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**UBS AG**
100 Liverpool Street
London, EC2M 2RH
Tel. +44-20-7567 8000

Legal and Compliance Europe
Corporate Legal Services

Tel. +44-20-7568 9032
Fax +44-20-7568 7168

www.ubs.com

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**CESR's Advice on Possible Implementing Measures of the Directive 2004/39/EC on Markets in Financial Instrument (17 June 2004)**

Comments of UBS Investment Bank

UBS Investment Bank (UBS-IB) welcomes the opportunity to comment on CESR's Advice on Possible Implementing Measures of the Directive 2004/39/EC on Markets in Financial Instrument (CESR Advice), published on 17 June 2004. The CESR Advice seeks comments from all interested parties on the draft technical advice CESR proposes to give to the European Union (EU) Commission. This technical advice addresses the implementing measures set out in the first set of provisional mandates received by CESR from the EU Commission on 20 January 2004.

UBS-IB is the investment banking business group of UBS AG, employing 16,000 people in offices located throughout 30 countries. UBS AG is a global, integrated investment services firm and bank domiciled in Switzerland, with offices in over 50 countries worldwide. UBS AG's business is managed through four main business groups and its Corporate Centre.

## General Comments

UBS-IB has contributed to, and is generally supportive of, the responses submitted by the International Swaps and Derivatives Association, Inc., the British Bankers' Association and the London Investment Banking Association. In addition, UBS-IB believes it is desirable for CESR to receive individual responses that can, at a more granular level, allow CESR to gauge more precisely the impacts of some of its proposals on an investment firm.

Given the volume of the CESR Advice, UBS-IB has limited its comments to three very specific topics, namely, conflicts of interest, outsourcing and telephone taping of trade orders, all as further discussed below.

## Specific Comments

### Conflicts of interest

1. Use of information barriers

As a general principle, UBS-IB supports the robust approach to management of conflicts of interest informing the detailed proposals set forth in Box 6. This includes the use of information barriers, often a necessary, albeit powerful, tool for managing conflicts of interests within multi-function investment firms.

CESR defines an "information barrier" as:

> …effective procedures to control the flow of relevant information between persons principally engaged in the different activities that are to be separated by the barrier…

UBS-IB, therefore, understands CESR to be proposing a *procedural* information barrier, rather than a *physical* barrier, the former of which is a considerably less stringent requirement than the latter. Currently, UBS-IB has in place various procedural barriers for the three business areas of concern to CESR, namely, proprietary equity trading, asset management and corporate finance (including equity and debt capital markets businesses). On this issue, UBS-IB believes procedural information barriers between, respectively, (i) proprietary equity trading and client equity sales and sales-trading; (ii) equity investment research and equity sales and sales-trading; (iii) investment banking and asset management business groups; and (iv) corporate finance and equity and fixed income investment research departments, are appropriate and in line with best regulatory practice for all similarly situated investment firms.

As opposed to a procedural, electronic or virtual barrier, a physical information barrier is the most intrusive of all the tools available to both regulators and investment firms in addressing conflicts of interest. However, an investment firm may find that physical separation is the only logical means by which regulatory principles (as opposed to rules) can be fairly interpreted and applied. For example, UBS-IB believes physical information barriers are both desirable and appropriate between investment research departments and corporate finance for all similarly situated investment firms. At UBS-IB, corporate finance (including the equity capital markets business area) is physically secure from both the equities and fixed income investment research departments. This view also extends to separation of investment banking and asset management business groups, in this case, UBS-IB and its sister business group, UBS Global Asset Management.

Moreover, UBS-IB is exploring the relative value of establishing physical information barriers between investment research and business areas other than corporate finance and the equity capital markets business area. Investment research as a department tends to be lightning rod not only for conflicts of interest but also for what will in future be deemed to be inside information in the EU (and is currently so-deemed in certain Member State jurisdictions). UBS-IB recognises the value of investment firms being forward-looking in the area of management of conflicts of interest rather than merely preserving the status quo. Only in this way can investment firms continue to deserve, through progressive thinking coupled with demonstrable actions, the flexibility granted by regulators in managing their conflicts of interest. UBS-IB believes this kind of partnership is both desirable as a regulatory model and effective in practice.

