Z E N T R A L E R K R E D I T A U S S C H U S S

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Comments of the *Zentraler Kreditausschuss*[1] on CESR's Consultation Paper Draft Technical Advice on Possible Implementing Measures of the Directive 2004/39/EC on Markets in Financial Instruments

2nd Set of Mandates

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[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 2,300 banks.

I. General remarks

- Appropriate degree of detail

We consider the recommendations for technical implementing measures in CESR's 21 October 2004 consultation paper a marked improvement on the previous consultation documents with Level 2 advice on the MiFID. In particular, we believe CESR has succeeded for the first time in avoiding an excessive level of detail. This is welcome for two reasons.

First, it allows investment firms to retain the scope they need to provide investment services and ancillary services. This will promote competition and benefit both investors and the internal market in financial services as a whole. Second, it makes it easier to take account of established legal and market structures in member states.

We explicitly call on CESR to continue to pursue the approach it has adopted in this consultation paper.

- Need for transitional arrangements

We would like to reiterate our view that implementation of all Level 1 and Level 2 measures by 30 April 2006 is a highly ambitious goal. Considerable adjustment to existing organisational and IT structures will be necessary. Transitional arrangements are consequently a key issue for us. We therefore warmly welcome the fact that the Commission is considering providing for a transitional phase until 2007.

II. Comments on specific recommendations

1. Definition of "investment advice" (Article 4(1) No. 4); page 8 ff.

a) Assessment

The recommendations on the definition of *investment advice* are generally practicable. It is welcome that CESR has taken account of the fact that *investment advice* is already defined quite precisely at Level 1 and, in line with the Commission's mandate, confines itself to defining what constitutes a *personal recommendation*.

Nevertheless, we would suggest indicating in Box 1, no. 1, that the definition is based on the point of view of a reasonable observer. This would be in line with the explanatory text (cf. page 10: "from the position of a reasonable observer"). No. 1 should therefore be amended as follows:

> "1. *"Personal recommendation"* means … that is held out, either explicitly or implicitly, to the reasonable recipient as being suited to, or based on a consideration of, his personal circumstances."

b) Replies to the questions

Question 1.1.: *Do you agree that advice on services, such as recommendations to use a particular broker, fund manager or custodian, should not be covered?*

Reply: Yes. CESR points out that no member state has regulated this kind of advice to date. This makes it clear that no such regulation has been deemed necessary up to now and, in our view, nothing has occurred to make it necessary at this stage. CESR is also correct to state that such regulation would not be covered by Level 1. Article 4(1) No.4 focuses exclusively on advice on financial instruments and Article 19(4) on investment services within the meaning of the MiFID.

Question 1.2.: *Do you agree with the approach that a personal recommendation has to be held out as being suited to, or based on a consideration of, the client's personal situation or do you consider this criterion to be unnecessary or ambiguous and would like to refer to the bilateral nature of the relationships and bilateral contracts between the firm and its clients? In the latter case which criteria would you use to differentiate between a "personal recommendation" and a "general recommendation" or a "marketing communication"?*

Reply: We agree with the approach that a personal recommendation should be based on a consideration of the investor's personal situation. This is the only approach, in our view, that will allow investment advice to be defined with any degree of legal certainty. If this criterion were dispensed with, the term "investment advice" would be all-embracing. It would cover every communication containing some sort of reference to a financial instrument. The term would become totally unmanageable.

Furthermore, there is no objective justification for such a wide definition. The investor does not require protection every time he receives some kind of communication. A need for protection exists only if the communication could give the impression that it contains a recommendation

specifically geared to the investor's personal situation. This gives the recommendation more clout in the eyes of the investor; this is what makes it a "**personal**" recommendation.

This is also the view taken in Article 19(4). It requires investment advice to be based on a certain level of knowledge about the client's circumstances. If, however, a recommendation – in contrast to other types of communication – assumes certain knowledge about the client, it follows that the recommendation will be influenced by this knowledge.

Question 1.3.: *Do you think it is reasonable to restrict "investment advice" to recommendations of specific financial instruments or is it necessary to cover generic information including financial planning and asset allocation services for financial instruments?*

Reply: We believe it is right to restrict "investment advice" to recommendations of specific financial instruments. Only in the case of a specific recommendation does the client make a decision, based on the investment firm's assessment, which has direct economic consequences. It is these direct consequences of a recommendation that make specific regulation necessary. General recommendations, such as those given on financial planning, lack this direct effect and thus need no specific regulation. Only this restrictive interpretation, moreover, would be covered by Article 4(4) No. 4 and Article 19(4) – the latter being confined to investment services within the meaning of the MiFID.

2. List of financial instruments (Article 4 – Annex I Section C); page 17 ff.

No comments.

3. General obligation to act fairly, honestly and professionally and in accordance with the best interest of the client (Article 19(1)); page 38 ff.

a) Assessment

We agree with the proposed recommendations on an investment firm's general conduct of business obligations in portfolio management.

b) Reply to the question

Question 3.1.: *Do you agree with the proposals on portfolio management? Should any other issues be addressed under Article 19(1)?*

Reply: Yes, we agree with the proposals on an investment firm's general conduct of business obligations in portfolio management. Furthermore, we see no need for further recommendations regarding Article 19(1).

