

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 Kreditausschuss¹
on the consultation paper
MiFID Review – Investor Protection and Intermediaries**

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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 Pfandbriefbanken (VdP), for the mortgage banks. Collectively, they represent more than 2300 banks.

Part 1: Requirements relating to the recording of telephone conversations and electronic communications

I. General remarks

Germany's banking industry strongly speaks out in favour of upholding the discretionary right embedded in Article 51 (4) of the MiFID Level 2 Directive. It should continue to be left to the individual Member States to decide on whether or not to provide for the mandatory recording of telephone conversations. The special circumstances and impacts of such obligation in each Member State ought, by necessity, to be considered in deciding on the continued appropriateness of discretion. In our view they clearly speak against the pursuit of a "one size fits all" approach for the entire EEA in this sphere.

In Germany no recording requirement is imposed on those dealing in financial instruments, except for deals among traders. The current practice has proven its worth.

In our opinion voice recordings are unsuited, or suited to a limited extent only, to achieve the targets mentioned by CESR. Under no circumstances would there be a reasonable relationship between the expenses associated with the introduction of a recording obligation for the banks in Germany and the benefits set out by CESR. First, abusive practices in connection with the placement of orders by telephone are unknown to us in Germany. Second, the costs resulting from the recording obligation would be enormous, especially in the light of the strongly fragmented nature of the German market (for more details, see annex "Voice recordings of telephone orders"). The introduction of binding rules would finally lead to a situation where - not least - smaller and/or decentralized operating banks would in future no longer be in a position to offer investment counselling services and order placements via telephone to clients across the whole area in which they operate. Client protection would thus be done a bad turn, as clients in Germany explicitly wish, and are used to, entering into deals in financial instruments via their local consultant by telephone.

Nor does the *Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin)*, Germany's competent authority for financial services, see any added value in mandatory voice recordings. The argument that this would help regulators to enforce conduct of business rules and rules to fight market abuse thus appears untenable, at least for the German market. In this context, we would, moreover, doubt that retail client orders have a market abuse potential of the type justifying such measures. The argument that voice recordings would make it easier to present evidence in disputes between investment firms and their clients is, in our view, no reason to

justify such invasive measures either. We feel that controversies over the correct execution of a client order – if being relevant at all – are of an extremely negligible relevance only. As evidenced by CESR's deliberations, this view is shared by a large number of other competent authorities. Thus none of the arguments put forward by CESR are suited to prove any additional value, let alone the necessity of mandatory voice recordings throughout the EEA. With reference to the benefits of a recording obligation the consultation paper explicitly states in sec. 58: "... the extent of the benefits that will be delivered is less clear".

We believe that the objectives pursued by CESR can, alternatively, be achieved by means other than voice recordings, too, as shown by the legal obligation to document conversations between clients and investment advisors, introduced in Germany on 1 January 2010. On that date the scope of Germany's Securities Trading Act was widened to include the requirement of documenting the content of client-advisor conversations in writing. A copy of the record must be handed over to the client immediately after the advice on investment has been given. If investment advice is given by telephone, the record must either be transmitted to the client before the transaction is effected or – in the event that the client insists on effecting the transaction prior to the receipt of the record – the client must be granted the right of rescission within one week of receipt of the record; provided that the record is inaccurate or incomplete. This example alone shows that voice recordings are no solution without an alternative. At the time Germany's legislator deliberately decided against making voice recordings an obligation, arguing that such obligation would incur non-negligible costs and that a technical recording would also be embarrassing for many clients. In our opinion, it is unnecessary to further limit the national legislators' discretionary scope in this area, ignoring their assessment based on the special circumstances and impacts of such an obligation in their territories.

We do not see any reason why a one-size-fits-all approach should be chosen for the entire EEA in areas where the competent authority and the legislator of a Member State is presently clearly opposed to a legal obligation with lasting effects. In view of this we request the continued application of the discretion embedded in Article 51 (4) of the MiFID Level 2 Directive.

II. Answers to the questions

1. Do you agree with CESR that the EEA should have a recording requirement? If not, please explain your reasoning.

Germany's banking industry rejects mandatory voice recordings throughout the EEA. In our view the discretionary right embedded in MiFID has proven its worth. We regard the arguments put forward by CESR as unconvincing. Neither is it possible to discern any added value in, nor any necessity of, imposing the requirements proposed by CESR on the EEA as a whole. This is especially true in the light of the substantial effects of such measures on Germany's banking industry. The costs of purchasing the recording equipment alone would roughly amount to € 632m; additional operational costs would roughly total € 332m (for more details see annex "Voice recordings of telephone orders?"). Mandatory requirements would finally lead to a situation where - not least - smaller and/or decentralized operating banks would in future no longer be in a position to offer investment counselling services and order placements via telephone to clients across the whole area in which they operate. This is in conflict with efforts to ensure better client protection and unnecessarily limits clients' options to communicate with their banks.

