EFFAS THE EUROPEAN FEDERATION OF FINANCIAL ANALYSTS SOCIETIES

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via Email

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Comments on CESR's MiFiD 1st consultation paper for the 2nd Set of Mandates (CESR /04-562)

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 in the areas of Equity and Bond Research, Asset and Portfolio management, Investment Advice.

In the following, we comment on those issues and questions which we consider relevant for our membership.

Response to Question 1.1

EFFAS agrees that advice on services such as recommendation to use a particular broker, fund manager or custodian, should not be covered by the definition.

Response to Question 1.2

It is recommended not to define in an abstract manner the personal recommendation on the basis of the client's personal situation. Rather, the general recommendation should be defined on the basis of the number and category of recipients and means of communication leaving the remainder to a case by case approach whether the communication amounts to investment advice.

The approach to fit a statement under the term "investment advice" must start with the addressee of the statement. If the statement or recommendation, in the words of Considerant 30, is addressed to the "general public or to all or a large group or category of

clients", it is a general recommendation. Depending on its content and reasoning, it may be a simple offer, a marketing communication or a financial analysis or research report. Due to the number and generality of addressees, it is not "investment advice".

EFFAS proposes to define in an abstract manner, based on the nature and number of addressees of statements, the activities which are not considered investment advice. Thus, the level two legislation should create a safe harbour for those activities which in a common understanding or, at least, by the large majority are not considered „personalised".

The safe harbour is particularly necessary for all financial analysts and research firms and for journalists in the fields of investment which do not intend to venture into the future core service of investment advice and wish to restrict themselves to the ancillary activity of financial analysis and research and other general information.

Response to Question 1.3

EFFAS suggests not to restrict the category of investment advice under MiFiD to specific transactions in financial instruments and to leave out generic information including financial planning and asset allocation services.

In our opinion the definition of investment advice should also cover financial planning and asset allocation since they could generate decisions as relevant or more than a specific recommendation to buy or sell a certain financial instrument. Moreover the implementation of recommendations related to financial planning or asset allocation always implies one or more than one transactions.

Response to Question 3.1

EFFAS agrees with those proposals.

Response to Question 4.1

Investment advice or portfolio management can be reasonably considered if at least information on either the financial situation or the investment objectives are given by the potential client corresponding to CESR's approach in Box 8 No. 2. The lack of information on knowledge and experience can be compensated by active information to the client. Should the client, however, refuse all information whatsoever, it is not reasonable to make potentially inconsistent assumptions and to venture into a service where MiFiD does not permit any compensation by standardised or individual warnings.

CESR's discussion of the requirement that the investment adviser or portfolio manager obtain the necessary information centres on the relation of the information on the client's knowledge and experience to the type of instruments offered, e.g. if the client is only interested in shares, no information on client's experience and knowledge in derivatives must be obtained. It seems that this discussion restricts the dimension and, thus, the purpose and the meaning of the word "necessary". Starting point of any discussion is the fact, that many of the clients of an investment adviser and/or portfolio manager have no knowledge and/or experience in investing in financial instruments. This is the reason that

they want to engage an investment adviser or portfolio manager. Only a minority of the retail clients will engage an adviser or manager despite the fact that they have the experience and knowledge to invest themselves but do not have the time or inclination to do so. The information to be obtained from the client on knowledge and experience determines the extent to which the adviser or portfolio manager must inform in turn the client on the risks and repercussions of the advice or management on client's financial situation. It certainly does not require to bring the client up to the knowledge and experience standard of the adviser or manager or of a professional client. Art. 19 (4) must be read in conjunction with Art. 19 (3) which provides for the information which the investment firm has to give to the client or potential client. Therefore, it must be distinguished between the three categories of information to be obtained from the client. In the category "knowledge and experience" any failure of the client or potential client to give information to the adviser or manager can be compensated by the necessary information on the structure and the risk involved in the advice or management. It would not preclude meaningful advice or management as long as the client provides information on the financial situation and the investment objectives. The lack of information in either of the two latter two categories might be compensated by the result of the information in the remaining category.