4. Suitability test (Article 19(4)); page 40 ff.

a) Assessment

Most of the proposed recommendations on the suitability test seem practicable. We see a danger of two recommendations giving rise to unnecessary red tape, however.

aa) No. 5 (Box 8)

This recommendation is unlikely to be practicable in its present form. Furthermore, it exceeds the scope of the rule established at Level 1.

- *Distinction between advice provided on a continual and on an occasional basis*

It would be extremely difficult in practice to determine where to draw the line between advice provided on a *continuing basis* and that given on an *occasional basis*. What is more, it is not even necessary to make such a distinction because the firm providing the advice has to make sure anyway that it is geared to the investor's individual situation. Differentiation based on how often the investor makes use of advisory services is superfluous.

In addition, we see no legal basis for the review of the client profile called for in the first paragraph of No. 5. Under Article 19(4), the client has to make the information required for the suitability test available to the investment firm. Furthermore, the envisaged recommendation is at odds with the recommendation in No. 4 stating that the investment firm should generally be entitled to rely on the information provided by the client, and even with the view in paragraphs 2 and 3 of No. 5 that retail clients are in principle, and professional clients solely, responsible for advising the investment firm of major changes.

The first paragraph of No. 5 should therefore be deleted ("Where an investment firm provides investment advice, or acts as a portfolio manager, … it must undertake a review of the client profile whenever the retail client seeks advice.").

ab) No. 8 (Box 8)

The envisaged obligation under sentences 2 and 3 of No. 8 to take account of previous transactions is the correct approach when providing advice. Nevertheless, it must be made clear that this does not mean the investment firm has to monitor the client's portfolio continuously and actively. We firmly reject the view taken by CESR on page 42 ("*It [the investment firm] should therefore take reasonable steps to review the suitability of the client's portfolio in addition to conducting[…] This sort of arrangement is not confined to portfolio managers.")*. It is a distinguishing feature of portfolio management that the portfolio is under continuous review. The client is charged a corresponding fee for this service. Requiring the same level of analysis for transaction-related advisory services would erase the dividing line between normal investment services and portfolio management. We do not believe this is what CESR wants. No. 8 in Box 8 must therefore make clear that no such consequence is intended.

b) Reply to the question

Question 4.1.: *Do market participants think that adequate investment advice or portfolio management service is still possible on the basis of the assumption that the client has no knowledge and experience, the assets provided by the client are his only liquid assets and/or the financial instruments envisaged have the lowest level risk if the client is not able to or refuses to provide any information either on his knowledge and experience, his financial situation or its investment objectives? Or would this assumption give a reasonable observer of the type of the client or potential client the impression that the recommendation is not suited to, or based on a consideration of his personal circumstances?*

Reply: There is no one-size-fits-all answer to this question; it will always depend on all the given circumstances in each individual case. Should the client have a regular income which is sufficient to cover his fixed costs, it will be possible to provide advice on the conditions outlined above. If, on the other hand, the liquid assets are also needed to (partially) cover his fixed costs, it would probably not be appropriate to give a recommendation even of the kind described. This example clearly illustrates that it is not possible to draw up a rule to cover every single eventuality. CESR should therefore confine itself to recommending general principles.

5. Appropriateness test (Article 19(5)); page 45 ff.

In principle, we consider the proposed recommendations on the *appropriateness test* to be practicable. We agree that it should be up to the investment firm to define parameters suitable for testing the appropriateness of products or services for a particular investor. CESR adopts a practical approach by mentioning examples of appropriate parameters and refraining from drawing up an exhaustive list. In any event, the decisive factor for a product or service to be deemed appropriate is that the client is able to make an autonomous decision about the investment based on his knowledge and experience. This also means it must be possible for the investor to become more sophisticated by expanding his knowledge, for example, and broadening his experience on this basis.

Article 19(5) cannot be held to mean that appropriateness must be assessed solely on the basis of the investor's existing knowledge and experience. If a client wishes, and receives the information prescribed under Article 19(3), the investment firm must continue to have a certain ("appropriate") leeway to agree, together with the client, on types of product which lie outside the scope of his knowledge and experience to date. Otherwise it would be impossible, or extremely bureaucratically cumbersome, for investors to broaden their horizons. In our view, however, the word "appropriate" in Article 19(5) provides this necessary leeway while offering effective protection against its possible misuse.

The wording of No. 7 in Box 9 should therefore be amended as follows:

> "7. For assessing the appropriateness of the service or product envisaged, the investment firm shall define, **in particular,** on the basis of the information obtained from the retail client **according to Art. 19 (5)**, appropriate investment parameters (e.g. types of instruments, types of transaction and types of orders ~~in which the retail client has sufficient knowledge of or experience~~)."