As mentioned above, Germany already requires telephone conversations between traders to be recorded. We have no objection to this requirement because the speed at which professional trading is carried out means a mechanism needs to be in place to clear up misunderstandings without delay.

It has also become standard practice to record telephone conversations handled by call centres. This has come about because, first, banks have an interest in preserving evidence of what was said and, second, clients consciously opt for this method of placing an order.

A general recording requirement is a totally different matter. Given the associated implementation and maintenance costs, the question arises as to proportionality. A requirement of this kind could only be judged proportionate in the absence of a milder, yet equally effective method of achieving the same regulatory objective. We believe that written records are a perfectly adequate means of documenting orders received at high street bank branches. In the event of disputes – and experience shows that these are extremely infrequent – the bank has to demonstrate that the order was executed in the manner requested by the client. Recordings of telephone conversations are therefore not needed to protect consumer interests. Nor are we convinced by

the unsubstantiated rationale that telephone recordings would be a step forward in terms of more effective market oversight.

It is also argued that recordings would help to detect and deter market abuse. We share this view when it comes to conversations with a trader or between traders. As already mentioned in our general remarks, we do not believe that significant instances of market abuse would be identified among orders placed at high street branches.

Finally, it should be borne in mind that some Member States have already introduced alternative mechanisms for protecting client interests, such as the described requirement to document conversations in writing and subsequently give the client a copy of this documentation. An additional requirement to make recordings of telephone conversations would double the regulatory burden in such countries.

All in all, we support a recording requirement for telephone conversations with trade desk staff but firmly reject the idea of recording calls to high street branches.

2. If the EEA is to have a recording requirement do you agree with CESR that it should be minimum harmonising? If not, please explain your reasoning.

No comment

3. Do you agree that a recording requirement should apply to conversations and communications which involve: the receipt of client orders; the transmission of orders to entities not subject to the MiFID recording requirement; the conclusion of a transaction when executing a client order; the conclusion of a transaction when dealing on own account?

As explained above, we believe it would be appropriate to differentiate between conversations with or between traders on the one hand and conversations between clients and high street branches on the other.

4. **If you do not believe that a recording requirement should apply to any of these categories of conversation/communication please explain your reasoning.**

Please see our reply to question 1.

5. **Do you agree that firms should be restricted to engaging in conversations and communication that fall to be recorded on equipment provided to employees by the firm?**

Restricting the recording requirement to conversations made on equipment provided by the firm would be acceptable in principle. It is open to question, however, whether a restriction of this kind would be sufficient to solve data protection and privacy issues.

6. **Do you agree that firms providing portfolio management services should be required to record their conversations/communications when passing orders to other entities for execution based on their decisions to deal for their clients? If not, please explain your reasoning.**

In cases of doubt, the burden of proof is weighted in favour of clients, be they retail or professional. If a portfolio manager as professional client communicates with the trading desk directly, we believe recordings of the conversation can help to swiftly clarify the situation in the event of a dispute.

However, recordings of trading desk conversation appear to be sufficient; duplication – also at the portfolio manager's end - makes no sense.

7. **Do you think that there should be an exemption from a recording requirement for: firms with fewer than 5 employees and/or which receive orders of a total of €10 million or under per year; and all orders received by investment firms with a value of €10,000 or under.**

Permitting certain exemptions from a requirement cannot, in our view, dispel fundamental concerns about the requirement as such.

- 8. Do you agree that records made under a recording requirement should be kept for at least 5 years. If not, please explain why and what retention period you think would be more appropriate.**

The proposal to apply the general MiFID retention requirement to telephone recordings may seem logical at first sight. Given the amount of recorded material involved, however, a retention period of this length would prove highly onerous. Since disputes concerning miscommunication and investigations into market abuse do not normally begin after a time lag of several years, the retention period should be much shorter. We would suggest requiring records to be kept for a period of 12 months.

- 9. Are there any elements of CESR's proposals which you believe require further clarification? If so, please specify which element requires further clarification and why.**

It is not clear how compatibility is to be established between a recording requirement and national rules and regulations. Data protection issues, for example, have yet to be addressed.

- 10. In your view, what are the benefits of a recording requirement?**

The supposed benefits of a recording requirement throughout the EEA, as described in the consultation paper, are, in our view, unconvincing. On this point we refer to our "General remarks".

