



Fédération Bancaire Européenne
European Banking Federation

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RESPONSE - FIRST PART

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

2ND CP / 2nd Set of Mandates – Ref.: CESR/05-164

I. INTRODUCTION

1. The European Banking Federation¹ (FBE) welcomes the opportunity to comment on the Consultation Paper (CP) issued by CESR for the 2nd set of mandates of the implementing measures of the Markets in Financial Instruments Directive (MiFID). The FBE has participated in the Level 2 process from the start and is committed to contributing to an effective and timely implementation of the Directive.
2. In this response, which is being submitted on 4 April 2005, we address:
 - Aspects of the Definition of Investment Advice;
 - Aspects of the General Obligation to Act Fairly, Honestly and Professionally in the Best Interests of Clients; and
 - Best Execution.
3. We will address Market Transparency in a subsequent response, to be submitted by 6 April 2005.
4. Before we go on to the substance of the CP, however, we would like to make a few comments on the **process** followed which have a bearing on our response to both parts of the CP:
5. As many market participants stated in the Open Hearing of 23 March 2005, the **absence of timely, complete and relevant data** has greatly constrained our ability to assess the full implications of the proposals made by CESR in its 2nd CP. While we agree with the Chairman of the Markets Working Group, Mr Caspari, that imperfect data holds the potential of being useful, and appreciate the fact that CESR has made data available as early as possible under the circumstances, we still regret that the data needed to understand, test and comment on the proposals (which, moreover, were built on such data) has not been available to us from the start of the consultation period. As a result, we believe that it may be necessary to come back to some of the

¹ Set up in 1960, the European Banking Federation (FBE) is the voice of the European banking sector. It represents the interests of over 4,500 European banks, large and small, with total assets of more than EUR 20,000 billion and over 2.3 million employees.

underlying technical questions, in addition to the various open policy questions, during the preparation of the implementing measures by the Commission.

6. The **one-month period** made available for the 2nd CP, while in any event rather short (especially when considering the overlap with a Europe-wide public holiday), was made even less sufficient by the fact that the 2nd CP introduced some **new proposals** not contained in the 1st CP (e.g. suitability assessment for lending transactions, some details of the best execution part, most aspects of the market transparency section) and the fact that the data was made available as late as 29 March 2005.
7. Quite apart from timing constraints, we also regret some aspects of the **structure** of the 2nd CP, which fails to live up to the CESR standards, in the following ways:
 - o re-introducing subjects for consultation on which market input in the 1st CP was very clear (e.g. disclosure of percentage of execution on different venues) without an adequate argument as to why the market views were not found to be convincing or how the overall views were assessed; while at the same time taking the view that any aspect of the CP not explicitly reacted to by the consultees will be taken as an endorsement and not re-introduced or re-tested (Paragraph 121).²
 - o introducing many figures without sufficient explanation for the basis of the calculations, thereby making it difficult for the consultees to assess whether they are too high or too low, and whether they are appropriate to their objectives (e.g. 1 billion euro free float for liquid shares; 7,500 euro for the retail investor size; the five bands for the pre-trade transparency waiver); and
 - o introducing new proposals that must be justified on the basis of new input without drawing due attention to them (e.g. Question 129 asks for views on whether disclosure should be extended to the fact that speed is not given a priority, whereas the proposal regarding disclosure for price or cost in Box 4 itself is new).
8. We also note that on several issues, CESR's approach arguably **contradicts Level 1** (e.g. the introduction of a suitability requirement for lending activities; the extension of best execution obligations to explicit client instructions; the terms used in the calculation of the SMS).
9. Notwithstanding our concerns about the process, we also acknowledge that, to a large extent, CESR's consultation practices have been suffering as a direct consequence of the lack of time available. We appreciate CESR's efforts to make up for these constraints over the last few months. We found the exchange of views at the CESR Hearing quite helpful in answering some of the questions emerging from the CP. We also acknowledge the usefulness of the exchange of views with CESR on an informal, bilateral basis prior to the Hearing (while one could question the concrete effect of these contacts since CESR's eventual proposal deviated in many aspects from the early proposals discussed with the industry).
10. Overall, we believe that consultation with the industry needs to take place in a more continuous, collaborative fashion, and must include where needed an earlier and more

² The FBE considers that, quite irrespective of the inability of consultees to respond to all points in a CP given the extreme time constraints, the general principle should be that the lack of response from consultees on a specific point proposed in the first round should not be taken as an endorsement.

extensive exchange of data and analysis than has been the case with the current CP. If time will not be adequate to maintain CESR's standards, this must be acknowledged and rectified upfront. Since CESR's work at Level 2 is coming to an end in April, we wish to conclude by drawing attention to the need to improve on these aspects later in the process.

II. EXECUTIVE SUMMARY

11. CESR should not provide any advice on **lending for financial transactions**, above all because the proposed requirement does not have any concrete basis in Level 1 and would go against the stated objectives of MiFID. The lending activity for financial transactions should be left to the commercial credit criteria to be used by the bank. We are especially concerned that the services regulated by Article 19.5 and 19.6 would not be allowed to continue with such a requirement being imposed on these transactions.
12. We do not believe that what CESR refers to as "generic advice" in fact exists, and do not believe that there is any justification for including **generic information** provided to clients in the definition of investment advice.
13. Given CESR's continuing work on this subject, we would also wish to reiterate our view that **advice** has to be **explicit**; otherwise, from a purely practical point of view, it would be impossible to establish clear legal boundaries for what constitutes advice.
14. We appreciate the **high-level approach** taken by CESR with respect to best execution in general, which is aimed at taking into account the differences between markets. We fully agree that the application of the article to **non-equity markets** will need to be thought out carefully. Given the lack of time available and the complexity of the issues involved, we acknowledge the proposal of working on this question at Level 3.
15. If **best execution** obligations were to be extended to **intermediaries not executing client orders directly**, the obligation would first need to take market practice into account and then it would need to be tailored to the circumstances of these institutions, taking into account the relatively limited control they may in fact have over the execution. In such cases, the intermediaries should only have a duty to choose the right intermediary and to monitor their own choice, but not the internal arrangements of the executing intermediary. Hence we would propose deleting Box 1, and replacing it with wording that achieves this effect.
16. We strongly welcome the framework approach used with respect to the **criteria that may be taken into account in determining the relative importance of the factors related to best execution**. The list provided in Box 2 seems to us sufficiently clear and flexible to be used in the infinite number of possible situations posed by day-to-day execution of client orders.
17. We strongly welcome in principle the high-level approach taken with respect to the **review requirement of best execution arrangements**. As we have argued in the past, the regulatory requirement should stay high-level and should not get in the way of the bank's own processes for reviewing its arrangements. We believe that the guidance provided in respect of the content of reviews is appropriate. At the same time, we are not convinced that an annual review would add any benefit in those cases where no review was triggered by the requirement outlined in the advice. We urge CESR to consider whether the benefit expected from a general standard of at least an annual review would be commensurate with the costs involved, in particular for the smaller firms.