As stated above, UBS-IB already has in place procedural, but not physical, information barriers between its proprietary equity trading desk and its client equity sales and sales-trading desks. At this point in time, we are not convinced of the need for a physical information barrier between the foregoing, nor yet of procedural information barriers within our fixed income businesses, which is almost entirely principal-to-principal trading. Even so, UBS-IB is mindful that new thinking prevails on these sources of potential conflicts of interest. As a result, traditional views on management of conflicts of interest in these and other business areas within UBS-IB continue to be revisited.

UBS-IB believes that any decision by regulators to mandate physical barriers should be underpinned by factual and economic analyses while taking into account both views of market participants and regulatory trends in jurisdictions outside the European Union. This approach is especially important given that views on what constitutes a conflict of interest and the best means of addressing those deemed significant, is still evolving. Twenty-four months ago, prescribing separation of investment research and corporate finance departments represented a fundamental shift in thinking on the issue of conflicts of interest by both regulators and investment firms. Today, it is accepted best practice among multi-function investment firms.

The result of this long incubation period has been to consolidate general thinking by regulators on the role both of investment research analysts and of the products they disseminate. These issues, both within the UK and globally, have been fully ventilated by market participants, regulators, industry groups and practitioners. This debate has now solidified into new and widely-accepted standards of best practice in the area of independence of investment research, exemplified by the September 2003 IOSCO Statement of Principles for addressing sell-side securities analyst conflicts of interest to which CESR refers.

Accordingly, physical information barriers should be used with discretion and only after an extended review of their costs, impacts, expected benefits and available alternatives. Such was the case in relation to independence of investment research. As a rule of thumb, we believe that the more onerous the organisational and administrative arrangements, the more considered (both EU-wide and globally), the nature and effects of the conflict, and the relative merits of imposing such requirements, should be.

CESR has stated that:

> It is suggested that for large, multi-function investment firms, the occurrence of conflicts of interest will be inevitable. Regulators should not require such firms to disaggregate, as similar conflicts can be expected to emerge at the group level, and the costs associated with disaggregation cannot be shown to outweigh the benefits to clients.

By this, we take CESR to mean that there is a point after which any potential conflicts of interest that might arise are so *de minimis* as to be insufficient to justify the costs of managing them to both the investment firm and its clients. On this basis, we would agree that any regulator should proceed with caution in prescribing or otherwise imposing physical information barriers, as this measure is, as a practical matter, nearly equivalent to disaggregating various functions within a single investment firm.

In conclusion, UBS-IB believes the CESR proposals relating to procedural information barriers are, with the exception of their application to fixed income businesses, generally in line with current best practice within investment firms of a similar size, complexity and scale. UBS-IB further believes that it is desirable to create a level playing field among similarly situated investment firms in the management of conflicts of interest without unduly sacrificing flexibility. In this regard, UBS-IB favours the indicative proposals on information barriers put forward by CESR.

With respect to physical information barriers, UBS-IB observes that they can be an important supplement to procedural information barriers. The physical information barrier is also a uniquely powerful tool, and its deployment should follow a well-considered inquiry into the appropriateness of its use. Although physical information barriers are not now prescribed, investment firms such as UBS-IB will want to be forward-looking in their handling of actual and potential conflicts of interest, thereby meriting the confidence of national regulators in their ability to manage them effectively.

Finally, UBS-IB would ask CESR to bear in mind that, for global investment firms, the sum is greater than its parts. Allowing investment firms to preserve this gestalt within acceptable boundaries, to the benefit of the investment firm, its clients and the marketplace, will promote mutual confidence and cooperation between regulated entities and their regulators.

2. Recordation of potential sources of conflicts of interest

As mentioned above, UBS-IB supports robust management of conflicts of interest issues both in the EU and globally. However, we also recognise that a measured approach must prevail to ensure a viable and economically efficient outcome. Onerous new regulations that do not reflect the way investment firms are organised or are capable of being organised benefit neither the EU at large nor its financial services industry. Such is the case with the proposal that an investment firm must record, on a more or less "real-time" basis, each identified "potential" conflict of interest arising under the categories of interested persons, areas of business, types of financial instruments and transactions, all in accordance with the very detailed criteria set out under paragraphs 1 and 2 of Box 6.

