversity will help to ensure that CESR's advice to the Commission will seek to avoid one-size-fit-all solutions.

Question 13. Do you agree that to enable firms to make effective decisions about venue selection it is necessary, as a minimum, to have available data about prices, costs, volumes, likelihood of execution and speed across all trading venues?

We agree that this is the minimum range of information required in ideal circumstances but not at any cost. In particular the relative cost to small firms of acquiring such information is far higher as a proportion of turnover than for large firms. If requirements in respect of gathering such information are to be imposed we would want them to be appropriately proportionate in respect of smaller and larger firms in order to account for and alleviate the relative cost differential. We would for example be very concerned if it was made mandatory for all smaller firms necessarily to access all the data in every case.

Question 14. How frequently do investment firms need data on execution quality: monthly, quarterly, annually?

No more than quarterly, although with smaller firms undertaking small bargains only on regulated markets it could be less than that. We note that investment firms in the UK are in any case required to review execution venues on at least an annual basis, which would suggest that information on data execution quality annually is unlikely to be often enough. We would suggest semi-annually at a minimum and quarterly or more frequently for larger cross-border firms.

Question 15. Do you believe that investment firms have adequate information on which to make decisions about venue selection for shares?
Question 16. Do you believe investment firms have adequate information on which to make decisions about venue selection for classes of financial instruments other than shares?

We have anecdotal evidence from APCIMS' member firms to the effect that they are not always certain that they have necessarily been able to secure all the information available to make such decisions. However, it is not clear that this means that the information they have used has not been adequate and to achieve that knowledge some form of objective definition of "adequate" in this context needs to be deployed. The need to ask this question derives from market fragmentation and in that regard it is instructive to examine what the market itself has begun to produce in response. The Fidessa Fragmentation Index (FFI), for example, set up by the Fidessa Group Plc, is designed to provide the trading community with an accurate, unbiased measurement of the state of liquidity fragmentation across the order driven markets in Europe. Most crucially in respect of MiFID

requirements and adequacy of information it shows the average number of venues that must be visited in order to achieve best execution when completing an order. An index of 1 means that the stock is still traded at one venue, while increases in the FFI indicate a fragmentation of trading across multiple venues so that any firm wishing to trade that security effectively must be able to execute across more venues. In general the FFI shows that liquidity in Europe continues to fragment rapidly as more low-cost alternative trading platforms are set up, while the newer venues seem to be associated especially with smaller order sizes. We think that CESR should take account of these market initiatives and their impact in filling information gaps for firms, especially smaller ones, when framing their advice to the Commission in this area.

Question 17. Do you agree with CESR's proposal that execution venues should produce regular information on their performance against definitions of various aspects of execution quality in relation to shares? If not, then why not?

It is in the commercial best interests of the execution venues to provide regular such information, either directly or via a third party, and this should be done at reasonable cost to the information's users. Competition between venues should ensure that costs do not escalate while both competition and user demand will condition the information's quality and content. We are not sure that prescriptive regulatory intervention is required here.

Question 18. Do you have any comments on the following specifics of CESR's proposal:

- **imposing the obligation to produce reports on regulated markets, MTFs and systematic internalisers;**
- **restricting the coverage of the obligation to liquid shares;**
- **the execution quality metrics;**
- **the requirement to produce the reports on a quarterly basis?**

As indicated under Question 17 the market should be encouraged to produce its own reports within a competitive framework and in conformity with a set of broad-brush or headline point standards or metrics from the regulators about what as a minimum such reports should cover. But these should not be prescriptive and should avoid detail. On this basis we believe that paragraph 118, bullet point 1, offers the best option.

Question 19. Do you have any information on the likely costs of an obligation on execution venues to provide regular information on execution quality relating to shares? Where possible please provide quantitative information on one-off and ongoing costs.

No.

Question 20. Do you agree with CESR that now is not the time to make a proposal for execution venues to produce data on execution quality for classes of financial instruments other than shares? If not, why not?

We do not have a view on this issue.

Part 3: MiFID complex vs non-complex financial instruments for the purposes of the Directive's appropriateness requirements

APCIMS responded to CESR's May 2009 consultation on complex and non-complex financial instruments for the appropriateness test and we have been interested to see the results in the feedback statement and the current draft advice to the Commission. Given the specific concern for retail clients made explicit in the development of the appropriateness test, and the fact that APCIMS' member firms' client base is universally retail, we have a very particular interest in this area. Broadly speaking we think that CESR is right to want to seek greater legal certainty and our short answers to the questions below are given against this perspective.

Question 21. Do you have any comments about CESR's analysis and proposals as set out in this Chapter?

We support CESR's proposals. However, we would suggest that consideration is given to ensuring that documentation issued in respect of financial instruments clearly states whether or not the instrument is complex or non-complex. For example, it is often not readily apparent whether or not a financial instrument has an embedded derivative; more prominent disclosures would assist firms in ensuring instruments are correctly categorised.

Question 22. Do you have any comments on the proposal from some members that ESMA should work towards the production of binding Level 3 material to distinguish which UCITS should be complex for the purpose of the appropriateness test?

We have no comment to make on this issue.

Question 23. What impact do you think CESR's proposals for change would have on your firm and its activities? Can you indicate the scale of, or quantify, any impact you identify?

The majority of 'execution only' transactions undertaken by our member firms are in non-complex instruments such as shares. However, as noted at question 21 above, the main difficulty APCIMS' firms face is in being able readily to identify whether or not a financial instrument is complex or non-complex. In the light of this we would welcome any greater clarity that relevant documentation can provide and hope that CESR could look into this aspect at some stage with a view to securing improvements.

Part 4: Definition of personal recommendation

Question 24. Do you agree with the deletion of the words 'through distribution channels or' from Article 52 of the MiFID Level 2 Directive?

We understand that what CESR is proposing is a clarification which will ensure that Article 52 reflects the reality that it is possible for the internet to be used to deliver investment advice which fulfils the criteria for a personal recommendation. We have no difficulty with this and no comments to add.

Part 5: Supervision of tied agents and related issues

Question 25. Do you agree with CESR that the MiFID regime for tied agents has generally worked well, or do you have any specific concerns about the operation of the regime?
Question 26. Do you agree with the proposed amendments to Articles 23, 31 and 32 of MiFID?
Question 27. Could you provide information on the likely impacts of the deletion of the ability of tied agents to handle client money and financial instruments?

We have no comment on any if this section.

Part 6: MiFID Options and Discretions

Question 28. Do you agree with the suggested deletions and amendments to the MiFID texts proposed in this chapter?

Yes.

APCIMS
May 2010