18. We fully support the principle that **disclosure of best execution arrangements** needs to be useful to the client. Disclosure to the client that price, cost or speed is not deemed to be a key factor for them would not only undermine the principle of not pre-judging the relative importance of the factors for best execution, but also be superfluous for the client, who in any event will be informed of “the relative importance the investment firm assigns to the factors cited in Article 21(1) or the process by which the firm determines the relative importance of these factors”. Hence we do not believe that there needs to be disclosure with respect to either price/cost or speed.
19. While we appreciate in principle CESR requesting the industry to possibly submit more information regarding possible disclosure of **percentage of orders executed by venue**, we urge CESR to re-consider the weight of the responses submitted by the industry on this subject in the first round of consultation, which we believe has covered all of the relevant aspects of the relative costs and benefits of this proposal. We find the original reasons cited by the clear majority of consultees against this proposal sufficiently convincing, and reiterate that there is no rationale for pursuing this requirement further.
20. Finally, we are convinced that the **warnings proposed with respect to client instructions** would deviate from the Level 1 principle that such cases not be subject to Article 21. To us the wording used at Level 1 makes it very clear that the latter situation is a full exemption from the Article, and that the obligations imposed by Article 21 do not apply to those cases where the firm is following a client instruction. This principle is an appropriate recognition of the practical reality that it would be very difficult for the firm to comply with the instruction while also following its own policy. In the absence of a Level 1 justification, we urge CESR to delete the proposed disclosure.

III. DETAILED REMARKS

A. ISSUES LINKED TO ARTICLE 19

CESR’s proposal concerning lending for financial transactions to be subject to suitability assessment (Chapter 1 of the CP):

21. CESR has introduced this completely new proposal at a very late stage and, we believe, without any proper rationale. We believe that CESR should not provide any advice on this subject, because of the following reasons:
 - o ***The proposed requirement does not have any basis in Level 1 and would go against the stated objectives of MiFID***
22. CESR explained in the Hearing that Article 19.1 allowed it to include any ancillary services, such as lending, in the scope of the article. This paragraph’s careful wording (“where appropriate”) indeed allows for extension of Article 19.1 to ancillary services, but makes this subject to a determination of whether this is appropriate, i.e. beneficial for the investors. What is even more important is the fact that this paragraph cannot be extended in a way that would contradict the objectives of the paragraphs 19.5 and 19.6, which would be impossible to render if lending were included under 19.1 (please see below the 3rd bullet point in this section). Furthermore, we believe that the objectives of MIFID – such as widening the quality and range of choices for the investors – make it imperative that a proper balance be found between the need to set high standards for investor protection and the need to avoid over-regulation. Finally, as the time in the remainder of the schedule is very limited, we question the inclusion of a new subject at this late a point.

- o ***The lending activity for financial transactions should be left to the commercial credit criteria to be used by the bank.***

23. In this context, we disagree with the comparison made by CESR in the Hearing between a derivative product and lending for a financial transaction. CESR argued that lending was not dissimilar to derivatives, and thus justified the suitability assessment. We find this comparison not useful for several reasons. First of all, we do not agree that derivatives are similar to the credits given to the client; they are not comparable either from a conceptual or a technical point of view.

24. Secondly, even if a derivative were deemed to be a complex instrument (which may not be the case for all derivatives, depending on the conclusion of CESR's ongoing work on this subject), the options available to the customer are not limited to Article 19.4, but also include Article 19.5. By contrast, CESR's proposed plans for lending for transactions would extend full suitability assessment to this service.

25. Moreover, derivatives are financial instruments as defined by MiFID, whereas lending for transactions is an ancillary service, as described above. While many activities may carry direct and indirect risks for the clients of banks, not all of these risks are appropriate to be handled through a suitability assessment.

26. Finally, as we note above, whether or not all derivatives are complex products is a subject under the 1st CP, regarding which we hope CESR remains open minded. Since there are many different types of instruments that have very different features, the majority of our members considers that it is not possible to categorise all derivatives as either complex or non-complex (please see our Response to the 1st CP).

- o ***Despite CESR's attempts to explain how this proposal would interact with Article 19.5 and 19.6, we fail to see how these other services would be allowed to continue with such a requirement being imposed on these transactions.***

27. Perhaps most decisive is the perspective of the client. We believe that the investor's interests with respect to the appropriateness of the credit would already be addressed when receiving investment advice, which would in any event take into account the full circumstances of the client, including any credit taken for the transaction. By contrast, when the client has not decided to receive investment advice, the imposition of a suitability assessment for the credit itself would interfere with the structure of the services under 19.5 and 19.6, and would in effect curtail the range of services available to the client.

28. In conclusion, we believe that CESR should not provide any advice on this subject.

CESR's consideration of including "generic advice" within the scope of investment advice (Chapter 2):

29. By definition, advice has to be specific and personal. Therefore we do not believe that what CESR refers to as "generic advice" (page 9) in fact exists, and therefore do not see any justification for including generic information provided to clients in the definition of investment advice.