As a threshold matter, CESR is asked to consider the practicalities of such a requirement. We query how reasonable the expectation is for an investment firm to be aware of, and to document, each and every potential and individual conflict of interest as it arises. Often what is "potential" never materialises. Also, both regulatory and market perceptions of what constitutes a conflict of interest evolve over time, never more so than in the past 24 months.

Moreover, to fulfil this mandate would require creation of a customised IT database capable of holding and manipulating vast amounts of information, as well as employment of at least one individual per a business area to identify, input and manage the relevant information. At the moment, an individual employed by the UBS-IB investment banking department conducts internal conflicts of interest checks for corporate finance as well as for equity and debt capital markets business areas for each proposed mandate. This model would need to be extended to each and every business and support area, with links created among the databases to capture potential conflicts of interest on a cross-product, cross-functional and (potentially) cross-business group basis. Yet another individual would need to assess and evaluate, on a daily basis, the relative impact of the information as well as to ensure that records were updated regularly. As a practical matter, such a requirement would be beyond the capacity of most global multi-function investment firms such as UBS-IB.

Putting aside the prohibitive costs of building and operating such a global conflicts of interest database, UBS-IB submits that creating a new layer of records administration and infrastructure is duplicative and unnecessary. While a more decentralised model, UBS-IB Legal and Compliance product specialists interact daily with their respective businesses on issues of potential conflicts issues and are centrally involved in reviewing new business initiatives. Group policies and procedures already necessitate that Legal and Compliance, as well as other staff, follow specified guidelines on the reporting and handling of actual and potential intra-group conflicts of interest. As cited above, business areas such as corporate finance that require higher-level identification, coordination and management of potential conflicts of interest within their businesses have designed internal conflicts clearance systems and procedures to address these concerns.

In short, we see no need for a centralised register, manned by dedicated individuals, to ensure broad identification and monitoring. This is not to say that such identification monitoring does not occur. Rather, these functions are meted out and performed in a more decentralised and, in our view, more efficient way by Legal and Compliance product specialists. These individuals, who have extensive understanding of the products, organisational arrangements and functional roles of the business areas they cover, are exceptionally well placed to perform this activity, as they do now.

The idea of a comprehensive and current list of potential conflicts of interests is understandably appealing to regulators. However, we believe the current decentralised method of identifying and tracking conflicts of interest is not only more practical by working within the existing structures of a global investment banking firm, but also more effective and timely. This organisational structure does not, by any means, preclude Legal and Compliance product specialists from providing detailed documentation on potential conflicts of interests as necessary. However, it does obviate the need for superfluous administrative personnel and systems when such product specialists are already performing this critical oversight function in a direct and interactive way according to well-defined internal policies and procedures.

Consequently, we ask CESR to reconsider the efficacy of recordation of potential sources of conflicts of interest, which we believe to be a purely administrative, rather than a risk control, exercise.

3. Inducements

The definition of inducements is wide and, given CESR's stated reluctance to take up issues such as soft commissions and bundled brokerage arrangements in this section, ambiguous as to its scope of application. On the assumption that CESR intends to capture the foregoing within its scope, we ask that CESR reconsider its advice on this complex and highly controversial topic.

According to the CESR Advice in paragraph 9 of Box 6, the offer or acceptance by relevant persons of inducements is permitted only if such inducements (i) can reasonably assist the investment firm in the provision of services to its clients; and (ii) do not conflict with the duty of the investment firm to act in the best interests of the client.

We believe these criteria misconstrue the intent behind management of conflicts of interest. First, any activity that meets the above test poses neither an actual nor a potential conflict of interest and, hence, is not subject to regulation. Second, the test should be whether other clients are positively *disadvantaged* by soft commission and bundled brokerage arrangements between an investment firm and a particular client, and not whether such other clients are positively *advantaged* by these private contractual arrangements. UBS-IB agrees that such private arrangements should not conflict with its obligations to act in the best interests of any of its clients. However, where (a) no conflicts of interest arise as a result of these private contractual arrangements; and (b) all clients are accorded fair treatment, UBS-IB can see no basis for a flat prohibition on these long-standing and legally permissible practices.

In this regard, it is worth noting that other jurisdictions have had long-standing permissions on soft commissions, notably in the USA. Section 28(e) of the Securities and Exchange Act of 1934 was enacted in 1975 and provides a "safe harbour" for soft dollar arrangements. This safe harbour was introduced with the express purpose of increasing the competitiveness of brokerage firms, resulting in better and cheaper services for investors.

