VERBAND DER AUSLANDSBANKEN IN DEUTSCHLAND E. V.
ASSOCIATION OF FOREIGN BANKS IN GERMANY

INTERESSENVERTRETUNG AUSLÄNDISCHER BANKEN, KAPITALANLAGEGESELLSCHAFTEN, FINANZDIENSTLEISTUNGSINSTITUTE UND REPRÄSENTANZEN
REPRESENTATION OF INTERESTS OF FOREIGN BANKS, INVESTMENT MANAGEMENT COMPANIES, FINANCIAL SERVICES INSTITUTIONS AND REPRESENTATIVE OFFICES

The Committee of European Securities Regulators (CESR)
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September 17th, 2004\VA

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

Consultation Paper – CESR/ 04-261b

Dear Madam, dear Sir,

The Association of Foreign Banks in Germany appreciates the opportunity to comment on the Consultation Paper CESR/04-261b on CESR's Advice on Possible Implementing Measures of the Directive 2004/39/EC on Markets in Financial Instruments.

We represent foreign banks and investment firms doing business in Germany. Therefore we would especially like to focus on issues concerning investment firms as parts of international groups and issues of cross-border business. Together with our Association's working groups, in which the specialists of our member institutions take part, we have concentrated our work on 5 areas we would like to comment on:

- Compliance and personal transactions (Art. 13 (2) MiFiD), see attachment 1.
- Obligations to avoid undue additional operational risk in case of outsourcing (Art. 15 (5) first sub-paragraph MiFiD), see attachment 2.
- Conflicts of interest (Art. 13 (3) and 18 MiFiD), see attachment 3.
- Best execution (Art. 21 MiFiD), see attachment 4.
- Other issues, see attachment 5.

You will find our comments and proposals attached to this letter. Should you have any questions please do not hesitate to contact us.

Yours sincerely,

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Attachment 1 to the letter of September 16, 2004:
Compliance and personal transactions (Art. 13 (2) MiFiD)

Proposal 1:

Box 1 para. 2. (d) (ii) (page 15) should be reconsidered and drafted as follows:
"the budget and remuneration of the compliance function is linked to its own objectives and not to the financial performance of ~~the~~ particular business lines.

We agree that a linkage between the remuneration of the compliance function and the financial performance of one or more business lines could put at risk the independence of the compliance function. But nevertheless we think that a linkage to the financial performance of the investment firm as a whole should be permitted, for the following reasons:

- Establishing a link between remuneration of the compliance function and the investment firm's overall financial performance is common practice today.
- If this link was to be removed, the compliance function would lose its attraction especially for highly qualified staff members. To a certain degree, the quality of the compliance function's work would be put at risk.
- In addition, the direct reporting line to senior management who do not have direct business line responsibilities will efficiently prevent any conflicts of interests.

Proposal 2:

In Box 1 para. 7. (a) the term "reasonable steps" should be defined more precisely, either on level II or on level III of the Lamfalussy process.

There is a large variety of measures that may be considered for preventing relevant persons entering into personal transactions. Investment firms need more detailed determination what would be expected by supervisory authorities. Over-regulation should be avoided.

Proposal 3:

Box 1 para. 9. (Question 1.3., page 17): See attachment 2, proposal 4.

Attachment 2 to the letter of September 16, 2004: Obligations to avoid undue additional operational risk in case of outsourcing (Art. 15 (5) first sub-paragraph MiFiD)

Proposal 4:

Question 1.3., page 17: In Box 1 para. 9 (b) should be deleted and reliance be placed on the status and responsibilities of the outsourcing investment firm.

We agree with CESR basically putting the emphasis on the supervision of the outsourcing investment firm. We believe that the supervision of the outsourcer is sufficient to ensure a sound outsourcing practice of the investment firms, because:

- Investment firms have to apply rigorous standards for their outsourcing activities according to CESR's outsourcing advice (Box 3, para. 9 (b) and (g) (page 24)).
- The implementation of these standards is supervised.
- Investment firms are liable to their clients for the proper functioning of outsourcing arrangements.
- It is in the best interest of investment firms to maintain the quality level of their services, even if parts of the production and/or provision of the services is subject to outsourcing agreements, simply because clients will not accept any quality decrease.

Proposal 5:

In Box 3 para. 2 (page 23) the words "or reputation" should be deleted.

