Response

of the Association of German Banks
to the CESR Call for Evidence
in connection with the future Financial Instruments Markets Directive
(FIMD)
of 20 January 2004

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CESR - Call for Evidence – Financial Instruments Markets Directive (FIMD)

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Executive Summary

- **Directive or regulation?**

For many areas in which the implementing measures are to be adopted, directives will be preferable to a regulation. This is the only way to ensure creation of a uniform European legal framework that does not clash with national provisions outside the field of supervisory law, e.g. labour law or company law provisions.

- **Compliance**

A **definition of the term “compliance” is needed**, as no generally valid definition exists yet. To ensure conduct in conformity with the law, a functional and not an organisational approach should be adopted. This would mean that compliance would have to be understood as a function comprising different duties that has to be performed within investment firms, with the way these duties are assigned being left to each individual firm. To be consistent, only **general guidelines** should be established for the organisation of operations and processes too. The Guiding Principles for Staff Transactions used in Germany are a suitable model.

- **Record-keeping requirement**

Any **requirement to keep a record of all client orders placed by telephone must be firmly rejected**. This would be in no proportion to the financial and organisational burden involved.

- **Conflicts of interest**

In the case of **potential conflicts of interest, a distinction should be made according to whether or not their existence materially affects the interests of clients**. Effective **Chinese walls** that prevent existing conflicts of interest from affecting relationships with clients would be helpful in this respect.

- **Conduct of business obligations**

The conduct of business obligations should take due account of the different habits and the different situation in the product landscape and the banking and stock market environment in the individual Member States. This also means that **information about investment firms and the investment services offered should not be too detailed**. It should instead be remembered that information also has to be **valid for some time**. The information brochures on investments in securities and forward trading that have been used successfully in the German banking industry for many years are a sensible approach.

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- **Best execution obligation**

With regard to **best execution** of client orders, it is vital that the relevant requirements are designed as **organisational requirements**. There must be no requirement to ascertain the best possible mode of execution in each individual case, as this would impose a considerable technical and administrative burden, thus leading to much higher execution costs. Such a requirement might also clash with the duty to execute orders immediately. With regard to the proposed requirement for investment firms to inform clients about their **execution policy**, it must be ensured that this is confined to **essential basic features**. At the same time, firms should be free to decide how the information is provided to the client.

- **Reporting of transactions**

When setting the **reporting requirements** that investment firms are required to comply with vis-à-vis supervisors, it must be ensured that, where functioning systems are already in place, no parallel systems have to be set up. It would therefore be advisable to improve **the exchange of information between supervisors** where necessary.

- **Admission of financial instruments to trading**

When admitting financial instruments to trading, care should be taken to ensure **consistency with the Market Abuse Directive, the Prospectus Directive and the Transparency Directive**. These directives set numerous requirements for issuers that are linked to admission to trading in each case.

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3.1 Organisational requirements

a) Definition of "compliance"

To allow discussion of the questions concerning compliance obligations raised in the consultation document, the first step should be to **define the term "compliance"**, since, as far as can be seen, no generally valid definition exists at present. If compliance is defined as "acting in accordance with the law" and **ensuring conduct in conformity with the law**, a **functional** and not an organisational **approach** should be adopted. This means that compliance should be understood as a function comprising different duties that has to be performed within investment firms, with **the way these duties are assigned being left to each individual firm**. Such a definition of compliance avoids prescribing to firms how they should organise these tasks internally and thus ensures that firm-specific differences are preserved.

b) Establishment of procedures to prevent and detect violations of applicable rules

It is right to require investment firms to organise their internal operations in a manner appropriate to their structure, size and business activity and to continuously monitor the proper performance of investment services. The actual selection and arrangement of suitable organisational and technical measures should, however, be left to each individual investment firm. **For the organisation of operations and processes only general guidelines** that can be adapted to accommodate firm-specific differences should be established.

c) What is to be considered as a personal transaction for the purpose of the rule?