30. This interpretation is first of all supported by the basic definition of the word "advice" from any **dictionary**, generally defined as "Proposal for an appropriate course of action." In other words, advice has to be of a specific nature to result in an appropriate

course of action. More importantly, the **wording used in Level 1 text of MiFID** clearly intends to exclude “generic” information from the definition of advice. Article 4, Para 1, subpara 4) states:

“Investment advice” means the provision of **personal** recommendations to **a client**, either upon its request or at the initiative of the investment firm, in respect of one or more **transactions** relating to financial instruments;” (emphasis added)

31. While Article 19.4: states:

“When providing investment advice or portfolio management the investment firm shall obtain the necessary information regarding the client's or potential client's knowledge and experience in the investment field relevant to the **specific type of product or service**, his financial situation and his investment objectives so as to enable the firm to recommend to the client or potential client the investment services and financial instruments that are suitable for him.” (emphasis added)

32. Furthermore, as a practical matter also acknowledged by CESR, it is very difficult to separate marketing communications, generic information and investment advice from one another, unless one is making a distinction on a clear basis. As we argued in our response to the 1st CP, the basis of this decision should be whether a specific instrument was involved, and whether the personal recommendation is being held out as being suited to, or based on a consideration of, the client's personal situation. The only clear criterion by which one can determine whether advice was delivered in such situations is whether the advice was linked to a specific instrument and a specific transaction.

33. Moreover, we agree with CESR's assertion that including such generic discussions under the scope of advice would have the negative effect of discouraging firms from entering into such useful discussions with their clients and may effectively force banks to offer it only when there is a special contract paid for.

34. Hence we would view the inclusion of generic information provided to a client or clients within the definition of investment advice as completely impracticable.

35. For these reasons, we were grateful for CESR's clarification that the intention of the CP is not to deviate from a definition based on specificity. We also sympathise with CESR's goal of closing all possible loopholes that might undermine investor protection in this field. However, we believe that the interests of the investor are well protected without such a proposal, because:

- a. if the generic discussion is followed by investment advice and action, or if there is only investment advice provided, the investor is fully protected (and we agree that the fact that a generic discussion preceded the investment advice should not become a way for the firm to avoid the investment advice obligation);
- b. if it is not followed by investment advice and/or action, there is no investor interest involved. In these cases, the investor's rights and the interest of market integrity would be upheld by other provisions (e.g. information to clients in Article 19 of MiFID and provisions regulating research in MiFID and MAD), but there would not be a situation giving rise to protection under investment advice.

36. Under the “scenario a)”, whether the information constitutes advice or not should depend entirely on the full set of criteria being developed by CESR in line with Level 1, e.g. whether the advice was based on the personal circumstances of the client and

whether it related to a specific transaction. If the investor reads a piece of general information for the industry X in a context that was not related to her/his own circumstances and receives no further personalised investment advice for any shares in this industry, then any decision taken by the investor to buy such shares would be at her/his own initiative, and not related to any investment advice received.

37. Hence we believe that CESR should not include any advice on “generic advice”.

Additional questions regarding advice which CESR is still working on:

38. We note CESR’s statement on page 10 of the CP that it is still working on whether advice can be “implicit”: CESR gives the example of a recommendation by a firm that is supposed to be an implicit advice. We disagree with CESR’s interpretation of this hypothetical case. In any event we wish to reiterate our view that advice has to be explicit. Otherwise it would be impossible to establish clear legal boundaries for what constitutes advice; it would be simply impossible to draw a reasonable line between what was and was not “implicit” advice.

B. BEST EXECUTION (Chapter 3)

Scope of best execution:

39. First of all, we appreciate the high-level approach taken by CESR with respect to best execution in general, which is aimed at taking into account the differences between markets. We fully agree that the application of the article to non-equity markets will need to be thought out carefully. We would like to note in passing that the range of issues to take into account would be broader than just the liquidity of the markets (contrary to what seems to be the assumption in Para 45). Given the lack of time available and the complexity of the issues involved, we support the idea of working on this question at Level 3, where high standards of consultation will of course apply.

40. We note that CESR proposes extending the best execution obligation to portfolio managers and firms that are transmitting the client’s order to another bank, arguing that this is allowed under Article 19.1, and that otherwise customers of portfolio management will not benefit from best execution.

41. We believe that as a principle, Level 1 would certainly allow for the possibility of not extending best execution to these cases. However, we understand that investment firms should not be able to escape their best execution obligation simply by inserting another bank in the chain of execution. We could therefore agree that there may be a case for ensuring that clients of such services also receive best execution in an arrangement whereby the first bank retains accountability to the client, but the internal arrangements of the second bank determine the execution. However, how to achieve best execution in these cases requires further thought.

42. We would like to stress that in any event the firms that deal through other intermediaries will do so on the basis of a contractual relationship. Moreover, we see considerable merit in the argument that customers of portfolio management, for example, may be more interested in the overall quality of their portfolio management than in the individual execution of transactions. Some of our members would even challenge whether portfolio management should be in the scope of best execution at all.

43. With these caveats in mind, we consider that, if such an obligation were to be extended to portfolio management or transmission of orders, the best execution obligation would need to be tailored to the circumstances of these institutions so that their obligations vis-à-vis their clients are appropriate to the level of involvement they have in the process, which may be rather limited when compared with a firm executing the client order. The differentiation of the regime should ensure that these intermediaries only have a duty to choose the right intermediary and take reasonable steps to ensure that their choice achieves their objectives, but not require them to be responsible for or to monitor the internal arrangements of the executing intermediary.
44. CESR seems to acknowledge this problem in the text. We find the diagrams provided by CESR helpful, and we share CESR's analysis that indeed there are many different scenarios possible in terms of the control maintained by the transmitting firm or portfolio manager with respect to the ultimate execution received by the client. However, we are puzzled as to the link between this nuanced analysis and the more mechanistic, literal approach taken in Box 1 on page 19, which does not seem to allow for any such tailoring. It may be too difficult to draft a Level 2 text that captures all the nuances, but it is also clear that any general principle established at Level 2 should avoid imposing on these intermediaries an obligation not suited to their role in the execution chain.
45. Furthermore, one needs to consider that the relationship between the transmitting firm/portfolio manager and the firm executing the client orders is itself governed by a clear contractual relationship, which will allow the former to impose its requirements on the latter so that the client's best execution needs are duly served in any case. Any regulatory requirement introduced in this area has to take into account this contractual relationship and be complementary to it, rather than seek to replace it with a new administrative burden. This is very important since, in the end, the quality of execution received by a portfolio manager, for example, will depend on its efforts to negotiate the best terms with the brokers it chooses to direct its orders to.
46. As a solution, we would propose deleting Box 1, and replacing it with the following wording:
- “Member States shall require investment firms providing the service of portfolio management and investment firms providing the service of order reception and transmission to comply with the obligations under Articles 21 and 22(1) of the Directive when carrying out decisions to deal. This should be on the basis that their obligations vis-à-vis their clients are appropriate to the level of involvement they have in the process and are limited to the choices they make with respect to the executing firms/venues to achieve best execution for the clients and the ability of these choices to deliver best execution for their clients on a reasonable basis.”
47. Finally, a very important problem regarding the scope of Article 21 emerges from CESR's seeming assumption that client instructions (with respect to venues or other aspects of the execution) are nonetheless subject to Article 21. We come back to this point in greater detail below in our reactions to the disclosure of best execution.