There are functions within an investment firm, weaknesses or failures of which may cast serious doubts on the investment firm's reputation, but which are nevertheless not material to the firm. They should therefore not be subject to outsourcing regulations. Examples:

- Car fleet management (if the service provider chose pink cars for the management…).
- Catering services (if the food was bad…), even if explicitly mentioned in para. 5 of Box 3, would be covered by the definition, too.
- The same applies for cleaning services.

**Attachment 2 to the letter of September 16, 2004:
Obligations to avoid undue additional operational risk in case of outsourcing
(Art. 15 (5) first sub-paragraph MiFiD)**

Proposal 6:

Box 3 para. 4 should be deleted. Instead, it should clearly be stated that CESR's advice does not cover intra-group outsourcing. So the intra-group "outsourcing" should either not be regarded as outsourcing, or else be subject to further consultations in future.

In our opinion, the supply of goods, facilities and services to an institution by a group entity should not be subject to the same provisions as outsourcing from an institution to other entities which are not part of the group. For six reasons:

- Provided that a sufficient supervision of a parent institution as a service provider and the group on a consolidated level can be ensured, there is no need for additional regulatory burden on the supply of services, goods or facilities by the parent institution to a group institution at all. In our opinion, this applies at least for all parent institutions either domiciled in the EEA or in a home country with well developed financial centres where similar supervision over institutions and banking groups is exercised (e. g. countries represented in the Basle Committee, Australia, and others).

- The concentration of processes and facilities on one group entity leads to scale and quality effects. The group can possibly afford the development and purchasing of up-to-date technology that one group entity could not afford on a stand-alone basis. So the provision of services, goods and facilities between group entities should be welcomed by supervisory authorities, as it helps managing risks in a sophisticated manner.

- Maintaining outsourcing activities within the group can significantly reduce banking system risks due to concentration, because a concentration of activities from several groups on one entity would be avoided.

- The intra-group work processes are subject to daily and weekly changes. If every change was to be notified to the supervisory authority, both the investment firm and the authorities would be overwhelmed by bureaucracy.

- According to the Final Report of the Expert Group on Banking on the FSAP from May 2004, page 3, the creation of "centres of excellence" that provide horizontal services to different parts of EU banking groups should be promoted. Therefore the regulatory regime on intra-group "outsourcing" should be specially designed in order to encourage further integration of different elements of the banking business.

- The exception for intra-group "outsourcing" in Box 3 para. 4 sentence 2 of the Consultation Paper is not sufficient, because it doesn't explain to which extent the application of para. 9 may be waived. Therefore the future supervisory practise is not at all foreseeable by the investment firms, and the result is legal uncertainty.

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Attachment 2 to the letter of September 16, 2004:
Obligations to avoid undue additional operational risk in case of outsourcing
(Art. 15 (5) first sub-paragraph MiFiD)

Proposal 7:

In addition to the outsourcing arrangements mentioned in Box 3 para. 5., arrangements not intended to last for more than 12 months should not be covered by the scope of application of CESR's advice.

- The basic idea of any outsourcing arrangement is to transfer the performance of certain activities to someone else for a long or even, provided that the arrangement performs well, for a basically indefinite period of time (regardless of any ordinary and extraordinary termination rights).

- Arrangements covering periods shorter than 12 months do not expose the investment firm to the same additional operational risk as the before-mentioned basically indefinite outsourcing arrangements.

Proposal 8:

In Box 3 para. 5 (e) (page 23) should read as follows:
"e) <u>any form of legally required co-operation of investment firms with investment firms and/or credit institutions, for example</u> the use of depositories under arrangements falling within Articles 13 (7) and (8) MiFiD.

Arrangements falling within Art. 13 (7) and (8) of the Directive are just one example of co-operation between investment firms and investment firms and/or credit institutions. There are other fields of necessary co-operation required by law. There is no need to avoid additional operational risk in these cases because the law itself decides that this risk is not "undue". Examples:

- There are regulatory provisions that oblige parent institutions to fulfil group management duties, corresponding with a supervision of the group on a consolidated basis. This kind of group management, concerning basically strategic responsibility and functions, should not be regarded as outsourcing of functions from an institution to a parent institution. Example: Co-operation duties from the Financial Conglomerates Directive.

- Other examples are (inter alia): Clearing and settlement, money transmission services over correspondent banks.

