

The City of London Law Society
4, College Hill
LONDON
EC4R 2RB

The Committee of European Securities Regulators ("CESR")
11-13 avenue de Friedland
75008 PARIS
FRANCE

21 January 2005

Dear Sirs

CESR'S DRAFT TECHNICAL ADVICE ON POSSIBLE IMPLEMENTING MEASURES OF MiFID – SECOND SET OF MANDATES – CONSULTATION PAPER OCTOBER 2004

The City of London Law Society Regulatory Committee is pleased to have the opportunity to respond to CESR's Consultation Paper on the second set of mandates. The members of the Committee are all lawyers whose practice covers the law and compliance matters for clients who operate in the financial markets, both in Member States and third countries (see our submission of 17 September 2004 for further details).

INVESTMENT ADVICE

General

We agree with CESR that, in view of the consequences that flow from the characterisation of behaviour as the provision of investment advice, the activity should be defined in a proportionate manner whilst ensuring an appropriate level of investor protection. It is important to distinguish between matters which may involve general laws relating to, say, misrepresentation, and the kind of behaviour which should require authorisation as an investment firm. We also agree with CESR that any definition must enable all relevant circumstances to be taken into consideration. We support CESR in preferring a new definition which adopts only certain criteria of the definition in the Market Abuse Directive.

Question 1.1: We agree that advice on services, such as recommendations to use a particular broker, fund manager or custodian, should not be covered by the concept of investment advice.

Definition of Investment Advice

We agree with CESR that the assessment of the nature of a communication requires consideration of the overall effect of all of the circumstances surrounding the communication. We consider this point to be so important that it should be expressly referred to in the definition as in our suggested draft. In this context it is particularly relevant to consider what would be reasonably understood by the recipient of a communication. Will the recipient be

under the impression that he is being given a personal recommendation or is it clear to him that this is not the case? This assessment requires account to be taken of all of the circumstances, as noted by CESR.

We suggest below certain changes to the proposed definition.

“Personal recommendation” means any communication to a specific person which includes a value judgment or opinion on the merits or any other express or implicit recommendation whether to (a) buy, sell, subscribe for, exchange, redeem or underwrite one or any more specific financial instruments, or (b) to exercise, or not to exercise, any right conferred by one or more specific financial instruments to buy, sell, subscribe for, exchange or redeem one or more financial instruments which is reasonably understood by the recipient to involve the assumption of a duty to him to make a recommendation, either explicitly or implicitly, suited to, or based on a consideration of, his personal circumstances. The assessment of the nature of a communication shall consider the overall effect of all the circumstances surrounding the communication.”

We would comment on the above that it is important that the definition does not refer to “any information given” - this introduces a concept which CESR has clearly (and we believe correctly) rejected as being a determinative factor as to what is a personal recommendation. We suggest replacing “information” with the more neutral “communication”. The important factor is that there is a communication which includes a value judgement or opinion which would reasonably be understood by the recipient to mean that the firm has assumed a duty to make an express or implicit recommendation to him based on a consideration of his personal circumstances. The issue should be - is it reasonable on the part of the recipient to assume that he is being given personal advice suited to his own personal circumstances? Such a formulation places the burden on the firm to demonstrate that such an understanding would not have been reasonable, taking into account all of the relevant circumstances. We do not think that paragraph (c) in the draft adds anything to (a) and so our draft suggests deleting it.

Personal Recommendations

Question 1.2: In addition to the comment above on the issues raised by this question, we consider that the bilateral nature of a relationship and bilateral contact may be one of the circumstances surrounding the communication which is relevant - but it should not be determinative - there are many situations where there is bilateral contact, but the recipient of a communication is not under the impression that he is receiving a personal recommendation.

We agree with CESR that a contract is not a pre-requisite for the provision of investment advice, but that the existence of a contract may be a factor in assessing the circumstances as to whether investment advice has been provided in a specific case.

Question 1.3: We think it is both reasonable and necessary to restrict “investment advice” to recommendations of specific financial instruments. We believe that the definition in the Directive requires this. Even if it did not, for the good reasons given in CESR’s own commentary, we do not believe that extending the concept to generic information would have a particular investor protection effect. Generic information and generic recommendations cannot, on their own, lead to any particular transaction.

Simple Offer

We agree with CESR that in contrast to a personal recommendation, an “offer” will generally lack a value judgement or other recommendation and will generally not be held out as being suited to, or based on a consideration of, the recipient’s personal circumstances. Offers may, however, refer to the fact that the investment could be of particular use to, say, a particular type of investor - for example, one with excess tax allowances to use - we do not think that such a reference of itself would mean that there is a personal recommendation - the issue would be whether the offer could reasonably be construed as being a personal recommendation, or as merely noting factors that might be relevant to an investor in considering the same. We also agree that whilst a disclaimer may not be conclusive, its inclusion may be relevant - and the effect and impact of the disclaimer may have more or less effect taking into account all of the circumstances surrounding the communication.