Benefits that might justify such far-reaching consequences for Germany's banking industry are not recognisable for us. The associated costs would be out of all proportion to the benefits CESR assumes such a requirement would deliver.

- 11. In your view, what are the additional costs of the proposed minimum harmonising recording requirement (for fixed-line, mobile and electronic communications)? Please specify and where possible please provide quantitative estimates of one-off and ongoing costs²⁶.**

See annex "Voice recording of telephone orders?"

12. What impact does the length of the retention period have on costs? Please provide quantitative estimates where possible.

The length of the retention period would have an impact on the need for storage space, on administrative costs and on the cost of securing the data (making backups).

Part 2: Execution quality data (Art 44(5) of the MiFID Level 2 Directive)

I. General remarks

Valid information about the execution quality of trading venues is of great interest to the market participants, as it facilitates comparability, thus serving the purpose to achieve the best possible result for the client.

Germany's banks already now have the necessary information for choosing venues in accordance with their "best execution policy". At the same time, we fear that the extensive requirements to be met by the committed data providers may lead to higher prices for securities trading services, finally having an effect on the clients, too. So, the question arises whether the benefits for the market participants sought by the initiative are reasonably proportionate, compared to the potential disadvantages. As relevant cost estimates have not been made as yet, a weighing-up process seems hardly possible for the time being.

Should CESR opt for binding requirements for the data providers in its recommendation to the Commission, we feel that two aspects ought to be given special attention. First, it must be ensured that the factors "price" and "costs", which are of major importance to retail clients, are prominently considered, bearing in mind, too, that price quality is not the only crucial factor. Second, it must be ensured that the more stringent requirements on the data providers do not lead to additional burdens on the investment firms.

II. Answers to the questions

- 13. Do you agree that to enable firms to make effective decisions about venue selection it is necessary, as a minimum, to have available data about prices, costs, volumes, likelihood of execution and speed across all trading venues?**

It is true that the mentioned data are necessary for elaborating a best execution policy, but in the opinion of the market participants such data are already available in Germany.

14. How frequently do investment firms need data on execution quality: monthly, quarterly, annually?

Since there is no standard interval at which investment firms conduct their regular best execution policy review, it is impossible to provide a one-size-fits-all reply. Naturally, all firms are interested in having up-to-date information.

15. Do you believe that investment firms have adequate information on which to make decisions about venue selection for shares?

Yes. As CESR itself notes in para 91, firms currently experience no significant problems obtaining the information they require.

16. Do you believe investment firms have adequate information on which to make decisions about venue selection for classes of financial instruments other than shares?

Yes, we do. In the case of non-listed financial instruments such selection is anyhow usually only possible from a very limited number of venues.

17. Do you agree with CESR's proposal that execution venues should produce regular information on their performance against definitions of various aspects of execution quality in relation to shares? If not, then why not?

As mentioned above, firms already have sufficient information to be able to select venues whose performance corresponds to their best execution policy.

In this respect it is important to note that price quality is not the only crucial factor for developing the best execution policy. The introduction of standard execution quality data which are solely based on price quality aspects might, in the medium and long term, lead to a situation where the use of such data comes to be standard market practice, putting those banks which, in a perfectly legitimate manner, take guidance from other factors, such as execution speed and execution likelihood, under pressure to justify themselves.

- 18. Do you have any comments on the following specifics of CESR's proposal: imposing the obligation to produce reports on regulated markets, MTFs and systematic internalisers; restricting the coverage of the obligation to liquid shares; the execution quality metrics; the requirement to produce the reports on a quarterly basis?**

As mentioned above, the German credit institutions already have sufficient information to be able to select execution venues whose performance corresponds to their best execution policy. To the extent that a standardisation should nevertheless be effected, the proposals appear to be appropriate on points of substance. To ensure that the data are meaningful and comparable, it is important that they should all relate to the same period of time.

- 19. Do you have any information on the likely costs of an obligation on execution venues to provide regular information on execution quality relating to shares? Where possible please provide quantitative information on one-off and ongoing costs.**

We have no information on this point.

- 20. Do you agree with CESR that now is not the time to make a proposal for execution venues to produce data on execution quality for classes of financial instruments other than shares? If not, why not?**

We share CESR's view.

Part 3: MiFID complex vs non complex financial instruments for the purposes of the Directive's appropriateness requirements

21. Do you have any comments about CESR's analysis and proposals as set out in this Chapter?

Generally, we consider CESR's analysis and proposals as comprehensible. However the distinction between complex and non complex financial instruments is only of certain relevance; among other things due to strict requirements in the civil law which superpose the regulatory law. As regards the treatment of UCITS, the outer form should in our view be the exclusive criterion; looking through to the underlying investments would lead to uncertainties concerning the treatment of the products.