- In these cases, investment firms have to exercise all due skill, care and diligence in the selection, appointment and periodic review of the investment firm/ credit institution it co-operates with. But an additional supervision and control of supervisors according to outsourcing regulations is not necessary. Such supervision would result in huge bureaucratic burden for both the investment firms and the authorities, because the outsourcing regime requires notifying procedures, while co-operations between undertakings change frequently, sometimes even on a case-by-case basis.

Attachment 2 to the letter of September 16, 2004: Obligations to avoid undue additional operational risk in case of outsourcing (Art. 15 (5) first sub-paragraph MiFiD)

Proposal 9:

In Box 3 para. 6 (page 23) the third sentence, concerning so-called "empty boxes", should be deleted.

- As long as the provisions in Box 3 para. 8 and 9 are fulfilled, there is no such thing as an "empty box", because there are a lot of functions that always have to be retained by the investment firm:
  - managing the outsourcing agreement,
  - identification, assessing, monitoring and managing the risks inherent in outsourcing,
  - internal review,
  - evaluation of the service provider's performance,
  - etc.

- Therefore the third sentence of para. 6 is superfluous.

Proposal 10:

In Box 3 para. 9 (b) (page 24) the words "must ensure" should be replaced by the words "must take reasonable steps to ensure".

It is true that investment firms have to carefully evaluate the abilities and capacities of the service provider. But no matter how careful a due diligence takes place, investment firms will never be able to guarantee the abilities and capacities of the service provider to the full extent. (If that kind of guarantee was actually achievable, then additional outsourcing regulation would be spare.)

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Attachment 3 to the letter of September 16, 2004:
Conflicts of interest (Art. 13 (3) and 18 MiFiD)

Proposal 11:

Question 6.1. (Box 6, page 45): It is not necessary to refer to additional methods for managing conflicts of interest in the advice.

We think that an extension of the list provided for in Box 6 para. 8 might lead to over-regulation, especially if according to question 6.2. (b) the included measures will have to be included in the conflicts policy to the fullest extent possible.

Proposal 12:

Question 6.2. (Box 6, page 45): The examples of methods for managing conflicts of interests in para. 8 should be stated as examples of appropriate arrangements, applicable only if necessary, appropriate and proportionate in the light of the nature, scale and complexity of the investment firm's business.

Every regulatory measure should take into account the appropriateness and proportionality to the nature scale and complexity of the investment firm's business. Regulatory requirements that exceed the appropriate and proportionate level are always putting more regulatory burden on the investment firm than actually necessary and represent examples of over-regulation.

Proposal 13:

In addition to Box 6 para 14 (a) (page 46) the disclosure of the conflicts policy to clients should be made possible by electronic means, too (e. g. internet).

- We fear that CESR might just expect too much in terms of the clients' capabilities and will to read and understand disclosures and information to be handed out to them in written form by investment firms. Therefore it might be useful to present some of the information as a mere option to clients, for example in form of a homepage.

- If the conflicts policy was explained in a document available on the internet, then it would be possible for clients to access an up-to-date version even long time after the business relationship began.

Attachment 3 to the letter of September 16, 2004:
Conflicts of interest (Art. 13 (3) and 18 MiFiD)

Proposal 14:

As far as the contents of the conflicts policy regarding investment research are concerned, CESR should undertake steps to develop one single definition of investment research covering all issues of the Market Abuse Directive (MAD) and the MiFiD.

The differences of the definitions of investment research according to MiFiD and financial analysis according to MAD are difficult to handle in practice. It would facilitate the compliance work of all investment firms if there was one definition of investment research/ financial analysis in place. Therefore the development of one single definition is absolutely necessary.

Attachment 4 to the letter of September 16, 2004:
Best execution (Art. 21 MiFiD)

Proposal 15:

Articles 21 and 22 should not be applied for investment firms that do not execute orders on behalf of clients. Especially they should not be applied for investment firms which receive orders and

- **transmit these orders to another investment firm within the same group which will execute the orders, or**
- **transmit these orders to investment firms domiciled in a third country for execution on a regulated market in that third country.**

We disagree with the approach to apply Art. 21 and 22 MiFiD for investment firms which are not doing the execution of orders. Instead, only Art. 19 (1) MiFiD should be applied for these firms. We do not understand why the requirements according to Art. 19 (1) MiFiD, in CESR's view, imply the requirements according to Art. 21 and 22 MiFiD.

- We believe that the application of Art. 21 and 22 MiFiD on investment firms which are not doing the execution of orders will be contrary to the will of the European Parliament. If Parliament had wanted the application of Art. 21 and 22 MiFiD on firms which do not execute orders, it would have chosen another wording.