The law is still evolving in many of the areas addressed and we believe it is highly desirable for these complex issues to be thoroughly and, as is the case here, painstakingly reviewed by the relevant Member States prior to imposing "minimum" standards. The organic nature of the financial services markets means that the goal of maximum harmonisation will inevitably trail fast-moving developments in this sector. CESR should, therefore, capitalise on the Member State "laboratories" in which new regulatory approaches, views and methodologies keep pace with market practices and seek to discover the appropriate balance of interests prior to imposing new rules.

For instance, the Financial Services Authority (FSA) has been engaged for the past 18 months in a close and well-publicised consultation with the UK financial services industry, the biggest user group within the EU of soft commissions and related practices. The FSA has now, after reviewing comments and considering numerous consultancy studies, put forward new rules tailored to address the specific issues identified as potentially problematic under its current soft commissions regime. Inasmuch as CESR stated in its Explanatory text that it should reserve its detailed advice for more mature market developments, we would ask that CESR, at a minimum, await the final outcome of this and other consultations.

Moreover, paragraph 11 in Box 6 suggests that an investment firm must inform each and every client of "the relevant details of such inducements". UBS-IB believes that provision to each potential new client of policy on inducements, updated as and when necessary, is sufficient to inform and disclose on this activity. Providing more detailed information on an annual basis to individual clients would be extremely costly and burdensome, if it could be effected at all. Similar to the recordation of potential conflicts of interest, we believe this exercise elevates form over substance, especially as such information is available and retrievable through other means. We would also point out that those clients with whom UBS-IB has soft commission and similar arrangements are required to maintain their own very detailed records of the nature and type of these modified fee arrangements. These institutional clients, who are acting in a fiduciary capacity for the underlying investors, must under the new FSA rules provide their own clients with annual statements apprising them of management fees, soft commissions and similar arrangements, costs and profits. Hence, to require UBS-IB likewise to supply its institutional clients with detailed statements on soft commissions and similar fee arrangements would be duplicative and serve no useful purpose.

Finally, we would suggest that CESR narrow its definitional scope of inducements to include only those arrangements that give rise to a conflict of interest or to unfair treatment of clients.

> "*inducements*" means any monies, goods or services (other than the normal commissions and fees for the service) received or paid by an investment firm or

> any of its relevant persons in relation to business for a client that gives rise to a conflict with its duty to clients or to unfair treatment of them.

In conclusion, we believe the effects, and not the fee arrangements themselves, should be the sole focus of this section.

<u>Outsourcing</u>

Outsourcing is a very topical issue, and has been the subject of no less than three consultation papers issued by four international regulatory bodies within a five-month time span. Specifically, the Commission on European Banking Supervisors (CEBS), the International Organisation of Securities Commissions (IOSCO) and the Joint Forum (consisting of the Basel Committee on Banking Supervision, IOSCO and the International Association of Insurance Supervisors), have each addressed outsourcing in varying levels of detail. That international regulatory standards should be consistent in respect of this activity is self-evident, given the migration of such standards to national regulatory regimes. Our concerns stem from this lack of consistency not only in approach, but also in the fundamental conception of outsourcing.

1. Definition of outsourcing

The threshold question turns on how to define the activity of outsourcing. While CESR states in the Explanatory text that its draft text has taken into account the Consultation Paper on High Level Principles on Outsourcing (April 2004) published by the CEBS, it has crafted a definition set forth in Box 3 even broader than that of CEBS, namely:

> Outsourcing means all forms of relying on third parties in relation to operational functions through an arrangement which involves an investment firm making use of a process or a service from an outside service provider that could otherwise be undertaken by the investment firm itself.

As a conceptual matter, this rule has no obvious endpoint. UBS-IB believes the focus should be on core or material activities, a concept that CESR introduces in paragraph 2. In paragraph 3 of Box 3, CESR provided specific examples of outsourcing arrangements included in the scope of application, such as information technology and information system management and maintenance. The extent to which intra-group outsourcing is covered by the definition is addressed, somewhat ambiguously, in paragraph 4. Finally, in paragraph 5, outsourcing arrangements specifically excluded from the definition, including non-material functions and the purchase of standardised services, are enumerated.

