



EFFAS THE EUROPEAN FEDERATION OF FINANCIAL ANALYSTS SOCIETIES

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via Email

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Comments on CESR's MiFID 2nd consultation paper for the 1st Set of Mandates (CESR /04-603b)

Response by EFFAS European Federation of Financial Analysts Societies

Dear Mr Demarigny,

The European Federation of Financial Analysts Societies, EFFAS, is the European umbrella organisation of national analysts societies. It comprises 23 members representing more than 14,000 investment professionals mainly in the areas of Equity and Bond Research, Asset and Portfolio Management, Investment Advice.

In the following, EFFAS comments on those issues which might primarily affect the membership of EFFAS.

As to No. 2 Independence of compliance

We agree with CESR that the issue of independence of compliance should be approached from a functional rather than an organisational perspective.

This will permit the necessary flexibility of organising compliance within investment firms according to their size and complexity. This principle will also give small firms the opportunity to perform internal controls and compliance checks within the firm rather than outsourcing such tasks. The disadvantage of outsourcing of internal control and compliance functions is that such control tends to be in time and experience removed from the actual operations of the firm to be controlled. Especially in smaller firms who cannot afford a permanent review of the operations by an outsider (delegate), outsourcing internal control and compliance functions tend to duplicate the audit.

Even in small firms having not more than two operative members, independent compliance and internal control is possible using four eyes where the two members check each other (cross-checking). Small firms are typically found in the following areas of investment services:

- Investment advice
- Receiving and transmitting orders
- Portfolio management

with the ancillary service of

- Investment research

Most of these firms do not hold customer funds and/or securities.

The activities consist typically of

- marketing of services, soliciting or acquiring new customers
- getting the necessary information on the customer's profile
- providing the necessary information on the nature and the extent of services provided by the firm, closing a service agreement
- selection of suitable financial instruments
- giving advice and recommending transactions in financial instruments
- portfolio managers' arranging of management rules and guidelines
- introducing brokers' taking orders
- placing orders with the execution and account carrying firm
- reviewing the execution and account information
- proprietary accounting within the firm
- reporting to and liaison with the regulatory authorities

Compliance and internal control consist of monitoring

- the marketing and solicitation process and the methods employed therein
- the suitability of advice and recommendations
- the proper taking of orders
- timely and proper placement of orders
- observance of management rules and guidelines
- handling of conflicting interests, if any (partner and staff transactions, churning clients etc.)
- timely and proper accounting and reporting
- handling of customer complaints
- the ensuing documentation of these control actions (checklists, countersigning of documentation)

Most of these control activities consist of the review of the operational documentation.

In many small firms the members have their respective customers to attend and divide the administrative functions among. Functionally independent compliance can be achieved by each member controlling the operation of another member by reviewing the respective documentation and to follow up on problems detected. This cross-checking is a functionally independent, effective and non costly method of compliance and control.

In other firms one or more members are responsible for customer contact and another member handles all administrative functions. In these cases as well, the partners can cross-check each others activities.

In a one man firm, there is no direct “four eyes” approach possible unless the control function is delegated to a part time clerical employee or is fully outsourced with the effect of becoming rather similar to an audit. But also a one man firm can practice a self control which is not independent in the true meaning of the word but which provides some independence of the control versus the performance of the operational function. A financial service provider can control his own activities by making a time deferred periodic review (e.g. per day, per week) and documenting the completeness and timeliness of his/her own previous operations on checklists. This is certainly not a perfect control mechanism but will force the service provider towards self-discipline and a structured operation and will uncover mistakes and omissions not prompted by wilful and intentional breaking of rules. Checklists of this sort can be reviewed and audited by independent third parties for longer periods.

The level two legislation should not prescribe any details, but should require that smaller firms use suitable methods of cross-checking by their members and that one man firms practice and document a time deferred self-control. A provision to this effect might read:

“Investment firms having not more than 15 employees and tied agents and offering only one or more services of investment advice, investment research, receiving and transmitting orders and managing portfolios of others may organise internal control and compliance through suitable means of cross-checks or time-deferred self-control provided they do not hold customer funds or financial instruments and do not deal for own account”.

Details and the determination which of standards must be observed to meet the requirement of “suitability” should be left to level 3.

As to No. 3 Record keeping and burden of proof.