- It is common practise that branches and subsidiaries (e. g. in domiciled in Germany) receive orders and transmit them to their head offices/parent companies abroad for execution. They cannot fulfil best execution requirements themselves, because the link to their head offices/parent companies is fixed, and their business models do not allow different execution venues.

- If Art. 21 and 22 MiFiD were applied, branches could carry on transmitting orders to the head offices without best execution requirements (because it is a transmission within one investment firm). But subsidiaries' transmission of orders exclusively to parent undertakings would be forbidden, because they cannot fulfil best execution requirements. So subsidiaries would be discriminated against.

- Further problems arise if the investment firm receives and transmits orders from clients who wish them to be executed on a regulated market domiciled in a third country, and the investment firm transmits these orders to a parent company or another investment firm domiciled in that third country. It is not proportionate to force every investment firm to assess executing venues all around the world.

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Attachment 5 to the letter of September 16, 2004:
Other issues

Proposal 16:

Box 4 Question 4.1. (page 28): Investment firms should not be obliged to be able to demonstrate that they have not acted in breach of the conduct of business rules under the Directive.

It is one of the most central principles of the human rights, and also the German constitution, that citizens are not obliged to prove that they have acted in conformity to law, but state authorities will be obliged to prove any breach of the law if they want to take measures against a citizen. So the burden of proof has always to remain with the authorities, and not be put on the citizens, in this case, the investment firms.

Proposal 17:

Box 5 para. 8 (a) (i) (Question 5.1., page 35): The investment firms should be able to chose an unregulated depository if overriding considerations show that a regulated depository would not be the best choice.

Investment firms need to chose depositories on the basis of their due diligence concerning the depository's services quality. The rather formal fact of the depository being regulated or unregulated may not indicate the best choice in the interest of the clients.

Proposal 18:

Box 7 para. 13 (page 52) should be deleted. There is no need to forbid the use of simulated historic returns, as long as the simulation is clearly characterised as such, is not misleading and the requirements in para. 14 are met.

- There are innovative financial instruments (in the German derivative securities' market, so-called certificates), the return characteristics of which can hardly be shown without historic simulations.

- On the other hand, we agree that historic management decisions cannot be simulated. So products the performance of which refers to ongoing management decisions should not be marketed with simulated track records.

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Attachment 5 to the letter of September 16, 2004:
Other issues

Proposal 19:

In addition to Box 8 para. 1 (page 55) it should be made possible to provide information required under Art. 19 (3) MiFiD by electronic means, too (e. g. internet).

- We fear that CESR might just expect too much in terms of the clients' capabilities and will to read and understand disclosures and information to be handed out to him in written form by investment firms. Therefore it might be useful to present some of the information as a mere option to clients, for example in form of a homepage.

- If the information required under Art. 19 (3) MiFiD was provided in a document available in the internet, then it would be possible for clients to access an up-to-date version even long time after the business relationship began.

Proposal 20:

Para. 51 of the level 3 recommendations on page 133: There should be a choice for the investment firms, which are remote members of regulated markets in the EU, to report <u>either</u> directly to the authority of the member state where the transaction took place <u>or</u> to the authority of the home member state without any double reporting obligations.

According to para. 51, in general, remote members should report their transactions to the competent authority of their home member state which would then forward the transaction report to the authority of the member state where the transaction took place. According to the Directive and the recommendations by CESR, reports are also possible to the competent authority of the member state where the transaction took place by the remote member itself or via another reporting channel, e.g. an eligible third party, so called "Geeignete Dritte" (choice to report in Germany). In addition, besides the report to the authority of the country where the transaction took place, a further report to the authority of the home member state is also required, which would impose double reporting.

In our opinion, a double reporting should be avoided, as this would impose additional administrative costs e.g. for the implementation or the change of IT systems. In Germany, according to sec. 9 para. 1 sentence 4 German Securities Trading Act (WpHG) all remote members have to report to the member state authority where the transaction took place. As a consequence, a lot of the remote members, e.g. of the Eurex Germany, are affected by the proposed recommendation and have to change their reporting. On-exchange transactions are fully electronic trades so that the authorities in the country where the trade took place have access to all the insider relevant data of the transactions. From the German point of view, additional obligations (report to the home member state authority) are not necessary.

To avoid any additional reporting obligations or burdens on investment firms, there should be no double reporting obligations in the case of reporting to the authority of the member state where the transactions took place.