UBS-IB can appreciate that CESR has chosen to draft a definition of outsourcing which purposely defines the activity as broadly as possibly for maximum flexibility in this evolving regulatory area and then successively narrows it through a series of exclusions and tests. However, we would suggest that this drafting technique is cumbersome and confusing, given the five paragraphs that trail the initial definitional statement. Moreover, stylistically it is out of step with those definitions produced by the international regulatory bodies referred to above.

Hence, UBS-IB proposes a more tailored definition such as the following:

> Outsourcing means an arrangement between a regulated entity and a third party under which the third party undertakes to provide services that are significant to the regulated business activities of the regulated entity and such services are

> provided on an independent and ongoing basis. A service is deemed to be significant if it can have a material impact on the identification, limitation and monitoring of market, credit, settlement, default and liquidity risks as well as operational and legal risks.

We believe such a definition articulates a more standardised view of outsourcing that include the salient points of materiality, while at the same time allowing for regulatory interpretation.

2. Intra-group and extra-group outsourcing

UBS-IB is of the opinion that the CESR Advice does not adequately distinguish between intra-group and extra-group outsourcing arrangements. Paragraph 4 of Box 3 includes intra-group outsourcing arrangements within the scope of application if the materiality test of paragraph 2 is otherwise met. This stance is somewhat ameliorated by the second sentence, which states that:

> ...where the investment firm and the service provider are members of a group that is subject to supervision on a consolidated basis, the extent of application of the obligations of the investment firm as referred to in paragraph 9 shall take this situation into account accordingly.

UBS-IB, both as investment firm and as service provider, and in relation to other service providers within the UBS Group, are subject to supervision by the Swiss Federal Banking Commission on a consolidated basis. Accordingly, we support the weight given by CESR to this supervisory arrangement. However, the open-ended language in the above paragraph 4 makes it unclear whether UBS-IB intra-group outsourcing arrangements will be subject to the extremely detailed requirements of paragraph 9. UBS-IB recognises that many of these requirements simply reflect best practice. On the other hand, other requirements are of questionable value within the context of intra-group outsourcing.

For example, clause (d) of paragraph 9 requires a written agreement, in addition to a service level agreement, which must include (among other things), choice of law, designation of an applicable code of conduct, remedies and termination rights. UBS-IB suggests that, while these provisions are of obvious value in an arm's-length transaction, they are of considerably less value within a group structure. Intra-group outsourcings can perform multiple functions from realizing cost efficiencies in the delivery of services to overall management and reduction of risk across the group as a whole. Applying the same level of procedural and legal requirements to intra group outsourcings as is applied to extra group outsourcings could effectively lead to an increased level of risk and cost to the group as a whole and to the local entity, with no real corresponding risk reduction to the local entity. Where a group is subject to consolidated supervision, there are other, less intrusive and costly means of accomplishing the goal of ensuring that the risks associated with outsourcing are taken into account, including any risk that a local regulator may not be able to discharge effectively its oversight responsibilities.

Thus, intra-group outsourcing does not warrant application of highly prescriptive provisions. As a general rule, UBS-IB believes that principles, and the regulations they engender, should be tailored to the risks inherent in the specified activity. We would therefore urge CESR to adopt a more proportional approach towards intra-group outsourcing by permitting more flexibility.

UBS-IB believes that the CESR Advice, by failing to consider adequately the nature of intra-group outsourcing arrangements, is both overbroad and unduly burdensome. In most cases, a formal contract is neither necessary nor appropriate. Consequently, regulated entities should be permitted the flexibility to determine the approach that most suits the individual circumstances of any intra-group outsourcing arrangement. In particular, CESR does not consider alternative controls to a formal written contract between group entities, such as whether the outsourcing service provider retains a recognised auditor, or its willingness to disclose audit information, or whether it is located in a country where there is applicable legislation on outsourcing.

3. Outsourcing of investment services and activities to non-EEA countries

UBS-IB appreciates the distinction CESR draws between outsourcing of investment services and activities and operations functions in paragraph 1 in Box 1. Even so, UBS-IB believes the current text of the CESR Standard 127 is far too restrictive. Specifically, an EU investment firm may delegate these functions to a non-EEA investment firm authorised in its home country only if an "appropriate formal arrangement" exists between regulators facilitating the exchange of material information on cross-border delegations and on the outsourcing service provider.