Criteria for best execution:

48. We strongly welcome the framework approach used with respect to the criteria that may be taken into account in determining the relative importance of the factors related to best execution. We especially appreciate CESR's confirmation in the Hearing that it will be up to the firm to determine the relative importance of these criteria, as intended by the Directive. The list provided in Box 2 seems to us to be both a sufficiently clear

and a complete framework to be used in the infinite number of possible situations posed by day-to-day execution of client orders.

Review of best execution arrangements:

49. We strongly welcome in principle the high-level approach taken in Box 3 of pages 29-30 to the review requirement of best execution arrangements. As we have argued in the past, the regulatory requirement should stay high-level and should not get in the way of the bank's own processes for reviewing its arrangements. Otherwise the regulatory requirement would add an additional layer of complexity without any benefit. We believe that the guidance provided in Paragraph (b) of this Box is appropriate in this respect.
50. At the same time, looking at the contents of Paragraph (a), we are not convinced that Item iv) (annual review) would add any benefit in those cases where no review was triggered by the requirement outlined in sub-paragraphs i) through iii). Arguably, if a firm did not have to carry out a review because none of the elements mentioned in i), ii) or iii) have occurred, the annual review would be a simple bureaucratic burden. While this may be seen as helpful by establishing a general standard of at least an annual review, it would not come without a cost. In particular, the smaller firms, which would have to hire additional staff to carry out this exercise, would incur a significant cost.

Information/disclosure to clients:

51. We fully support the principle that disclosure of best execution arrangements needs to be useful to the client. Box 4 on page 35 is therefore an important element of the best execution obligation. The intention of the Directive is not to create an information burden for the client, but rather to enable the client to understand the quality of the execution s/he will be getting from the firm. The Box should therefore contain only those items that would be of benefit to the client and items that are in line with the basic approach to best execution laid out in the Article.
52. With these principles in mind, one could argue that the proposal to require disclosure to the client that price, cost or speed is not deemed to be a key factor for them would undermine the principle of not pre-judging the relative importance of the factors for best execution. As this point was discussed in the Hearing, we recognise that CESR sees this as a mere disclosure issue. In principle we welcome CESR's confirmation that the intention of the proposal is not to prioritise any of these items for any specific client category. Nonetheless, one could view such a disclosure as constituting such an assumption.
53. Moreover, since, under (a) i) of the Box, the firm will already provide information on "the relative importance the investment firm assigns to the factors cited in Article 21(1) or the process by which the firm determines the relative importance of these factors;" the majority of our members finds it more appropriate to leave it to the firm to decide, at its own choice, whether or not disclosure with respect to specific factors is needed to comply with (a) i). If the firm decides to make such disclosure under sub-paragraph (a) i) (for example because it considers that the relevant customer base would make such an *a priori* assumption about the given criteria) then it would be free to disclose this aspect of its approach to its clients. Hence we do not believe that there needs to be disclosure with respect to either price/cost or speed.
54. Secondly, we note that CESR is asking for further input on the possible disclosure of percentage of orders routed to venues (page 31). We note CESR's statement (Para

108) that this proposal was rejected by the great majority of the respondents in the earlier round of consultation. We believe that the reasons cited by the respondents as summarised by CESR on page 31 (Para 107) remain valid. We appreciate in principle CESR's request for more information before making up its mind, but fail to see how consultees can be expected to provide even more detailed information in one month than they were able to generate in the first three months of consultation. Given the very limited time available, we would urge CESR to re-consider the weight of the responses submitted by the industry on this subject in the first round of consultation, which we believe has covered all of the relevant aspects of the relative costs and benefits of this proposal. We believe that there is no rationale for pursuing this requirement further.

55. Finally, we are very concerned about the warnings proposed in Box 4, Paragraph (a) iii), regarding the cases when the firm executes client instructions. It is proposed that the client be informed that such instructions may affect the firm's ability to achieve the best possible result for the client's orders. We believe that there is a serious risk of deviating from the Level 1 principle here. Article 21, Para 1 states:

"Member States shall require that investment firms take all reasonable steps to obtain, when executing orders, the best possible result for their clients taking into account price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order. **Nevertheless, whenever there is a specific instruction from the client the investment firm shall execute the order following the specific instruction.**" (emphasis added)