Overlaps Between Personal Recommendations and the Other Terms

We agree with CESR that there may be overlaps between general recommendations, marketing communication, information, offer and personal recommendations. This is not a reason for including them all within the concept of personal recommendation - we agree with CESR that, depending on all the relevant circumstances, there may be different regimes that apply at different stages to different communications. Though these terms can be differentiated from “*personal recommendation*” by the criteria mentioned above, there may be overlaps. It is therefore necessary to determine whether, based upon a consideration of all the relevant circumstances, the test set out in paragraph 1 is satisfied (as amended in line with our suggestion). In most cases it will be clear from the material that there is no personal element to the recommendation because the recipient is being addressed in the same terms as members of a wider group of clients or potential investors. This is the case even where material is “personalised” to the extent of containing an individual’s name and address. In any event, it should be considered that firms which use such quasi-personalised marketing techniques do so at their own risk.

General Considerations

We support CESR in rejecting the preparation of a list of scenarios - by definition it could never be complete.

UNANSWERED ISSUES

There remain, however, in our view, some very important points which need clarification in the advice. These are:

- (1) Is a person who is an investment adviser to a fund manager giving personal recommendations within the meaning of the Directive? The fund manager receives the advice and uses it to inform the decisions that he takes when acting as agent on behalf of his investor clients. We consider that it is important for the markets generally that there is clarity on whether this advice - i.e. advice to a professional intermediary who is an agent for underlying investors (the classic example being investment advice to a fund manager) comprises a personal recommendation and is therefore the activity of an investment firm.

- (2) The second element on which clarification is required is to ensure that personal recommendation is not defined so as to include situations which do not involve personal recommendations to investors and prospective investors. It is necessary to clarify that personal recommendations are given to persons who are “investors”. Investment advice should relate to investment decisions. It is particularly important that advice to corporate clients - for example, from a corporate finance adviser to a company about securities issues, or on a takeover, is not construed as a personal recommendation. There needs to be a clear distinction between the core activity of investment advice and the ancillary services or other activities of a general advisory nature in the corporate sphere. Corporate finance advice is not usually a term used to describe personal recommendations; it appears to us that it is within the remit of CESR to make clear the distinction between investment advice in the sense of a personal recommendation and corporate finance advice given to a company.
- (3) We also think it should be clarified that advice on the exercise of voting and similar rights attaching to financial instruments (other than those rights referred to in our re-drafted definition of personal recommendation) should be clearly stated not to be personal recommendations.

LIST OF FINANCIAL INSTRUMENTS

We have limited comments on this issue, which we believe will be covered in more detail by the market experts. However, the following points occur to us.

Box 2, page 25

The statement “the above groupings of commodities are solely intended for the purpose of illustration and are not intended to have wider significance” is an ambiguous statement - what is intended to be its effect?

The definition of commodity includes a reference to the delivery system and methods of transferring ownership. We believe that, particularly in relation to electricity and gas, there are significant differences between delivery systems in different member states which may cause difficulties with the proposed definition.

Box 3, page 30

We believe that the reference to “the lesser of” in paragraph 1(a) should be to the “greater of”.

Box 3, paragraph 5

We believe that bespoke pricing is becoming a trend in the over-the-counter market for energy products. We suggest that an express statement that the use of standard published prices does indicate that a transaction is for commercial purposes would be a helpful amendment.

OBLIGATION TO ACT FAIRLY, HONESTLY AND PROFESSIONALLY

We query whether the concept of having an investment strategy is a relevant issue in a section which deals with a duty to act fairly, honestly and professionally. It does not seem appropriate to us to include it in this section. An obligation to create strategies would seem to create more paperwork and effort without any particular corresponding benefit. If CESR wishes to retain this concept we suggest that at least it is reworded to refer instead to “should consider investment strategies appropriate to meet the investment objectives of the clients”.

We do not think that a firm would ever be in a position to demonstrate that a transaction carried out has been “exclusively motivated by the interests of the relevant client” - and we question what such a concept adds to all of the other duties which are to be imposed on investment firms that provide portfolio management services.

SUITABILITY TEST

We agree with CESR’s approach to professional clients.

We welcome the way that CESR has limited its advice in this respect to guidelines and examples of the kind of information that could be obtained from the client or potential client if relevant and necessary in the particular case. This requirement of relevance and necessity should be set out in the draft Level 2 advice, as at the moment it only appears in the commentary to the draft advice.

We are concerned by the reference in the top paragraph on page 41 to the fact that an investment firm does not need to obtain information on the client’s experience with execution-only services if it does not intend to offer this service to the client. In fact, firms do not need to obtain information on the client’s experience with execution-only services at all under Article 19(6) of the Directive. The inclusion of execution-only services as an example in relation to the suitability test is unhelpful and CESR should confirm that execution-only services are not caught by Article 19(4) at all.