It is important for CESR and other regulators to remember that outsourcing is by no means a new phenomenon. Hence, far from starting with a *tabula rasa*, regulatory bodies now consulting on this activity are advantaged by being able to draw upon the customary practices, accumulated experiences and overall risk control records of investment firms operating both within and outside of, the EEA.

As a result, UBS-IB believes these "front-office" outsourcings, which under paragraph 9(a) sweep in intra-group outsourcing arrangements, should be accorded more flexibility given that many investment firms already have established arrangements in place with non-EEA countries spanning several years. Under the rule of proportionality, CESR must demonstrate a correspondingly high level of risk to recommend such a prohibition, bearing in mind that regulatory authorities are, in effect, substituting their commercial judgement for that of the investment firms they regulate.

Finally, any investment firm cannot, and clearly should not, be permitted to escape its regulatory obligations using outsourcing as a subterfuge. CESR Standard 127 was published in April 2002, in which CESR expressed its concern that an investment firm could delegate its functions to such an extent that it became a "letter box entity." Since that date, regulatory understanding and appreciation of, outsourcing as an important cost-management tool, has increased immeasurably.

Consequently, we would elect, in accordance with the options set forth in Question 1.3 of Box 1, that paragraph (b) be deleted and that reliance for compliance with regulatory obligations be placed squarely on the "status and responsibilities of the outsourcing investment firm". In this way, both regulators and investments firms are permitted to work symbiotically towards workable, commercially viable rules that take full account of the principles of safety and soundness.

<u>Telephone tape-recording</u>

In the CESR Advice to the European Commission, CESR proposes to “keep records of telephone orders on a voice recording system for a period of at least one year”. As a threshold matter, we note that the Level 1 text of the Directive 2004/39/EC on Markets in Financial Instrument (MIFID) makes no mention of tape recording of telephone trade orders. Instead, this proposed requirement materialises in the indicative elements of the provisional mandate of the EU Commission delivered to CESR. In this provisional mandate, CESR is asked to consider the procedures and arrangements for the recording of telephone conversations.

By introducing a requirement to record telephone orders on a voice record system, we would like CESR to consider the:

- **negative commercial and competitive impact.** CESR should consider the effect of this requirement on the international competitiveness of the EU market. The mandatory taping of telephone orders is not a regulatory requirement in the global financial centres of the UK, the USA, Japan or Hong Kong;
- **increased pressure on resources.** This will have a bottom-line cost impact for the financial services industry, requiring investment firms to spend substantial money and time on implementing measures;
- **lack of clear benefits.** In the experience of UBS-IB, telephone recording of trade orders has provided only limited benefit in clarifying client orders. The details of client orders are being recorded in other forms of documentation such as deal tickets and order confirmations as a matter of course. Accordingly, CESR is asked to elucidate what significant added benefits are being envisaged;
- **excessive retention period.** UBS-IB would like to underline that the settlement of client orders typically occurs within a matter of a few days. In addition, local regulators and other competent national authorities ought to take the measures required to ensure that they discharge their investigatory obligations as speedily as possible in the interest of the good administration of justice; and
- **uncertain origin of requirement.** UBS-IB would like to query the extent to which this requirement is reflective of the original intent of the MIFID.

1. Commercial and competitive impact

As stated above, the mandatory taping of telephone orders is not a regulatory requirement in the UK, the USA, Japan, Hong Kong, as well as Switzerland, Italy, Russia, Israel and Cyprus, among other jurisdictions. UBS-IB recognises that this requirement is an accepted practice in some Member States within the EU and, as such, has some currency as a means of trade dispute resolution and regulatory recordkeeping. However, we believe that wholesale imposition of taping of telephone orders across the EU, despite the well-considered approaches by other competent authorities, is out of step with predominant international regulatory practice.

For investment firms competing in a global market where margins are being squeezed and the costs of regulatory compliance are rising, any cost affecting the bottom line that does not provide a material benefit, cannot be justified on the basis of a "nice to have."

2. Costs

To assist CESR in assessing the full financial impact of its telephone taping proposals, UBS-IB has outlined below the projected absolute costs of compliance. UBS-IB would need to install a "best of breed" voice recording system containing the necessary functionality to cope with the volume created by a global investment bank that has a large proportion of its business in Europe. The estimated costs below are based on approximately 5,500 channels being taped (approximately 840 trading positions) in offices based in London, Amsterdam, Milan, Frankfurt, Stockholm, Madrid and Paris and include internal hardware and server costs. The proposed system has the following features: online system, centralised storage, targeted deletions functionality, extensive search criteria, fast search/find/playback features, the potential to integrate with other systems.

