

ZENTRALER KREDITAUSSCHUSS

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**Comments
of the
Zentraler Kreditausschuss¹
on CESR's Consultation Paper "Draft Technical Advice on Possible Implementing Measures
of the Directive 2004/39/EC on Markets in Financial Instruments
1st Set of Mandates"**

17 December 2004

¹ The ZKA is the joint committee operated by the central associations of the German banking industry. These associations are the *Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR)*, for the cooperative banks, the *Bundesverband deutscher Banken (BdB)*, for the private commercial banks, the *Bundesverband Öffentlicher Banken Deutschlands (VÖB)*, for the public sector banks, the *Deutscher Sparkassen- und Giroverband (DSGV)*, for the savings banks financial group, and the *Verband deutscher Hypothekenbanken (VdH)*, for the mortgage banks. Collectively, they represent more than 2.500 banks.

INTERMEDIARIES

1. General

- Limited scope of the second consultation round

We strongly welcome the fact that the second consultation round has become a standard practice in the consultation process on CESR advice concerning possible technical implementing measures at Level 2 of the Lamfalussy procedure. Yet, we feel it is rather unfortunate that the scope of the Second Consultation Paper is confined to but a limited number of individual issues. Whilst the topics which are addressed clearly indicate an open minded discussion of comments submitted by market participants, material issues, however, still remain unaddressed in the second round of consultations. This notably relates to:

- the requirements with regard to client information (box 8, item 7 to 9, First Consultation Paper), notably the question if and when such information may be given in a standardised form,
- the requirements with regard to the client agreement (box 9, First Consultation paper) which, in our opinion, features an excessive level of detail,
- the disclosure obligations when granting inducements (box 6 item 9 to 11, First Consultation Paper).

Due to the limited scope of the Second Consultation Paper and for the sake of transparency in the consultation rounds, we feel a compelling need for CESR to publish a Review Paper together with its final recommendations; such Review Paper should cover the consultation with market participants and clearly highlight why and where suggestions submitted by market participants have been adopted/have not been adopted.²

CESR's motivation to ask the Commission for an extension of the deadline for submission of its recommendations receives our full support. CESR needs be given enough time to deal with the comments submitted concerning the First Consultation Paper. The quality of CESR recommendations must have absolute priority over rigid compliance with the envisaged timetable.

² In our view an exceptional case is formed by the provisions on best execution. Here, CESR has to date not submitted any specific proposals for the consultation process. We therefore take it that this area will be covered by a separate consultation round.

- Degree of detail inherent in the advice; Relationship between Level 2 and Level 3

We share CESR's view where CESR points out that the First Consultation Paper is widely regarded as excessively detailed. We feel that such a level of detail in the advice would not even be necessary for the purposes of a full harmonisation. Quite on the contrary: The present level of detail may even hamper competition by investment firms because they would no longer have the freedom to meet the regulatory requirements with due respect for their own specific corporate structures and their client structures. We therefore feel that it shall be of pivotal importance that CESR will always keep an eye on the potential impact of its advice. Whenever there are doubts as to whether the envisaged requirements really will improve investor protection or whenever there is a potential danger that the proposed requirements can only be implemented at disproportionately high costs, such advice should be deleted.

We feel that a segregation of Level 2 and 3 of the Lamfalussy procedure is essentially feasible. In our understanding, at Level 3, the Lamfalussy approach is exclusively concerned with harmonised application of the rules which were previously adopted at Level 1 and 2. The establishment of new rules shall be exclusively reserved to Level 1 and 2.

- Need for transitional periods

For us, the transitional periods which CESR mentions are of fundamental importance. Given the host of new provisions, market participants must be given enough time for an adjustment of their systems and procedures. We therefore welcome the Commission's most recent deliberations, i.e. especially those which dealt with a transitional period up until the year 2007 for technical innovations. Experience has shown that particularly for IT related processes an adequate timeline will be essential. By way of example, we should only like to mention the implementation of Art. 20 of the 1993 Investment Services Directive in Germany. A period of approximately 18 months elapsed between the point when the reporting obligation was enshrined in law and its final application, i.e. the point at which the first reports came in. This time was needed in order to first clarify all legal issues before preparing the technical specifications and then setting up the corresponding reporting systems.