56. The wording used makes it very clear that the latter situation is a full exemption from the Article, and that the obligations imposed by Article 21 do not apply to those cases where the firm is following a client instruction. By contrast, CESR's wording in Box 4, as well as the explanatory text, implies that the firm's execution policy must be applied to all clients, even when they are giving instructions.
57. Moreover, there are also very good practical reasons why the approach taken in the Level 1 text makes sense. It may be true, as CESR notes on page 35, that "client instructions are unlikely to address every aspect of a firm's order execution policy and arrangements". However, whenever there is an instruction, the firm's ability to apply the other elements of its execution policy will be severely restricted. To take the example used by CESR, if a client gives a specific instruction regarding venue selection, it is very hard to imagine indeed what other aspect of its own execution policy would be available for the firm to utilise. Even for instructions that may seem to be less encompassing or prescriptive, it would be very difficult for the firm to comply with the instruction while also following its own policy. It is with this principle in mind that the Directive has simply stated that the firm's obligation in the cases of a specific instruction consists of executing the order in line with the instruction.
58. Furthermore, we find CESR's statement in Paragraph 130 related to "soliciting instructions" very unclear. There are many business models that cannot survive without client instructions. Article 19.5 and 19.6 are two types of services that would need to have instructions: Is CESR suggesting that banks should not offer these services? Moreover, we believe that for all such cases of obvious misconduct (e.g. a firm systematically seeking to escape best execution by manipulation of clients), the supervisors would have at their disposal a wide range of tools for detection and enforcement. This particular concern would not justify, in our view, extending best execution obligation to client instructions, even if the Level 1 text allowed for such a possibility.

59. In the absence of a regulatory obligation to apply the firm's execution policy to cases of client instructions, and given the fact that it is not reasonable to require firms to educate the clients in this respect , we urge CESR to delete the disclosure proposed in Paragraph (a) iii).

IV. CONCLUSION

60. We support many aspects of the CP, such as the approach to best execution criteria and review requirements, where we believe CESR's careful analysis has led to balanced proposals. But we still have serious concerns regarding the various new proposals made by CESR, such as suitability assessment for lending for transactions, and some of the details of CESR's proposals on best execution, such as the disclosure on price, cost or speed, or warnings for client instructions, which were not available for comment in the first CP on the subject.

61. There are, of course, many other important questions which CESR is currently looking at, which have not been explicitly included in the current CP for comment (for example other elements of investment advice; the distinctions between the different types of services provided to clients; the application of Article 19.5 and the scope of Article 19.6). On all these important subjects, we refer CESR to our response to the 1st CP. We would be happy to provide any further assistance on any of the issues raised in the current or the earlier response.

62. We will be completing our response to the 2nd CP with a separate paper on Market Transparency (Chapter 4 of the CP).



RESPONSE – SECOND PART

CESR's Draft Technical Advice on Possible Implementing Measures

of the Directive 2004/39/EC on Markets in Financial Instruments

2nd CP / 2nd Set of Mandates – Ref.: CESR/05-164

I. INTRODUCTION

1. The European Banking Federation¹ (FBE) welcomes the opportunity to comment on the Consultation Paper (CP) issued by CESR for the 2nd set of mandates of the implementing measures of the Markets in Financial Instruments Directive (MiFID).
2. In a previous document (Enclosure to FBE letter 214), we responded to the parts of the CP addressing "Aspects of the definition of Investment Advice", "the General Obligation to Act Fairly, Honestly and Professionally in the Best Interests of Clients", and "Best execution". In that response, we also expressed our views on the process followed, which we will not repeat here.
3. In this second and final part of our response, we address Market Transparency (Chapter 4 of the CP). We are grateful for the additional two days provided by CESR for this part of our response.

II. EXECUTIVE SUMMARY

4. We believe that CESR's definition of **systematic internaliser** has become clearer and more focused on the kind of activity intended to be captured by the Level 1 text. We welcome in particular the attempt to incorporate the **Recital 53** into the definition. The attempt to bring in additional, quantitative criteria to capture the concept of "frequent" is also potentially useful. Nonetheless, considering the central role played by this definition in the scope of Article 27, there is still room for improvement.
5. In particular, the **cumulative relationship** between the qualitative and the quantitative criteria has to be made explicit. The quantitative criterion has to be focused on a measure that the firm can control and can rely on as a stable tool for managing its systematic internalisation business. It should therefore not include any measure of the share of the firm's business to the overall market activity.
6. Our approach to the definition of liquid shares for the purpose of Article 27 is based on two principles: First, we believe that it is better to err on the side of **caution** when defining liquid shares if we wish to avoid any damage to liquidity in Europe. Second, the approach to liquidity has to be consistent with the overarching goals of the Directive and in particular with the objective of building a single market that is fully integrated, **without any artificial national boundaries**. As long as these principles

¹ Set up in 1960, the European Banking Federation (FBE) is the voice of the European banking sector. It represents the interests of over 4,500 European banks, large and small, with total assets of more than EUR 20,000 billion and over 2.3 million employees.

are respected, we are willing to support a **pragmatic approach** that may not be theoretically perfect but which is at least likely to bring about a regime more or less appropriate which will be implemented consistently.

7. With these principles in mind, we laud CESR's statement that liquidity is to be defined on a **pan-European basis**, and appreciate that CESR has resisted calls to set a minimum arbitrary number of "liquid" shares for each Member State. At the same time, we believe that CESR would be acting inconsistently with its stated principle if it allowed a **nationally differentiated approach** to the two predetermined criteria which it is proposing. These criteria, even if they are arbitrary, could provide a pragmatic solution, but only if they are applied cumulatively and consistently across Europe. We therefore object to the proposal of giving Member States an option to choose between the two criteria. In fact, provisional calculations based on these two criteria applied cumulatively yield a relatively high number of shares (our guess is at least 400), which surely corresponds to a universe large enough that will include at least all of the most liquid shares from the EU. Finally, we would see CESR's current proposal of 1 billion euro as a starting level appropriate for the **pan-European free float reference**, which should be set at a sufficiently high level to capture shares which offer a real potential for liquidity at any point in time since by definition free float is subject to significant fluctuation and can only be seen as an indirect measure of potential liquidity.
8. We find that CESR's current proposals with respect to SMS classes would yield class sizes that are both **too many** and also **not sensitive** to the range in each band. Thus we would like to support CESR's own suggestion of using a **logarithmic scale**.
9. The relevant exemptions provided with respect to **negotiated trades** and **portfolio trades** have to be revised in order to make them truly useful under actual market conditions.
10. As a general principle, **the reviewing of the SMS bands** has to be based on material changes to the share. Considering the novelty and untested nature of the regime, the review should in any event occur relatively frequently, for example on an annual basis, at the start of its application. The SMS of **new shares** has to be set only after allowing an adequate period of time, such as three months, to allow trading patterns to stabilise.
11. As a general remark on pre-trade waivers and post-trade deferral regimes, we strongly urge all parties involved to ensure that CESR's work can be of use in building a single European approach to the **relevant thresholds**. While we recognise the wording of the Level 1 text gives the Member States the right to decide whether or not to provide these waivers and deferrals, we sincerely hope that the agreements reached between the CESR members in the context of the Level 2 advice on this subject will lead to a **consistent approach** among all members towards respecting the thresholds established at Level 2.
12. We find it difficult to assess the five bands of figures proposed by CESR with respect to the **pre-trade transparency waiver** as well as the respective merits of the two options mentioned in the footnote and the annex, especially in the absence of a rationale for these numbers and an uncertainty as to whether or not CESR intends to offer the current five bands as a temporary solution, to be followed by a more sophisticated methodology over time. Given that these choices will have a huge impact on the market, we urge CESR to consider carefully whether these figures are appropriate even on a temporary basis. We will continue to study these options in the light of the new data available and seek to provide our views during the Commission's preparation of Level 2 measures.