Question 4.1: We are of the view that adequate investment advice or portfolio management is still possible on the basis of the assumption the client has no knowledge or experience, that the assets provided by the client are his only liquid assets and/or the financial instruments envisaged have the lowest level of risk. This is the situation envisaged if the client is not able to, or refuses to provide, information on his knowledge and experience, or his financial situation or his investment objectives.

Box 8

Paragraph 2 - This sets out the factors that the investment firm must take into account when deciding the extent of the information to be obtained from the client or potential client. At present, firms which arrange execution-only transactions for private customers (i.e. individuals) are not generally required to obtain any personal or financial information about that client, except as required by the anti-money laundering regime. A similar exemption should be introduced to CESR’s advice otherwise investment firms will be placed under an undue administrative burden to obtain information from all their clients, even ones where the firm is only providing an execution service without advice.

Paragraph 4 - CESR states that, when gathering information for the purposes of the suitability test, the firm shall be able to rely upon the information provided by the client unless it is manifestly inaccurate or incomplete. We do not think that the use of the phrase manifest inaccuracy is helpful. It is not clear to whom the inaccuracy must be manifest. In relation to incompleteness, an investment firm is entitled to rely upon the fact that a customer has not provided information, provided that the firm has not invited the client to not provide the information (see Box 8(3)). The same issue arises on page 47 of the CESR paper, in Box 9, paragraph 4.

If a client or potential client has been asked to supply information and has chosen not to do so, or has chosen to provide only partial information, then it is for the client to be satisfied that, having been asked for information, he has decided what information he is prepared to provide. In many cases (indeed in the personal experience of members of our committee) investment firms may ask a whole range of questions, which the client chooses not to answer or to answer only to the extent that he considers it relevant. It should not be for the investment firm to second guess the client's choice. If CESR wishes to deal with the possibility of inaccurate or incomplete information it could instead consider requiring an investment firm, in seeking information, to warn the client to ensure that the information provided is accurate and complete. To put the burden on the investment firm when the client has elected to take a particular approach, seems to create significant and unfair liability issues for firms.

Paragraph 5 - The first two paragraphs are confusing, and in part contradictory. Firms should be able to agree with retail clients that the firm will act upon the basis of information provided, and that if the information has changed the retail client should inform the firm. It will be a disincentive to the provision of services to retail clients if firms are constantly required to update the information that they hold on clients, rather than being able to rely upon clients to update that information. After all, the client is in the best position to know whether the information they provided has changed or not. In any event, many clients do not respond to requests to update information. The paragraph also refers to a person who is in charge of the service for the client becoming aware of a major change - we consider that both of these terms are ambiguous - in particular the concept "in charge" might refer to a fairly senior level in the hierarchy and not attach to a person who actually is in a position to know what situation has been described by any particular client. In any event, we query the practicality of such a requirement in the context of a firm which has many clients - surely the onus should be on the client - but he should be warned by the firm that it is for him to update the firm of changes in his situation.

Paragraph 8 - This reinforces the point made earlier about the undue burden placed on the investment firm to continue obtaining information and background from the client. This is because it says the suitability test must be conducted for each personal recommendation or decision to trade. It also says this must be conducted in the light of any previous transactions. The difficulty with this is that it will not be practicable. It imposes a large burden on the investment firm to look back historically, as well as forward into the future, when taking into account the client's background history of transactions and the client's future financial objectives.

EXECUTION ONLY

Question 5.1: In determining criteria, the legal categorisation seems largely irrelevant - the economic effect is more relevant. However, neither of these criteria are the only relevant issues - the point is that complexity must be judged with reference not only to the product but also to the understanding and existing experience of the investor.

Question 5.2: In CESR's approach to analysing when a service is provided at the initiative of the client, CESR goes into considerable detail on the concept of "undue influence". In our opinion, this is not relevant in this context. Rules relating to the management of conflicts of interest should address the extent to which firms must avoid exerting undue influence over clients. For the purposes of whether business is execution-only or not, in our opinion, there is sufficient detail included at Level 1 and in the recital to cover this area, and no CESR guidance is needed.

"Non-complex instrument"

We agree that the criteria must be considered as high level principles that are flexible. We consider it extremely important that CESR recognises that a non-complex instrument may need to be judged with reference to the investor base to which the execution-only service is offered. We believe that an assumption that every derivative is necessarily complex is incorrect and that there are a number of derivatives which are non-complex and which are in regular use by retail investors. The proposed definition of a "non-complex instrument" (which is important because firms cannot provide execution-only services in complex instruments) excludes all derivative financial instruments. In Article 19(6) of the Directive, it is made clear that, for example, securitised debt (excluding bonds which embed a derivative) are non-complex. This makes it clear that products which do not "embed" a derivative, but which are themselves a derivative, can be non-complex. If Article 19(6) had intended to exclude all derivatives, it would have said so, and would not have needed the "embedded derivative" caveats in relation to securitised debt and bonds. Therefore, we believe that this provision is ultra vires the Directive and that CESR should delete the words "non-derivative".