Example: If an investor refuses to give information on his investment objectives but provides sufficient information on his financial situation which shows that the investor is abundant in liquid assets and only a small portion thereof is entrusted to the adviser or manager, one can allow that the advisor or manager venture in riskier investments with a higher return expectation (Box 8 2 a ii). An investor indicating as investment objective capital maintenance accepting low returns with a long term outlook (conservative investment) might be reasonably served even though this investor refuses to disclose his/her financial situation. If, however, no information is given for either category, no service can reasonably be provided to such non professional client because the financial situation and management objectives are interdependent and the most protective assumption in one category does not necessarily go hand in hand with the assumed most protective assumption in another category. The lowest level of risk is not necessarily consistent with an assumable objective that higher returns are needed on a short term basis to meet certain obligations. Incomplete information should be supplemented by assumptions which are consistent with the available information and provide protection in the best interest of the client.

Art. 19 (4) does not allow to compensate the lack of information on the financial situation and management objectives by standardised warnings as it is possible under Art .19 (5). The service firms are forced either to switch the client to a service covered by Art. 19 (5) or to refuse the service. The retail clients are incapacitated by MiFiD to decide on the information they wish to give or withhold. This might have the unfortunate effect that potential clients provide inaccurate information in order to obtain the service otherwise refused.

Response to Question 5.1

In determining the criteria for distinguishing complex and non-complex instruments, CESR should pay attention to the (risk) structure of the instrument, not to the legal categorisation. In particular, attention should be paid to the so-called engineering of financial products which combines through aggregation or alternation simple instruments into complex and, therefore, non-transparent structures. The restriction of "non-derivative" in Box 10 should be eliminated.

CESR considers all derivatives as complex instruments. This interpretation seems to be derived not from an economic analysis of the derivatives vs. cash instruments, but rather from an interpretation of Art. 19 (6) which treats a securitised debt that embeds a derivative as a complex instrument. The conclusion of CESR seems to be that the wording and the purpose of this paragraph force an interpretation to treat all derivatives as complex. EFFAS thinks that this conclusion is not mandatory. Derivatives like long futures are not more complex than spot investments. Margined instruments are not more complex than partially or totally credit financed spot investments. On the other hand, the wording of "securitised debt embedding a derivative", in our opinion, points into another direction. Securitised debt embedding a derivative is a combination instrument, to wit in reality the instrument incorporates several elements which each in itself could and mostly do exist as separate instruments (e.g. fixed income instrument and equity options). The complexity lies not in the individual element of a derivative, but in the combination of several elements which make it difficult for an inexperienced or non-professional investor to assess all financial ramifications in this combination. Especially the so-called engineered financial products with an aggregate or alternative combination of elements which require a fine-tuned decision-making are the concern under Art. 19 (6) excluding execution only services. It is a (probably correct) statutory assumption that these products are usually so complex in their structure that the retail-client should not be left alone, but rather be tied into an advisory service obtaining and giving all pertinent information, explanations and warnings.

Response to Question 5.2

The consideration of the principle to ban "undue influence" is not an issue for determining the side of the initiative, but should be left to the general regulation under UCPD. Influence whether undue or due on the decision-making of the client will prevent the service of execution only at the outset or at a later stage.

The discussion on "undue influence" is difficult to understand. Since the advice in Box 10 stipulates that a service is not to be considered to be provided at the initiative of the client in response to a personalised communication which is intended "to influence" the client, one wonders why the qualification "undue" needs additional attention. Any communication, due or undue, influencing the client to enter into a specific transaction at the outset of the decision process is an initiative of the firm and not of the client, thus precluding execution only services.

"Undue influence" at a later stage of the process, does not pose the question as to whether execution only service is permitted or at whose initiative the transaction was entered, but rather leads to the conclusion that the firm has left the path of execution only service and entered into an advisory position with all the legal consequences for not meeting the corresponding obligations. Under this premise, Art. 19 (5) applies and the influence of the firm will be assessed as due or undue in light of the obligations under this provision.

Yours sincerely,

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Chairman of EFFAS