13. The FBE members (with the exception of our Italian member) find the **post-trade transparency deferral** thresholds, in combination with the delay times allowed, too high, and are also concerned about the wide bands of liquidity and the lack of attention to the liquidity variation during the day.
14. We urge CESR to revise its table on the basis of the overarching policy objective guiding the **post-trade transparency deferral regime** provided in Level 1, which is to protect the investment firms which take on large risk positions. Without this protection, they would not be able to enter into such risk positions in the first place. We urge CESR to revise its table on the basis of the overarching policy objective guiding the appropriate deferral regime provided in Level 1, which is to protect the banks which take on large risk positions and thereby to foster liquidity in the market.

III. DETAILED REMARKS

Definition of systematic internaliser (Box 1, page 40)

15. In our response to the 1st CP on the subject in January 2005, we urged CESR to make its definition of systematic internaliser **more precise** and to focus it on those activities that were intended to be captured by the **Level 1 text**. In particular, we urged CESR to incorporate the **Recital 53** in its definition, and to explore additional parameters that could be considered to make the definition more precise, such as quantitative criteria. Since the Directive does not intend to capture investment firms that only occasionally deal on own account, we noted, it was important to focus the definition on those firms practicing internalisation on an organised, frequent, and systematic basis.
16. Reviewing CESR's current proposal, we find the **qualitative definition** in Para 11 of Box 1 a clear improvement over the previous proposal. We find it particularly encouraging that CESR has sought to incorporate Recital 53 into its definition.
17. We also welcome the general principle of including additional, **quantitative** criteria that are aimed at capturing "**frequent**" in Para 12. Since this concept is a part of the overall definition of systematic internaliser in Level 1, we believe that the two paragraphs have to be taken together, and thus welcome CESR's confirmation in the Hearing that this is the intention and that the **cumulative link between Paragraphs 11 and 12** will be made clear in the final advice.
18. While we appreciate CESR's efforts on this front, we find that the **quantitative criteria** in Para 12 need further thought. For instance, 12(b) corresponds to factors not under the control of the firm. We presume that CESR is attempting to capture the ratio of the firm's business to the overall market. However, this measure may generate a problem by imposing a regulatory requirement on firms the trigger of which would not be under their control. This raises several practical and conceptual problems. Due to the need for stability, the only way of implementing this proposal would be to apply it on the basis of a retrospective reference period, so that banks would have to be subject to the rule based on their share of the market activity of the previous reference period. CESR suggests a year. Whether the period of one year is appropriate or not is one question. However, irrespective of the length of the period, the application of this parameter in a retrospective way would constrain the bank's ability to manage its business. Especially banks on the margin would find themselves subject to the requirements due to unexpected developments in market activity during the reference period, even if they made no plans for such a business strategy. This would not be fair or manageable. Moreover, arguably this ratio is not at all linked to the concept of frequency as utilised in Level 1.

19. We would therefore suggest deleting this criterion.
20. In any case, for consistency's sake, any calculation of such a parameter would have to take into account all the relevant exemptions (i.e., excluding all trading above the "block size").

Definition of liquid shares – Box 2

21. As we argued in our first response, it is too early to decide on a concrete method for determining the methodology for defining liquidity. Any method chosen at this point will have drawbacks and will by necessity be simplistic. At a later stage, more complex methods could be chosen to calculate the most liquid shares, if deemed necessary. With these caveats in mind, we had suggested to CESR in our response **two options**, one of which was using **proxies**, and the other using **pre-determined criteria** to capture the most actively traded stocks in Europe by daily **number of transactions** **and** **daily turnover**. We therefore see CESR's proposal as a good starting point towards finding a pragmatic solution.
22. Since the data is still not fully available to judge the results of CESR's proposal on this point, we can only make tentative observations.
23. First of all, as CESR had rightly noted in the Hearing and in its CP, the overarching principle here is not whether the share is liquid per se, but whether it should be deemed liquid for the purpose of Article 27. Given the objective set out in the Directive of fostering a genuinely pan-European market, we support CESR's view that liquidity should be determined not on a national basis, but on the basis of whether the share has enough liquidity from a **pan-European perspective**. **Thus we strongly support CESR's resistance to calls to establish a minimum number of shares per country that would be considered liquid.**
24. Second, and in line with our belief in the need to strengthen the basis for a pan-European market, we believe that all relevant criteria have to apply on **a consistent basis across Europe**. Thus, we believe that the two thresholds proposed by CESR should apply together, and not separately by choice of Member State. We acknowledge that there are differences in several aspects of market structures in Europe today, but we do not think that these differences have anything to do with the definition of liquidity. We do not believe that there would be any justification for taking a differentiated approach to the definition of liquid shares. In fact, the pan-European basis of liquidity and the ultimate goal of integrating the markets would be severely damaged by taking such a differentiated approach.
25. Thus, in the interest of establishing a level playing field and a clear and effective regime to determine the basis of pan-European liquidity for the purpose of Article 27, we strongly recommend that **the two thresholds be used together**. It should **not** be left to Member States to decide which one should be applicable to the shares in their jurisdiction. (In this context, we also support CESR's proposal for a single point of contact referred to in Para 64 of the CP and in Q 3.11. It would also be useful for members of CESR to make links available on their websites.)
26. This brings us to the final question of what **practical impact** we might expect from the chosen thresholds. Our general view is that the universe of shares to which the obligation applies should be sufficiently large to capture those shares which are most widely traded across Europe – but that it should not be so large as to hinder the goal of enhancing competition by introducing inappropriate implementation measures. In view of the fact that a significant withdrawal of liquidity from European markets would be