The purpose of monitoring transactions in financial instruments conducted by managers, employees and tied agents (personal transactions) is to avoid conflicts of interest between the persons concerned, the firm and clients. This point is thus closely connected to Articles 18 and 13 (3) of the Financial Instruments Markets Directive (FIMD) (formerly the ISD), so that sections 3.1 and 3.2 of the CESR document should not be viewed separately.

The **definition of "personal transactions"** could cover all those transactions in financial instruments that managers, employees or tied agents conduct outside the scope of their official duties for their own account or for the account of third parties, particularly their spouses, their parents or their major or minor children. It should in principle also cover those transactions that are conducted by third parties for the account or **for the benefit of managers, employees or tied agents** (see in this connection enclosure 1: Extract from Guiding Principles for Staff Transactions (translation from the German)).

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It should be made clear that those transactions conducted for the account or for the benefit of managers, employees or tied agents by third parties such as an asset manager (discretionary management of individual assets invested in financial instruments on behalf of others – financial portfolio management) are excluded from the definition of personal transactions. There are no conflicts of interest in financial portfolio management, as the financial portfolio manager makes investment decisions on his own, independently of the investor.

d) Criteria for identifying the persons that are to be considered as managers and employees

Under Article 13 (2) of the FIMD, the definition of this group of persons is linked to the definition of “personal transactions”. As what is in principle at stake in these transactions is avoiding conflicts of interest, and every person working for an investment firm, whether a manager or an employee, should be obliged to do so, we suggest first defining “managers” and “employees” uniformly as the “**staff**” of a firm. The term “staff of a firm” could then be understood to mean all those persons with whom the firm maintains an active service, employment or training relationship or who are engaged by the firm in a similar manner. It must also be borne in mind that, because of the duties they perform, some staff members receive insider information. These persons would have to be defined as “**staff with special functions**”.

e) Which rules governing personal transactions by managers, employees and tied agents could be appropriate?

The rules governing personal transactions would first have to be geared to the above categorisation of “staff” and “staff with special functions” proposed under d) above. Because of the special responsibility they have when handling insider information, tougher standards would have to be set for transactions by “staff with special functions”. It must also be remembered that, since their purpose is to effectively prevent and manage conflicts of interest, the rules could seriously encroach upon the personal rights of staff in some cases. To allow **their practical implementation**, **clear legal guidelines limiting encroachment upon the rights of the staff concerned** would therefore be required. However, these guidelines **should not at the same time contain detailed organisational requirements** for firms, as otherwise serious conflicts with national provisions of, for example, labour law or company law may arise.

f) Regulation or directive

Whilst, on the one hand, a regulation is being considered as the legal instrument for implementing Article 13, a directive is, on the other hand, being contemplated for Article

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18 and Article 13 (3). When selecting the legal instrument for adoption of the implementing measures, the following should be taken into account: The proposed rules could encroach upon (a) the field of labour law and (b) the organisational discretion granted to each investment firm. **As a legal instrument, only a directive takes sufficient account of national legislative powers and the widely differing structures, sizes and business activities of investment firms.** Generally applicable rules in the form of detailed regulations are therefore not feasible in this case.

3.1.4 Record keeping obligation (Article 13 (6))

Any general requirement to keep records of all client orders placed by telephone and to inform clients thereof must be **firmly rejected**. While such a practice is customary and in fact advisable in business with institutional clients, we regard it as totally inappropriate in the retail client sector: Differences of opinion on the contents of securities orders that have been placed are extremely rare in practice. Because investment firms are required to issue a securities contract note immediately and this contract note is subsequently checked by the client, any discrepancies are quickly detected and corrected.

The **actual benefit** that such a requirement would bring for the client by easing the burden of proof for him in the rare cases in which an order has not been correctly noted and forwarded is in no proportion to the financial and organisational burden that would be imposed by the need to equip thousands of bank/savings bank branches with the required technology.

3.2 Conflicts of interest (criteria for determining types)

While potential conflicts of interest will always arise at universal banks in particular, these are unlikely to affect a specific client relationship. To achieve a reasonable cost-benefit ratio, it would therefore be right to distinguish between conflicts of interest whose existence **materially affects the interests of clients** and those where the interests of clients are not materially affected.