Some types of derivative product are relatively simple and could be used to manage a customer's risk, rather than to expose a customer to risk. For example, a small corporation (which will be a private customer for the purposes of the Directive) might face a currency risk because it imports products from the US. That customer might want to enter into a currency forward transaction in order to eliminate currency risk. Such a company might previously have managed a similar risk and might want to go for a cheap, execution-only service in order to manage its existing risk, rather than to pay for a more expensive advised service. Such a customer will be denied the opportunity to deal in the simple derivative product for the purposes of risk management on this basis by CESR's implementing advice, either through the use of the words "non-derivative" in the preamble in Box 10 or as a result of (b), as such derivative contracts would involve the potential for loss. However, any loss on the derivative is not relevant to the client (given their corresponding gain on the movement of the currency rates) as it is held to hedge a pre-existing risk.

CESR states that, for an instrument to be non-complex, it must be possible to provide information on that product which is easily accessible, and likely to be understood by, the average retail client. Recent analysis in the UK suggests that investors have a very poor

understanding of financial products - for example, in a recent UK survey by the IFS in the UK, 79% of people did not correctly identify the meaning of the term APR (Annual Percentage Rate) in relation to a loan.¹ As defined, we wonder whether anything except for a deposit account would pass CESR's test. We do not think such an objective test is helpful in this area and would encourage CESR to delete (c), relying instead upon the general requirement that communications be fair, clear and not misleading. In any event, the understanding of an "average" retail client is irrelevant in relation to execution-only business. Only the understanding of those clients to whom the service is provided should be relevant.

Thus the concept of "likely to be easily understood by the average retail client" is unhelpful. It is unnecessarily restrictive - particularly where a firm's individual client is a sophisticated or knowledgeable professional. Firms should be able to justify that, in a particular context, the instrument concerned is non-complex. For example, executives in private equity firms may be entirely familiar with unquoted securities and should be capable of using an execution-only service to invest in them. Similarly, whilst an investment in an unregulated collective investment scheme might often be thought of as involving a complex instrument, it will not necessarily be so. Take, for example, a scheme established to enable employees to invest alongside their employer - there may be nothing particularly complex about such a scheme - it may involve no risk of loss beyond the capital subscribed, the terms may be very simple and benefit the employee. A firm which provides such a scheme should have the opportunity to justify it as being, in the particular context, "non-complex".

Similarly, there are persons who would fall into the category of retail client who are highly experienced in investing in unregulated collective investment schemes. Such schemes are common in real property and private equity contexts and persons who work in the property and private equity industries often invest in them. They understand the nature of such schemes and do not require advice - to them the instrument is non-complex. We have noted previously that the Directive's narrow criteria for a professional investor exclude those with professional experience in the less liquid markets, such as real property and private equity. One of the criteria for assessing professionalism will never be available in such a context - in these markets even the very largest firms are unlikely to carry out 10 transactions per quarter. This is why, in order to have a proportionate effect across the entire market, CESR's proposals must recognise a calibration across the range of persons who fall within the concept of retail investor. In this particular context this requires a degree of flexibility in the determination of a non-complex instrument - its definition must be capable of taking into account the characteristics and understanding of the investor to whom services are offered.

This entire issue highlights the difficulties that are caused by the range of entities that will fall within the definition of retail investor. The breadth of this concept needs to be applied in a proportionate way through the advice given by CESR. The advice needs to reflect that not all retail investors are the same - and that non-complex instruments may be non-complex because of the limited community of investor to which an execution service is provided.

"The Initiative of the Client"

We have one comment on the drafting of the draft Level 2 advice in this respect. It seems to us that a communication could contain an invitation - and that nevertheless the client responds on its own initiative. The question should be whether such an invitation has

¹ Institute of Financial Services Report on Financial Illiteracy in Britain, 18 August 2004.

promoted a particular service in a way that it would not be appropriate to regard acceptance by the client as being on its own initiative. We suggest that in paragraph 1(c) the words "neither contains an invitation" are deleted and replaced by "is not promotional in nature". We suggest a similar change to paragraph 2 - the deletion of the words "contains an invitation" and the substitution of the words "is promotional in nature".

We hope you find these comments helpful.

Yours faithfully

A handwritten signature in black ink, reading "Margaret Chamberlain". The signature is written in a cursive, flowing style.

Margaret Chamberlain
Chairman
City of London Law Society Regulatory Committee