very damaging, the FBE considers that regulators/the EU should err on the side of caution in setting the parameters for the universe of shares – i.e. the pre-trade quotation obligation should not apply to all traded shares and indeed there might be quite a few shares currently quoted on a national exchange to whom the pre-trade requirement might not apply. If the parameters are set within a pre-trade quote definition at Level 2, then they could be adjusted so as to increase the universe of shares in the future, if experience suggested that they had originally been set too narrowly.

27. Our calculations, based on market data published by CESR in December 2004, had shown that, excluding the UK market (for which data was then not included), the set of pre-determined criteria based on 500 daily number of trades and 2 Million € turnover would capture a number of shares **close to 300**. Estimations based on the recent data published by CESR in March 2005 suggest that, with the UK included, the total number of liquid shares thus defined would be about **400 or 500**. While there is no way of verifying what concrete impact these parameters will have on future business, this calculation at least suggests that the two parameters, when used together and cumulatively, would certainly seem to capture already a **relatively high number of shares**. It is also important to note that, of the 400-500 shares that would be designated as liquid using this methodology, only a small proportion would already account for a large share of the turnover and market capitalisation in Europe, and that increasing the number of shares offers diminishing returns in terms of capturing trading volume.
28. Thus the practical considerations also support the view that, if CESR were to recommend the thresholds of **500 trades** and **2 million trading volume**, these should be applied **cumulatively** to trigger the obligation for a systematic internaliser to quote.
29. Furthermore, we would like to note that the **free float figure** by definition is dependent on price of the share and is therefore subject to **significant fluctuation** which could lead to misleading and abrupt changes in the categorisation of a share. Moreover, free float can only be seen as an **indirect measure** of liquidity, in that it shows the magnitude of potential volume of shares available for trading, which may have little to do with actual trading. Hence, if free float is to be a measure of liquidity, then it should be set at a sufficiently high level to capture shares which offer a real potential for liquidity at any point in time. Thus, we would see CESR's current proposal of 1 billion euro as a starting level appropriate for the pan-European free float reference.

SMS classes- Box 3

30. For practicality reasons, we had argued in our 1st CP response for a smaller number of classes as well as for the need to avoid too wide a range between the shares within each class.
31. Reviewing CESR's proposal, we find that it would lead to class sizes that are both **too many** and also **not sensitive** to the range in each band. Thus we would like to support CESR's own suggestion of using **a logarithmic scale**. This would result in bands that go up in, for example, 10,000 euro intervals at the bottom end, and increasingly wider bands at the higher end.
32. Regarding Para 84, we note that the sub-paragraph would negate the usefulness of the exemption for a majority of **negotiated trades**. We would ask that this last subparagraph be deleted.

33. In addition, Para 83 and 84 need to be made **consistent** by way of ensuring that they both use the same terminology. Therefore we believe that “members/participants of the RM or MTF” in 83 and “member/participant in a share” in 84 should both be replaced by “market participant”.
34. As was also pointed out in the Hearing, we believe that the 3 years in Para 91 is too long a **period for reviewing the bands**, especially considering that this is a new proposal that has not been tested; initially at least it needs to be more frequent, for example on an annual basis. More importantly, we feel that the frequency of the reviews needs to be based on **material changes** to the share.
35. In Para 95, we believe that the period suggested for setting the SMS for **new issues** is much too short when considering the fluctuations experienced in the early trading of new shares and the time it may take to reach a stable level of trading. It will generally take weeks and at times even months to reach a level before the SMS can be computed on a reasonably stable basis. Our proposal would therefore be to put such shares into the lower liquidity band and to revise it within a base period, such as three months.
36. Given the differences between the business of RMs and investment firms, the situations that force a RM to suspend trading (Para 99) would be too restrictive for the investment firms if these were the only situations in which they were allowed to **withdraw quotes**. While recognising that there are other defences available to the firms as pointed out by CESR, we still think that this paragraph needs to be revised to fully take account of the relief intended at Level 1. The risks faced by the banks and the RMs are fundamentally different. Hence, a RM might suspend its trading for reasons completely unrelated to market events affecting banks (e.g. internal IT accidents or purely technical problems) and may well not suspend its trading when a major event that affects banks takes place which would force the banks to suspend quotations. Thus the basis of the banks’ withdrawal of their quotes should be de-linked from that of RMs.
37. Finally, we fully agree with CESR’s analysis that the systematic internalisation obligations would be fully unsuitable to portfolio trades, as recognised also in Level 1 (Article 27.3, subparagraph 5). This is because many investment firms tender for such transactions with only generic information about the portfolio. Moreover, a portfolio is normally priced as a percentage of the aggregate (and, at the time, unknown) mid-market value of its constituent prices of individual components. The application of Article 27 to these trades would reduce institutional ability to conduct such trades.
38. However, the nature of the exemption proposed with respect to portfolio trades in Para 103 is not at all helpful because the fixed structure of trades defined in the proposal does not correspond to market practice. It is the nature rather than value of the transaction that makes it unfeasible to apply pre-trade transparency obligations. We thus suggest for CESR to modify or to remove the second criterion of a minimum market value and revert to the original definition proposed in the 1st CP on the subject.

Pre-trade transparency waiver thresholds based on the four fixed numbers (from 100,000 to 500,000 in Table 1). – Box 6

39. First of all, as a general point, we would like to reiterate our belief that CESR’s work on pre-trade waivers or post-trade deferral regimes would be of very little use in contributing to a single market if the Member States did not respect these thresholds. We recognise the wording of the Level 1 text, which gives the Member States the right to provide these waivers and deferrals, but does not make these regimes mandatory.