In addition, it is both appropriate and welcome that CESR does not consider it necessary to provide advice on the content of warnings. We are also of the opinion that the rule is sufficiently concrete at Level 1.

6. Execution only (Article 19(6)); page 48 ff.

a) Assessment of the practical importance of the rules

In view of the high level of detail in Article 19(6), the scope for Level 2 rules is rather limited. In particular, the total exclusion of all bonds with derivative elements could result in the rules having little practical significance. It will be virtually impossible, for instance, for an online broker to agree with a client that he is allowed to buy any kind of share admitted to trading on a regulated market, but not index certificates on a European or international standard index. It would make sense, however, for a definition of non-complex instruments to include instruments that are comparable for the client as regards the extent to which their functioning can be easily understood. This applies, for example to certificates which track shares, and therefore to index or discount certificates. Otherwise, online brokers would probably also have to comply with the requirements in Article 19(5) on a permanent basis and the rule would miss its objective.

Irrespective of this point, we welcome the fact that CESR once again – as in its comments on Article 19(5) – plainly acknowledges that Level 2 measures may sometimes be dispensed with. Implementing measures on related warnings, as requested in the mandate from the Commission, would only result in unnecessary red tape without delivering any practical benefit.

b) Replies to the questions

Question 5.1: *In determining criteria, should CESR pay more attention to the legal categorisation or the economic effect of the financial instrument?*

Reply: Both aspects are important in our view since both are mentioned in Article 19(6). Normally, however, a financial instrument's economic effect is likely to be the decisive factor.

The examples of non-complex instruments expressly mentioned in Article 19(6) sometimes focus on their legal nature ("bonds") and sometimes on the economic impact associated with an investment, such the link to liquidity ("shares admitted to trading on a regulated market").

Recommendation c) in Box 10 ("where information on: …") is totally incompatible with Article 19(6). It is the financial instrument's structure alone which is the determining factor, not whether information about the structure, let alone costs, is easily accessible. Point c) should therefore be deleted.

Question 5.2.: *Do you think that it is reasonable to assume that a service is not provided "at the initiative of the client" if undue influence by or on behalf of the investment firm impairs the client's or the potential client's freedom of choice or is likely to significantly limit the client's or potential client's ability to make an informed decision?*

Alternatively, do you think that the consideration of this overarching principle is not necessary because the use of undue influence could be subject to the general regulation under the UCPD and that CESR should base its advice more strictly on Recital 30 or refer to this Recital advising the Commission that it is not necessary to adopt Level 2 measures in this area?

Reply: We see no scope whatsoever for Level 2 measures. The issue of determining when a service is provided at the client's initiative is dealt with exhaustively in Recital 30.

7. Transactions executed with eligible counterparties (Article 24); page 53 ff.

- *Obligation to classify an entity as an eligible counterparty?*

In our view, an investment firm is under no obligation to treat an entity mentioned in Article 24(2) as an eligible counterparty. We assume that firms only need to make a distinction – unless the client has made a specific request – between *professional clients* and *retail clients*. CESR's views can therefore only refer to cases in which an investment firm has decided to introduce a special "eligible counterparty" client category. This should be made sufficiently clear in the recommendations.

- *Information about the classification*

We see no basis for the envisaged requirement to inform eligible counterparties of their status (cf. second and third paragraphs of "Opt-in regime" in Box 11). Article 24 envisages no such obligation, nor is it addressed in the Commission's mandate.

Against this background, the administrative burden involved in a mutual exchange of information with numerous investment firms, credit institutions, insurance companies, UCITSs, pension funds and other financial services institutions would be unjustifiable, especially given that these are all professional market participants, familiar with the rules of the MiFID, and thus aware of their status. We would also point out that there is no general obligation to inform clients about changes

in the law. This would create a precedent that would unnecessarily depart from existing, established practice and give rise to considerable costs.

Question 6.1: *Do market participants agree that the quantiative thresholds for undertakings to request treatment as eligible counterparties should be the same as the thresholds for professional clients? Please provide reasons for your position.*

Reply: We believe it would be advisable in the interests of clarity and easier administrative handling to use the same thresholds for professional clients and eligible counterparties.

SECTION III – MARKETS

8. Pre-trade transparency – systematic internalisers (Articles 4 and 27) Definition of systematic internaliser; page 61 ff.

We warmly welcome the fact that CESR has considered Recital 53 in its deliberations. This recital clarifies that pre-trade transparency for shares traded OTC should not apply to transactions executed on an OTC basis between counterparties and regarded by market participants as belonging to the wholesale market (often also known as telephone trading). Recital 53 makes it very clear that it is by no means the European legislators' intention to apply the complex pre-trade transparency rules set out in Article 27 to this highly specialised market.

However, CESR's reference to Recital 53 is confined to the explanatory text, where the wording of the recital is included in brackets only. This is not sufficient, in our view. We believe CESR should explicitly refer to Recital 53 in its actual recommendations on definition and differentiation regarding systematic internalisation. Box 14 should therefore be amended accordingly.