Art. 13.6 of MiFID requiring the investment firm to keep sufficient records and documentation to monitor compliance is an exhaustive rule. It need not be enforced by any proposal that the firm has to demonstrate that it has not acted to breach the rules. Such a provision will be understood in many jurisdictions as a reversal of the burden of proof in relation to the regulator and to the customer. Vis-à-vis the customer, the decision on who should bear the burden of proof for an act or an omission ought be left to the private law in the respective jurisdictions. Vis-à-vis the regulator, there should be no question and issue of “burden of proof”, but rather the requirement of self-demonstrating documentation and record keeping. If the proposal means the obligation of record keeping, it should say so and not use ambiguous wording potentially even weakening the documentation requirement inasmuch it might allow other means of proof such as oral testimony. All other considerations (intensity, audit trails) presented by CESR are reasonable in connection with the obligation of record keeping and documentation.

As to No. 4 Tape recording requirement

The second consultation paper focuses upon the marginal cost of a tape keeping period of five years vs. one year.

EFFAS would like to address the basic point of the costs for maintaining a tape recording system. Whether these costs are marginal or not depends on the size and the commission income of the firms affected.

Telephone orders happen in the following types of investment firms:

- a) Firms receiving and transmitting orders (order takers, introducing brokers)
- b) Portfolio managers in those cases in which they individually and exceptionally receive instructions from their clients
- c) Executing firms (full brokerage)

The investigation with firms using such tape recording equipment resulted in the following expenses:

The purchase price for digital equipment to tape customers' orders of the necessary quality in clarity amounts to approximately € 35.000.

Expense per year:

The depreciation period of such equipment is about 5 years	€ 7,000.00
Maintenance contract (€ 200,00 per month)	€ 2,400.00
Price per tape € 85, a tape per year per telephone is required, e.g. 15 tapes	€ 1,275.00
Storage per year in a special deposit (estimated)	€ 500.00
Opportunity costs of staff involved in handling the equipment and tapes	€ 4,000.00
The total annual expenses for such a system are estimated at approx.	€ 15,000.00

For a small firm with annual commission income of € 150.000 the system represents 10%, of such income with annual commission income of € 300.000 5%, etc.

This is not marginal. Together with all other cost items caused by regulatory requirements, it becomes prohibitive.

Although a scrutiny of the internet reveals a multitude of very cheap telephone recording equipment, the lack of reliability and the complication of individually handling this equipment make it unsuitable.

There are situations which aggravate the cost burden. A portfolio manager who occasionally would receive telephone instructions from a customer could probably not generate enough fees or income from such activities to cover even a portion of the cost involved in installing and maintaining such a system. If an investment firm uses tied agent operating outside the premises of the firm, the firm would be required to install such a system for each tied agent accepting telephone instructions from the client. It is obvious that this would result in an excessive financial burden. One might consider using less costly systems for these cases while accepting their shortcomings.

If mandatory voice recording would become the rule of law, a great number of investment firms might have to forego the practice of accepting telephone orders and would have to insist on facsimile- or e-mail instructions. This again would be to the detriment of their clients who very often use an investment firm because they do not wish to be confronted

with these types of formalities. It would be one more element to drive small investment firms out of business because many customers would turn to larger firms which can afford reliable and practical voice recording systems.

As to No. 5 Outsourcing of investment services

CESR argues in favour of extending the outsourcing rules under Art. 5g of the UCITS Directive 2001/107/EC to the outsourcing of individual portfolio management functions.

EFFAS thinks that the approach of CESR in this respect is neither necessary nor advisable. The provisions in the UCITS Directive may be justified by the fact that the collective investment is a packaged product which the customer may take or leave. The customer has no possibility to influence the set up and distribution of the services involved in this product.

This, however, is not true for the individual portfolio manager. The customer can influence the individual portfolio management contract as to whether and under which circumstances and to what extent his/her contractual counterpart may outsource management functions to non-EU jurisdictions. The decision on who is managing the customer's portfolio should be left to the parties and not be restricted artificially by the European legislator.

By the same token, the responsibility for the delegate located either in a EU country or a non-EU jurisdiction should remain with the investment firm dealing directly with the customer. This should apply without regard to the type of services outsourced, individual portfolio management or others. Due diligence in selecting the delegate should be mandatory and the outsourcing should be fully disclosed to the customer.

As to No. 6 Conflicts of interest and the segregation of areas of business

EFFAS agrees with the proposed approach.

As to No. 7 Investment Research

EFFAS agrees with CESR's approach that different situations of research require different treatment and with the proposed requirement that firms should clearly disclose the fact if they do not comply with certain requirements under the objectivity standards.

Yours sincerely,



Fritz H Rau
Chairman of EFFAS