One year basis

| | EUR |
|---|---|
| Total Purchase costs (includes internal hardware and server costs) | 1,891,651 |
| Average maintenance cost per annum | 572,906 |
| Estimated cost of storage per annum (estimated against EUR 8 per month per channel) | 528,000 |
| 1 year cost of ownership including maintenance and storage | **2,992,557** |

Five year basis

| | EUR |
|---|---|
| Total Purchase costs (includes internal hardware and server costs) | 1,891,651 |
| 5 Year maintenance costs | 2,864,530 |
| Estimated 5 year cost of storage | 2,640,000 |
| 5 year cost of ownership including maintenance and storage | **7,396,181** |

This proposal should not be undertaken lightly, given that investment firms such as UBS-IB will approximate a spend of EUR 7.3 million over a five year period even before other MIFID costs have been calculated. The financial services industry is facing a barrage of cost implications in other areas of financial services regulation over the next five years *e.g.*, International Financial Reporting Systems, anti-money laundering legislation, Capital Adequacy Directive III, to name a few. This is in addition to compliance costs stemming from other Financial Services Action Plan legislation due to be implemented in the medium- to near-term. Hence, UBS-IB asks CESR to proceed with caution and to take a measured and practical approach to telephone tape recording of trade orders. Specifically, CESR should clearly demonstrate the countervailing benefits relative to costs before taking this proposal forward.

In addition to the above, UBS-IB would also be subjected to extensive administrative costs in issuing new terms of business with clients to comply with any privacy and data protection issues.

3. Benefits

CESR should be aware that many investment firms such as UBS-IB have, up until recently, tape-recorded telephone orders on their own initiative. Consequently, there is no need for either the EU Commission, competent authorities or investment firms to speculate on the value-added either to regulatory inquiries or trade dispute resolution by this measure. UBS-IB has taken the decision to cease tape recording its telephone orders, as the benefits have not been readily apparent and, in any event, have not justified the costs.

UBS-IB submits that there are other means by which an investment firm can demonstrate that it has not acted in breach of the conduct of business rules and "to ascertain that the investment firm has complied with all obligations with respect to clients or potential clients". For example,
the U.S. Securities and Exchange Commission (SEC) in conducting its regulatory inquiries will look to e-mail and real-time electronic interfaces (*e.g.*, "Chat"), both of which media have long retention requirements, to determine how an investment firm is conducting its business.

With respect to trade disputes, the SEC, the Financial Services Authority and other European regulators allow investment firms discretion in identifying the most effective means of resolution and do not mandate telephone tape recording of orders. For example, paperwork accompanying a telephone order, such as deal tickets, traders' notebooks, confirmations and other standard trade documentation relating to placement of orders, execution and settlement, provide a comprehensive record of the agreed terms. In all major markets, parties have a limited amount of time to review and dispute any terms before settlement of the trade. Investment firms, particularly in today's highly competitive marketplace, have an obvious incentive to resolve any disputes with their clients quickly. A survey of market practice evidences that the majority of trade disputes are resolved within the normal timeframe for clearing and settlement.

On the other hand, investment firms may choose to record telephone orders on their own-initiative depending upon the market. For example, the credit derivatives market has an unusually long settlement period, which may take up to 6 months. Both the complexity of the product, the highly negotiated terms, and the length of the settlement period have, for UBS-IB, justified the recordation of credit derivative trade orders.

Finally, telephone taping of trade orders is not itself a panacea in trade disputes. While they can be useful, such tapes are far from dispositive in resolving disputes and, in the experience of UBS-IB, the overall benefits of telephone recording weighed against its costs makes this particular tool of limited value when compared with other forms of documentation and dispute resolution.