2. Independence of compliance

We strongly welcome the fact that, when it comes to assessing the independence of compliance, CESR has committed itself to a functional approach. This understanding is bound to bring forth rules which will also allow smaller investment firms to meet their compliance obligations at reasonable costs. Yet, this requires as a precondition that there is a renunciation to detailed provisions and it must be ensured that the recommendations issued will provide a sufficient degree

of flexibility which shall allow all investment firms to meet their compliance obligations in line with their size, organisation and client structure.

3. Documentation obligations and the onus of proof

We strongly welcome the clarifying remarks on the onus of proof. We are furthermore convinced that CESR has now predicated the documentation obligations on a valid premise. The rationale behind such documentation obligation is that it should allow verification of compliance with the obligations under MiFID. Whilst this overarching goal on the one hand provides the justification for the effort associated with documentation, on the other hand it simultaneously also sets clear limits for the scope of the documentation. The call for a documentation shall only be warranted in those cases where this will allow the auditor to verify compliance with an obligation.

4. Tape recordings

We feel that CESR's presentations on the efforts associated with tape recording of orders are not acceptable. CESR briefly points to the absence of sufficient data for determining the costs incurred by such an exercise and merely refers to the costs for data storage. Yet, the costs that really matter far more in this regard are the migration costs which would potentially incur for thousands and thousands of bank branches. Alone in Germany, this would affect approximately 39,000 branches.

At the present point in time, the industry can hardly come up with any reliable ballpark figures. The reason why this is simply not possible at the moment is that the exact technical specifications will still have to be adopted at Level 3. What, in our view, is furthermore also slightly bewildering is that on the one hand, CESR expects the industry to produce estimates for potential costs incurred by its proposals. Yet, on the other hand it fails to provide even the slightest explanation for the rationale behind these proposals, i.e. it fails to highlight any shortcomings which would justify these costs. In Germany, neither the industry nor BaFin are aware of any specific shortcomings with regard to telephone orders which would warrant a specific provision on tape recordings in order to further enhance investor protection. Based on our information, the error rate of telephone orders is at the most in the region of one-tenth of a percent.

Yet, despite the current lack of a more precise technical specification, we should like to attempt a very cautious cost estimate. In this calculation, the cost drivers should be clear: In Germany the sales of securities services generally take place in a decentralised manner. This means that the client may call his advisor in the main branch or in his local branch in order to place his order with him. Hence, technically speaking, compliance with a potential obligation for tape recordings of

orders placed over the telephone would only become possible if all 39,000 bank branches in Germany had the capacity to make such tape recordings directly next to the telephone of each advisor. Given the fact that the tape recording would then have to be stored for monitoring purposes, this would mean that merely linking each telephone within a single branch to a conventional tape recorder would be deemed as an insufficient measure. Rathermore, in its potentially forthcoming technical specifications to be adopted at Level 3, CESR is likely to call for a system which would allow a systematic storage that would be accessible to the auditor.

A large German savings bank has asked its telephone service provider for a specific quote of the costs required for the logistics necessary to implement such a kind of tape recording at each advisor workplace. Based on 2,700 advisor workplaces, the additional service “tape recording” would involve an extra rent of EUR 500,000 annually. Whenever a telephone system is purchased and not rented, the estimated costs for installing the tape recording capability amounts to approximately EUR 1,000 per advisor workplace with the annual operating costs totalling EUR 120 per advisor workplace. For a larger bank with approximately 1,200 advisor workplaces this would involve installation costs to the tune of EUR 1.2 million and an annual maintenance cost of EUR 144,000. In our view, a mandatory obligation for such capital expenditure can only be warranted if it is associated with improved investor protection. Yet, given the fact that there are no known issues in this regard and given the fact that also CESR has failed to mention any specific problems with regard to telephone orders, retrofitting the existing infrastructure would deliver no such benefit in terms of enhanced consumer protection. Hence, in our view the costs associated with tape recording capabilities for telephone orders would be a complete misallocation of macroeconomic resources.