The crucial criterion for this distinction will be whether knowledge of the potential conflict of interests would have influenced **the client’s decision** in favour of a particular product or service. It will thus be largely a question of the extent to which the bank has **exploited the client’s trust**. Compared with asset management, for example, execution-only business is ultimately likely to give rise to only a relatively small number of potential conflicts of interest. A possible ban on providing services only makes sense where a very serious conflict of interests exists, i.e. only in exceptional cases.

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A particularly important point in this connection is **resolving the conflict of goals between organisational arrangements to prevent conflicts of interest and transparency for clients.** It can be assumed that **effective 'Chinese walls'** will prevent many conflicts of interest that may exist in other areas from filtering through to client relationships, so that disclosure will not be necessary.

If an information approach is deemed necessary, **any requirement to inform clients individually must be avoided.** This would impose an unacceptable administrative burden. Article 18 (2) of the Directive accordingly only stipulates disclosure **of a general nature**.

The type of organisational arrangements made to prevent conflicts of interest should at any rate be left to each individual institution. Their effectiveness can be ensured by means of regular, e.g. annual, supervisory audits.

3.3 Conduct of Business Obligations when providing investment services to clients

These implementing measures are to be adopted in the form of a regulation. A closer look at the details suggests that a **directive** would probably be a better option, as conditions differ widely in the individual Member States. For example, different national habits play just as important a role in marketing as the situation in the product landscape and the banking and stock market environment. There are big differences in this area that could scarcely be accommodated satisfactorily by a regulation.

3.3.1 Publicity and marketing communications

The requirements laid down in the Technical Annex must be viewed critically. Take, for example, the standards that are to be set for how marketing communications can be distinguished from personal recommendations. It must be ensured here that, for instance, addressing the client personally would not automatically mean that a personal recommendation is being made. The rules must leave investment firms enough scope for informing clients about new products and services in the future too without requiring them to provide advisory services at the same time, for example.

The Technical Annex also refers to the minimum content of marketing communications. It mentions that the person responsible for marketing must be named. Such **extensive details are inappropriate**. They only increase bureaucracy without ensuring that the person named in a given case is actually still in charge at the time the communication is published.

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3.3.2 Appropriate information to be provided to the clients or potential clients

When setting the individual requirements, a **distinction** should in principle be made between information provided to a potential new client and information provided to an existing client. To avoid any unnecessary burden, a **requirement to provide information about the investment firm should only apply where new clients are involved**.

With regard to the service offered, a **universal bank** should be able to merely inform the client that **all the usual investment services** are available.

The minimum content of information that has to be provided on financial instruments and/or investment strategies should be chosen sensibly. CESR should bear in mind that **information must be valid for some time**. By way of example, reference can be made here to the information brochures on investments in securities and forward trading that have been used successfully in the German banking sector for many years. Standardised information, i.e. information on the various **types of** financial instruments and investment strategies available, would therefore appear adequate. Further information is only required when a client is specifically advised in regard to his investment.

With regard to the information that is to be provided on **execution venues**, it must be remembered that requirements which go too far would be impossible to implement in practice. What is particularly important is that the client receives information that he can use. This may be limited in the case of globally active banks to notice that an order could in principle be executed on any stock exchange in the world. In this context, a distinction between on-exchange and off-exchange execution venues appears sensible. On the other hand, details of every single venue do not appear necessary and would almost certainly be non-exhaustive, given the large number of exchange and off-exchange execution venues throughout the world.

With regard to the rules on cost transparency, it must be noted that **it is not always possible to accurately determine the third-party costs incurred abroad**. An estimate of the costs will have to suffice in such cases. Information on fees and third-party costs should **not** lead to **disclosure of internal pricing models**.

3.3.3 Client Records

It appears essential that national civil law provisions should be taken into account in the proposals made in this connection. Obliging investment firms to have all records signed by the client as well does not seem feasible at any rate. **Incorporation by reference** to, for example, general business conditions and price displays must suffice in this case. Reference to legal bases also appears unnecessary.

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3.3.4 Reports from the firm to its clients (Events, content, delivery)

A distinction between reports made in connection with a transaction, reports made under the ongoing safe custody agreement, and reports made on the basis of an asset management agreement will be needed. **Any requirement for the securities account statement to contain details of account movements**, as already discussed in the course of the CESR's work, **must in particular be firmly rejected**.