4. One year retention period

UBS-IB's opposition to a requirement that telephone orders be recorded is set out above. However, if despite UBS-IB's arguments CESR decides to retain its proposals making the recording of telephone conversations mandatory, UBS-IB would urge that careful consideration be given as to the period for which such recordings must be retained. At present, the CESR proposal is for a period "of at least one year". No justification is given for this requirement that seems unreasonably long, unjustified by the use to which such tapes would be put and out of line with general market practice. Given that the objectives of Article 13(6) are that records should be kept "...which shall be *sufficient* [emphasis added] to enable the competent authority to monitor compliance with the requirements under this Directive, and in particular to ascertain that the investment firm has complied with all obligations with respect to clients or potential clients". We submit that a reasonable and sufficient period of retention would be three months. The following considerations support a shorter three-month period of retention:

- settlement of client orders normally take place within a matter of a few days (three days in London) so that the vast majority of complaints and/or disputes will arise well within three months of the date of the telephone conversations in which the orders in question were discussed. Once a complaint has been lodged or a dispute has arisen, the normal rules governing the preservation of evidence in the form of tape recordings will apply.

- local regulators and other competent national authorities ought to take the measures required to ensure that they discharge their investigatory obligations as speedily as possible in the interest of the good administration of justice. It seems fair and reasonable that these investigations should be started within three months of the execution of client orders while evidence is still fresh. Expeditious action by the competent authorities supports legal certainty in the markets and promotes the credibility of investigations. Of course, once an investigation has been started national authorities have (or should have) the power to ask for the indefinite retention of specified existing telephone recordings.

Finally, the Euronext membership rules currently require that all calls by salespersons and traders dealing on Euronext be taped and retained for a period of six months. Hence, UBS-IB and other Euronext members already tape and retain telephone conversations of their respective equity sales team and equity traders dealing on Euronext for that period. As a result, the costs of a telephone recording retention requirement of 6 months or less would be far less significant for market participants placing telephone orders on Euronext than would a longer retention period. If CESR is intent upon a lengthy retention period, it may want to consider adoption of a six-month rule, consistent with Euronext.

It should be noted, however, that the absolute costs of compliance with this proposed requirement set forth above will still apply to all telephone lines being used for fixed income, research, OTC trades and, depending on scope primary market offerings as well as to the telephone lines of all equity traders who are dealing on exchanges that do not require the taping of trade orders. If the scope of the requirement is indeed this wide, it will make the EU telephone taping of trade orders the most comprehensive and wide-ranging of any financial services market in the world and introduce telephone taping to areas where it has not previously been deemed necessary, even by those regulators requiring taping of orders.

5. Origin of requirement

Each new requirement must be framed within the legislative text from which it arises. Specifically, Article 13.6 of the Level 1 text of the MIFID states:

An investment firm shall arrange for records to be kept of all services and transactions undertaken by it which shall be sufficient to enable the competent authority to monitor compliance with the requirements under this Directive, and in particular to ascertain that the investment firm has complied with all obligations with respect to clients or potential clients.

It is only in the Technical Annex to the EU Commission's mandate to CESR that the instruction arose for CESR to "cover the procedures and arrangements for the keeping of the records and those related specifically to the recording of phone conversations."

The leap from record keeping in the Level 1 text of the MIFID to the recording of telephone conversations in the first set of mandates (First Mandates) to CESR is greater than the Level 1 text itself allows. We again point out that there is no clear European or international consensus that would justify such an interpretive leap, given that a significant number of Member States and regulators of global financial services markets do not require recording of telephone conversations.

UBS-IB believes the integrity of the EU financial services legislation, as effected through the Lamfalussy process, must be observed. Deviations from the Level 1 text of the MIFID through either infelicitous interpretations of such text by the EU Commission or ill-considered proposals by CESR exceeding the First Mandates, promote neither legal certainty nor clarity. The EU Commission gloss on the Level 1 text of MIFID will likely have the effect of law, as CESR has accepted this request in the indicative elements of the mandate without comment.

In conclusion, CESR has recognised that this is a difficult issue to deal with "as the cost to practitioners in the financial markets of installing and operating a recording system should not outweigh the benefits of recording data in this way" (Consultation Paper dated June 2004). UBS-IB is of the opinion that the benefits of recording data in this way have not, as yet, been clearly demonstrated to justify the costs involved in installing and operating a recording system for telephone orders, especially given other financial priorities facing investment firms. We would ask CESR to consider carefully the incremental value of this requirement as against alternative means for obtaining the same information, particularly in view of its cost impact and the marketplace in which investment firms now operate.

We trust you find this feedback useful.