Furthermore, for retail clients, this measure would clearly inflate costs of securities transactions meaning that given the higher break-even point they would have to think twice whether an investment into a securities transaction would really be worthwhile. In order to illustrate our point, we should like to quote an example from the field of cooperative banking: There are approximately 1,400 cooperative banks in Germany. In FY 2003, each of these cooperative banks on average has 50 advisor workplaces and an average volume of approximately 3,300 securities transactions in the field of retail banking. Under the envisaged CESR advice, all advisor workplaces in all bank branches would have to be retrofitted with a tape recording function. On average the annual costs for this would amount to at about EUR10,000 for each cooperative bank³. This would mean that for the cooperative banking sector with its annual volume of 3,300 securities transactions per annum, the introduction of tape recording facilities as contemplated by the advice would, on

³ Here, under German fiscal law, a 10 year write-down period would be imputed, i.e. the initial investment would be written down over a period of 10 years

average, drive up the cost for every single security transaction by 3 Euros. Since these are fixed costs, the minimum commission would have to be raised accordingly. The average commission in the cooperative banking sector currently amounts to about 25 Euros. This means that the additional requirement of tape recordings would drive up minimum commissions by as much as 12 %. Furthermore, taking into account the cost of a transaction, the break even point for retail clients would rise from 3,333 Euro up to 3,733 Euro.⁴

5. Outsourcing

The German banking industry strongly welcomes CESR's presentations on outsourcing. Especially the clear commitment towards synchronising all proposals with CEBS' work should prevent double burdens for credit institutions.

6. Conflicts of interest and the segregation of areas of business

We lend our unreserved support to CESR's presentations on this matter.

7. Investment research

The questions which CESR already highlighted in the First Consultation Paper imply that research which does not fully meet all IOSCO standards shall not be deemed as "objective". This approach is different from the approach adopted under the Market Abuse Directive. Under said Market Abuse Directive, it had been left to the companies' discretion whether they choose to disclose potential conflicts of interests (including those of their employees) or whether they seek to prevent such conflicts of interests *a priori* through internal precautions. Both options boil down to a protection of investor interests. This would make any kind of additional requirements redundant. Neither is there a need for "special identification" of research as "not objective". We should like to point out particularly that existing IOSCO standards fail to call for such an approach.

Neither does IOSCO issue any provisions concerning the specific implementation of its standards. It rathermore confines itself to listing potential alternatives to implementation under "government regulation": "regulations imposed by an independent, non-governmental statutory regulator", "binding rules imposed by self-regulatory organization" and "industry codes of conduct that are strictly applied and enforced". These are all possibilities that should be exploited first, before

⁴ Calculated with a commission fee of 0,75 %.

creating-at a European Level-two regimes which are not in sync (i.e. Market Abuse Directive on the one hand and MiFID on the other hand).

Last but not least, in the present case there are also legal concerns under procedural law which speak against the unabridged adoption of IOSCO standards. The Lamfalussy approach stipulates the need for mandatory input by market participants prior to the adoption of provisions. Yet, market participants did not have an opportunity to submit their positions prior to the adoption of the IOSCO standards “Principles for Addressing Sell-Side Securities Analyst Conflicts of Interest“. They have thus been denied any opportunity to influence the content of the standards. Yet, this means that there is an absence of the procedural *conditio sine qua non* for an unabridged adoption of the IOSCO standards under EU legislation.

TRANSACTION REPORTING

1 General remarks

In our comments dated 17 September 2004 we provided detailed comments on the proposals which CESR submitted under the 1st Consultation Paper on the topic of “transaction reporting”.

In view of our earlier comments we obviously welcome the fact that under its “General approach” (page 10, C) CESR has once more reaffirmed its policy of primarily using existing reporting systems and refraining from radical, costly changes in the European transaction reporting. To pursue this concept also to the benefit to the German transaction reporting system - which certainly counts to the most sophisticated in Europe - we propose two additional amendments of the minimum indications, set out in Annex A (Price, Counterparty). This will be further explained in the course of our specific comments under 2.

We furthermore welcome the fact that CESR no longer limits itself to issuing recommendations for technical implementing provisions at Level 2 but that it also plans to consider potential measures at Level 3. Indeed, the CESR proposals on Level 2 can only be adequately assessed if market participants have an idea as to if and into which direction CESR plans to issue Level 3 measures in the various subject areas. This is the only road towards a clearer and more conclusive overall idea of the likely impact which implementation of Art. 25, paragraph 3 and 5 may have on existing reporting systems.