Under asset management arrangements, a distinction must be made in turn between ad-hoc information requirements and periodic information requirements. In the case of **periodic information requirements**, supervisors should **not set any fixed period** during which the client receives information. As particularly in the case of asset management the client's individual requirements have to be taken into account, this should be left to an agreement between the client and the bank.

3.4 Best execution obligation

The implementing measures with regard to best execution of client orders are to be adopted within the framework of a regulation. This is unlikely to prove a successful approach, as it will not be possible to establish a matrix that would cover all conceivable individual cases appropriately. It should also be pointed out that the text establishing the relevant mandate does not include the important additional phrase that “all reasonable steps are to be taken”. However, the wording of the directive in this respect will be vital. In Germany, the Special Conditions for Dealings in Securities used uniformly in the entire banking sector have proved successful (see enclosure 2). These conditions also contain clear descriptive references to the execution of securities transactions.

3.4.1 Criteria for determining the relative importance of the different factors to be taken into account for best execution

The implementing measures must ensure that there is no obligation to ascertain the best possible mode of execution **in each individual case**, as this would impose a considerable technical and administrative burden, resulting in much higher execution costs. Such an obligation would also clash with the requirement to execute orders immediately. Particularly where volatile securities are involved, it could mean that prices have already moved before this obligation has been fulfilled. Such effects are not in the client's interest. The important thing will be to avoid any fixed prioritisation of the criteria specified so as to ensure the urgently required flexibility of execution.

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3.4.2 Trading venues to be included in the order execution policy

The criteria used by investment firms to determine the venues at which best execution is possible must leave enough scope for implementation in practice. It can only be a question here of fixing criteria that are to be taken into account in the decision. The definition of the term “consistent basis” should leave room for manoeuvre.

3.4.3 Information to the clients on the execution policy of the firm

The client should be given information on essential features of the investment firm’s execution policy. In this connection, the cases in which the investment firm accesses indirectly should also be indicated. It will be particularly in the client’s interest to ensure that information on execution does not contain **too many details**. The way in which the information is provided to the client should be left to the investment firm, which should be allowed to use modern communication channels as well. The same goes for information on updates, where the need for further information must be confined to cases in which important changes have been made to the execution policy.

3.4.4 Obligation to monitor and update the order execution policy

The Technical Annex points out that the execution policy must be periodically monitored and updated. It will have to be ensured that this can take place within a flexible timeframe, e.g. **annually**. Also, it may be advisable to design structures in such a way that exceptional corrections can be accommodated immediately.

3.5 Client order handling rules (procedures and arrangements)

Any over-regulation in this area, which is shaped to a great extent by system requirements, must be avoided. The **great variety of cases** calls for an arrangement based on principles and ground rules where consideration has to be given in each individual case to what is in the client’s best interest.

3.6 Reporting of transactions

Under Article 25 of the existing ISD, the details of transactions that have been executed will have to be provided in future not only to the competent home authority but also to the competent authority of the most relevant market in terms of liquidity for the financial instrument concerned and for the exchange of information between the competent authorities.

In any new arrangement, it is important that the market participants required to report transactions are not **needlessly** forced to **abandon** a **reliable national system** in favour of a **European system** that can only be set up **at great cost**. Instead, it should be examined

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whether tried and tested systems can be retained at national level and whether the required cross-border exchange of information can be performed by the competent authority in each case. This would prevent individual market participants from having to comply with several different reporting procedures at the same time.

3.7.3 Post-trade Transparency requirements for Investment Firms

It appears at least questionable whether the implementing measures can be specified within the framework of a regulation. This should be reviewed.

The introductory text lacks a reference to the fact that the post-trade transparency requirements under Article 28 are restricted to **trading in shares**. To ensure a clear mandate, such a reference should be added.

It should also be noted in general that the rules must ensure that competition between regulated markets, MTFs and investment firms is not upset by the post-trade transparency requirements.