From this perspective, it is clear that, legally, Member States would not be bound to apply these thresholds, and could, in theory, require higher thresholds (or not accept any at all). Nonetheless, if CESR's work in this area is to be useful at all, Member States should be using a consistent set of thresholds. While we do not ask for CESR to seek to 'forbid' the Member State authorities from using their Level 1 powers, we sincerely hope that the agreements reached between the CESR members in the context of the Level 2 advice on this subject will lead to a consistent approach among all members to respect the thresholds established at Level 2.

40. As for the concrete proposals of CESR in this area, it is difficult to assess the basis of CESR's decision to propose these numbers for the **pre-trade transparency waiver** and the respective merits of the two options mentioned in the footnote and the annex in the absence of rationale for the numbers. CESR's choice of figures seems arbitrary. It is not even clear to us whether CESR intends to offer the current five bands as a temporary solution, to be followed by a more sophisticated methodology over time. Given that these choices will have a huge impact on the market, we urge CESR to consider carefully whether these figures are appropriate even on a temporary basis.

Post-trade and pre-trade transparency – Boxes 5-7

41. With the exception of our Italian member, we find the **post-trade transparency deferral** thresholds in Box 6, in combination with the delay times allowed, too high. As a result, we believe that the corresponding relief allowed for banks is far from sufficient. Furthermore, the bands of liquidity are very large, and the liquidity variation during the day is also not taken into account.
42. We urge CESR to revise its table on the basis of the overarching policy objective guiding the deferral regime provided in Level 1, which is to protect the banks which take on large risk positions which, without this protection, would not be able to enter into such risks positions in the first place. Whenever the bank takes on a risk position on a share, whether the share is highly liquid or less liquid, the bank will face the risk of losing money, which will increase in reverse proportion with the time allowed for deferred publication. If the balance struck between the protection of risk positions and the legitimate need for public information is not set right, eventually this would force banks to behave more "risk aversely" towards clients than is optimal for the economy as a whole. This would be neither good for the bank nor the end investor. It would decrease liquidity overall - which is not the intention of the Directive.
43. On the other hand, we see no contradiction in the disclosure of the transaction happening once the bank has unwound the whole position (if this were to happen before the time allowed), as referred to in Q 6.4.
44. With respect to Box 7, while we appreciate that CESR has changed its 1-minute proposal to a 3-minute rule, we believe that it is still **not clear when the period starts**. As long as this lack of clarity persists, the extension of the period will not be helpful in itself. This situation may lead to unreliable data being published due to improper checks or even bigger delays due to the uncertainty over the starting time. We suggest that the wording make it clear that the period will start **after trade confirmation**. After the parties complete the trade and enter the information into the system, trade confirmation notes are generated by the two parties. We would suggest that the party that is responsible for publication then be given an hour to make the trade public. Such a system would avoid excessive delays and uncertainty while ensuring, overall, a more reliable level of data being published.

45. With respect to Box 5, the **content of publication**, we find the **level of detail clearly excessive**. In particular, we object to the inclusion of the **item 139a** in Box 5 (**investment firm's name**). Since the investment firm puts its own capital at risk, providing this information to the public would create a non-level playing field between the firm and the regulated market, which does not put its capital at risk. The firm would be put at a great disadvantage since the risk position of the firm would be known publicly. We would therefore strongly object to the inclusion of this item in Box 5.
46. Moreover, Para 141 seems to require an explanation as to the reason for the deviation **from the market price**. There may be an infinite number of reasons for such deviation, which would be very difficult to report in any standardised and meaningful way. This proposal, which does not have a basis in Level 1, would be clearly over-burdensome in that it would require a piece of disclosure that is of no public benefit while involving a heavy cost to produce. We welcome the confirmation in the Hearing that this was not the intention and therefore propose the 2nd subparagraph of 141 ("Any information published...current market price") to be deleted. In line with this, we suggest that items (f) through (h) in Item 139 be merged into one, which should state that there should be an indicator to reflect if the price deviates from the market price.
47. The wording used in Para 196, in conjunction with the trading hours of a global firm, would lead to a situation whereby a firm would be under an obligation to continue making **publication of transactions** long after the core trading hours of the relevant market. In some cases, this obligation may be a **24-hour publication** obligation. In other cases, the firm would be at a severe disadvantage, since it would have to make the publication during a time frame over which it cannot lay off the risk in the relevant market. To avoid these problems and to bring the text more in line with the intention of Level 1, the advice needs to be changed to "the opening hours of the lead market."

IV. CONCLUSION

48. The above comments indicate that there are several important questions that need to be looked at carefully before CESR concludes its work, such as the definition of liquid shares, the specifics related to the calculation of the SMS and their review, the content of post-trade transparency, the relevant exemptions based on the nature of trades, and the application of the waiver and deferral regimes for pre- and post-trade transparency. We urge CESR to consider the overarching objectives of the Directive in resolving these remaining issues, in particular the creation of a single, efficient and competitive pan-European market.

Annex: Number of shares to which the pre-trade transparency obligation would apply under two selected parameters (based on data published in 2004)

Minimum number of daily trades = 500 trades;

Minimum daily turnover = 2 Million € turnover

Stock Exchange	Number of shares	Summed percentage of total turnover (in %)
Copenhagen Stock Exchange	5	60,0
Athens Stock Exchange	8	39,5
Madrid Stock Exchange	33	92,6
Milan Stock Exchange	51	95,2
Oslo Stock Exchange	4	40,5
Warsaw Stock Exchange	2	27,5
Helsinki Stock Exchange	3	83,3
Stockholm Stock Exchange	20	79,2
Deutsche Börse	59	94,9
Hungary	1	29,8
Euronext Amsterdam	29	94,0
Euronext Brussels	5	50,6
Euronext Lisbon	3	69,3
Euronext Paris	64	95,3
Total	287	-

Source: Trade data published by CESR on 31 December 2004 (Ref: CESR/04-717, annexes 1 – 6)