In this context we have the following concern which we would like to highlight separately:

In our view it is of paramount importance that the envisaged Level 2 measures, notably the information standards laid down under Annex A, (similar to the Directive) shall only contain minimum conditions. As has been pointed out in our comments submitted on 17 September 2004, we feel that – at least in the short and medium term – this will be the only tenable approach. Yet, we do understand that CESR is simultaneously pursuing the ambitious goal of safeguarding a comprehensive and fully compatible data exchange between supervisory authorities. This becomes particularly clear in the detailed requirements under Annex B. Our concern is that the goal of enabling data exchange with identical information degree between competent supervisory authorities will eventually circumnavigate the minimum conditions stipulated under Annex A at a national level. In the final analysis, this would signify a *de facto* maximum harmonisation of transaction reporting for the sake of efficient information sharing between competent authorities and this would come at the expense of market participants. In this regard we do welcome the fact that under indent 7 on page 23, CESR basically points out that information sharing between authorities falls under their own issue and “would not require any further involvement of investment firms”.

Having said this, three aspects raise doubts as to whether there is truly consistent application of this philosophy by CESR.

Firstly, CESR’s recommendation concerning “the message and arrangements for reporting financial transactions“ under Item 1 f and g (page 13) envisages that a reporting channel shall only be authorised if and when - upon request by the national authority - it is capable of providing additional information elements which will be more comprehensive than the “minimum information”.

Secondly, under Annex B, CESR stipulates criteria for the content of data sharing between authorities. Said provisions under Annex B partly exceed the mandatory information level requested from investment firms under Annex A (cf. below). Yet, how should supervisory authorities meet the requirements under Annex B unless they have previously received the data by the reporting parties? Further, the optional reporting of individual fields provided for in Annex A has not been wrapped to Annex B.

Thirdly, the scope of application of Art. 25, paragraph 3 is unclear. There is, for instance, a lack of a uniform definition of the term “transaction”. Having said this, we do not feel the need for such a definition, either. In order to take account of the different interpretations that this term has received under the civil law and prudential supervision structures which have historically evolved within

individual Member States, the term “transaction” should rather receive its definition by the competent authority at a national level. The same is true for any other definitions which have an impact on the transaction reporting system (e.g. in Annex B under “Trading Capacity” the definition of “traded on a principal or proprietary basis” and “agency transactions”). Hence, we would highly appreciate it if already in its recommendations at Level 2, CESR were to explicitly clarify that - at least on a short and medium term basis - it plans to abstain from imposing standard definition of the terms relevant for transaction reporting at Level 3. Unless this is the case, we have concerns that this area, again, will run the risk of a further “harmonisation push” at Level 3 which may potentially incur the need for costly system adjustments without any benefit for the authority of the Home Member State.

2 Specific comments

- **Criteria for assessing liquidity in order to determine the most relevant market in terms of liquidity for financial instruments.**

We firmly support CESR’s approach to recommend using “liquidity proxies” for assessing the most relevant market instead of computing a liquidity measure for each financial instrument in Europe in order to determine who is the competent authority for the most relevant market in terms of liquidity for each of these financial instruments. Any other approach would lead to a complex and costly assessment procedure, which would be clearly disproportionate to any potential added value compared to the more general proxy approach.

In this respect, we believe, that CESR’s draft Level 2 advice on pages 17 and 18 which is based on the proxy approach entails a sufficient degree of differentiation between the different types of financial instruments and, therefore, serves as a good basis or a respective implementing measure at Level 2.

- **Draft advice and cooperation and exchange of information related to transaction reporting (Art. 58)**

We were to a certain extent surprised at the CESR proposals contained under indent 11 and 12, page 21 as well as under Annex C. At Level 1 of the MiFID, the European Legislator deliberately abandoned the concept of a market supervision and moved towards a supervision of institutions or products. This resulted from the provision pursuant to which remote members of a market place shall be under the obligation to report the transactions which they have made to the competent authority of their Home Member State. If and when CESR-

Members had disagreed with this philosophy, there surely would have been ample opportunity to criticise this during the regulatory process at Level 1 and to explore alternative solutions. Since this has not been the case, this philosophy which has been decided upon at Level 1 sets a precedent which can no longer be changed at Level 2. Any retrospective changes would rathermore presuppose an amendment of the Directive at Level 1. We therefore reject CESR's proposal that the report shall be submitted to the competent authorities of the market where the transaction took place. What is more, such a proposal would lead to a duplication of the reporting channels between the authorities. This would incur further costs in the data exchange between authorities regulated by Art. 58.