3.8 Admission of financial instruments to trading

It should be noted that the authorisation basis for these implementing measures is no longer Article 39 but Article 40.

Article 40 and the implementing measures for it are designed to regulate the admission of securities, trading in and information on these, subsequent admission requirements for the issuer and the inclusion of securities. The Commission believes that the implementing measures should be adopted in the form of a regulation.

- **Regulation or directive**

Careful consideration should first be given to whether the legal form of a regulation that is proposed by the Commission should not be dropped in favour of a directive, as Article 40 and the implementing measures for it affect an area that is largely the responsibility of the individual stock exchanges themselves (e.g. creating individual segments with certain admission requirements for issuers). To preserve the flexibility that currently exists in this area in Germany, a **directive** giving national legislators sufficient room for manoeuvre in this respect would be preferable.

- **Consistency with other directives**

Article 40 and the implementing measures for it should be based closely on the **Market Abuse Directive**, the **Prospectus Directive** and the **Transparency Directive** that is currently under discussion, as well as the implementing measures for these. Consistency is

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essential, as these directives also lay down numerous requirements for issuers that are linked to admission to trading in each case.

- **Prospectus Directive**

The Prospectus Directive and the implementing measures for it that are currently under discussion already broadly harmonise admission of securities to trading. All the details of the prospectus that is to be issued in future for admission to trading will probably be set out in a regulation. A distinction will be made both between issuers and different **categories of security** (shares, debt securities with a denomination of more than € 50,000, debt securities with a denomination of less than € 50,000, depository receipts, asset-backed securities, guaranteed debt securities, derivatives (covering all debt securities that cannot be included in the other categories). These categories should be retained.

The **admission mechanisms** (competent authority, periods, etc.) are also laid down in detail by the Prospectus Directive, so that no further regulation in the FIMD is needed.

In addition, Article 10 of the Prospectus Directive lays down a **subsequent admission-based requirement** stipulating that investment firms must compile an annual report summarising all the capital market information published in the past year. For this reason, too, further regulation in the FIMD would be unnecessary.

- **Transparency Directive**

The Transparency Directive, when it is adopted, will very probably lay down a large number of subsequent admission-based requirements. These will include preparing and publishing annual and semi-annual reports, submitting further financial reports for a period of less than twelve months in the case of shares, providing notice of shareholders' meetings and dividend payments, and announcing new issues. It will also regulate publication of this information in detail. This is why, like in the Market Abuse Directive, which refers in connection with the publication of ad hoc reports (Article 6), for example, to the Transparency Directive, reference should merely be made to the publication requirements under the future Transparency Directive.

- **Preserving the status quo in securities clearing and settlement**

Plans to regulate trading, as well as clearing and settlement, on regulated markets should in particular ensure that existing structures are preserved, as it is precisely these that allow smooth trading at present. The current rules on price-setting also allow trading in transferable securities in a fair, orderly and efficient manner. Changes, on the other hand, would prevent this.

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In the Technical Annex, the Commission calls for special rules for derivatives as well so as to ensure fair, orderly and efficient trading. The thinking behind this demand is unclear at least as far as securitised derivatives are concerned. Securitised derivatives were, after all, admitted to trading on the basis of the requirements laid down in the Prospectus Directive. Besides the prospectus issued for these securities, investors are also still protected by advice tailored to individual investment products and personal requirements, so that no further regulation appears necessary. Regulatory action could therefore only be considered for non-securitised derivatives.

- **Compliance with the Article 40 framework for the implementing measures**

The Technical Annex published in connection with the call for evidence appears to go further than Article 40 at least on some points. For example, Article 40 itself does not contain any authorisation basis explaining why different segments or separations of the regulated market should be established. Although such **segmentation** already exists in practice, it should be left to the individual regulated markets, in competition with each other, to establish segments or special requirements for issuers **on a self-regulatory basis** and thus become more attractive for investors. European regulation establishing uniform standards would prevent this. Mention must, however, be made particularly of Article 3 of the draft Transparency Directive, which stipulates that issuers from so-called host Member States must not be subjected to tougher publication requirements than in the Transparency Directive and Article 6 of the Market Abuse Directive.

Enclosure

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