- **The minimum content and the common standard or format of the reports to facilitate its exchange between competent authorities**

We welcome the fact that under Annex A, CESR has added a series of clarifications and improvements.

This is certainly helpful for meeting the general goal to avoid far reaching adoptions of the existing national reporting systems. In our view there is, however, still the risk to create such kind of adoption-work in respect of the fields "Price" and "Counterparty" which deviate from the German reporting standards. Since its creation in 1995 German transaction reporting has become more and more sophisticated throughout the years. All various types of transactions in all different market segments - be they on or outside a regulated market - are reflected in a reporting sheet providing 69 individual fields. For this purpose, various technical systems within the investment firms have to be linked (e.g. order reception, trading, order handling, client data recording) in order to compile the whole set of data relevant to the transaction reporting. Any change in the existing requirements will, therefore, cause considerable amount of adoptions of the different systems in each individual investment firm - resulting in immense cost impacts. This would for example be the case if the definition of the field "Price" - requiring the reporting of the price excluding commission irrespective of the individual client agreement - is maintained. Without creating any veritable benefit for the customer this would cause cost in the amount of several hundred thousands of Euros. We believe this to be inadequate and, therefore, recommend amending Annex A in this respect.

We still feel that one provision under Annex A remains a source of great concern i.e. that all counterparties which operate at a Europe-wide level and which are involved in a transaction that falls under the reporting obligation will have to have their own identification. Even if under systematic aspects this provision would appear justified, in practice it leads to a

considerable technical extra effort. A comprehensive data storage system would have to be established and permanently updated. The national transaction reporting systems would have to digest these information and be adopted accordingly. In Germany only those counterparties are currently identified which are also subject to the reporting obligation by using an analogous field and - as the case may be - an identification code provided for by the competent authority - to the effect that the competent authority is able to verify the completeness of the reported data. Here, the question arises whether the creation of such a Europe-wide counterparty identification system would yield an appropriate cost-benefit ratio.

It is helpful that the provision to prepare the buy-sell-indicator from the point of view of the reporting investment firm has been dropped since there are various concepts feasible (in Germany the report is drawn up from the client's perspective). Unfortunately, this provision, however, still remains included under Annex B. This is one of several instances where there are inconsistencies between Annex B and Annex A or, moreover, where Annex B contains more comprehensive requirements than Annex A (cf. further "Trading Time", "Price" - where in Annex B the unit price is relevant, in Annex A the price of the contract is relevant- "Price Notation", "Quantity Notation", "Cancellation/Amendment Indicator"). This raises the question how, in the absence of receiving the necessary information through the reporting party as a result of provisions under Annex A, the competent authorities are expected to deliver the information level required under Annex B. The same is true for the options in Annex A which are not provided for in Annex B. What is the sense of an option in Annex A when the information is mandatory for the data exchange between the competent authorities?

As has been pointed out above, in this regard we have strong concerns that investment firms will become subject to further forthcoming provisions either at Level 3 or at a national level and that such provisions would once more exceed the scope of the provisions contained under Annex A. By default, this would lead to a de facto maximum harmonisation. This consequence should be avoided in any case. It would also contradict CESR's objective to harmonise only the minimum content. We therefore firmly recommend to reduce the requirements of Annex B in order to bring them more into line with those requirements stipulated by Annex A.

Where no harmonised code is in place yet (cf. "Reporting Party Name and Identification", "Instrument Identification", "Underlying Instrument Identification", "Customer/Client Identification") we ask CESR to carefully reconsider if it really makes sense that each supervisory authority changes the code into a "clear name", taking into account both the

general purpose of the data exchange and cost aspects. Even in this case an automated evaluation would hardly be feasible.

For a more detailed discussion please see our comments on Annex A in the enclosure.