22. Do you have any comments on the proposal from some members that ESMA should work towards the production of binding Level 3 material to distinguish which UCITS should be complex for the purpose of the appropriateness test?

The proposal that complexity, and thus the requirement of the appropriateness test, be assessed on the basis of investment strategies or certain techniques is, in our view, impracticable and unnecessary, too. Especially the greater transparency offered by KID should suffice to correctly assess the given UCITS product.

23. What impact do you think CESR's proposals for change would have on your firm and its activities? Can you indicate the scale of, or quantify, any impact you identify?

Part 4: Definition of personal recommendation:

24. Do you agree with the deletion of the words 'through distribution channels or' from Article 52 of the MiFID Level 2 Directive?

CESR's interpretation of the definition of advice corresponds to the German understanding of the term. We therefore agree with CESR that a personal recommendation may also be provided via a distribution channel and warmly welcome the suggested deletion of "through distribution channels or". This will help to establish a standard pan-European interpretation, create a level playing field and prevent attempts to circumvent the rules.

In this context, we proceed from the assumption that the deletion of the words "through distribution channels or" will not be associated with a change concerning the meaning of "personal recommendation". In the solution to be reached it should also be ensured that neither marketing material nor research is considered as advice.

Part 5: Supervision of tied agents and related issues

- 25. Do you agree with CESR that the MiFID regime for tied agents has generally worked well, or do you have any specific concerns about the operation of the regime?**

The ZKA shares CESR's opinion that the MiFID regime for tied agents has worked well.

- 26. Do you agree with the proposed amendments to Articles 23, 31 and 32 of MiFID?**

Yes

- 27. Could you provide information on the likely impacts of the deletion of the ability of tied agents to handle client money and financial instruments?**

No comment

Part 6: MiFID Options and Discretions:

28. Do you agree with the suggested deletions and amendments to the MiFID texts proposed in this chapter?

Yes, we do; except with CESR's proposal to Article 51(4) of Commission Directive 2006/73/EC - Discretion for Member States to impose obligations on tape recording (see remarks to part 1)

VOICE RECORDINGS OF TELEPHONE ORDERS?

An impact assessment

Berlin, November 2008

Key points in brief

- The Markets in Financial Instruments Directive (MiFID) requires investment firms to keep records on the **placing of orders**. It has to be examined whether it should be mandatory in this context to make voice recordings of telephone orders.
- The Commission and supervisory authorities are committed to the **principle of better regulation**. Before new rules are introduced, they therefore have to consider alternative methods of regulation, including the retention of the status quo. Benefits need to be weighed against drawbacks, especially the associated burden on market participants and the bureaucratic costs involved.
- **Voice recordings** would generate **additional costs of between €1.03 and €8.06 per order**. Dividing these costs among all orders would ignore the principle of cost causality. Distributing them among telephone orders only would discriminate against customers using this method of communication.
- For the **German banking industry as a whole**, it is estimated that one-off **acquisition costs** of at least **€632m** would be involved. The annual **operating costs**, assuming straight-line depreciation over ten years, are put at a minimum of **€332m** for the whole of Germany.
- Clients wish their conversations about finances and investments to be **confidential**. Advisory services for high net worth individuals and asset management are likely to be damaged particularly seriously by a voice recording requirement. There is a danger of assets being diverted to countries outside the EU. This damage would be irreparable.
- An **exemption** for infrequently used telephone lines would **do nothing to reduce the burden** because of the time and expense involved in monitoring and adjustments.
- Bearing in mind the principle of proportionality, the **effects** of a voice recording requirement **cannot be justified**.

I. Introduction

The Directive on Markets in Financial Instruments (MiFID) has governed practices at investment firms since 1 November 2007. While most of the rules are final, the directive envisages that **certain areas will be reviewed** by the Commission at the end of a predefined period.

These include the scope of **record-keeping requirements**. At issue is one of the main points of contention in the European legislative process, namely **whether banks should have to make voice recordings of telephone conversations with their clients**. Two alternatives were discussed during the course of the legislative process in 2004 and 2005: recording the entire conversation between the bank and its client or only the actual placing of the order in the narrower sense¹. In the end, it was decided to refrain from making either of these options mandatory. Instead, the MiFID Implementing Directive leaves the decision up to member states, most of which, including Germany, have opted against requiring voice recordings of telephone conversations.

In accordance with Article 51(5) of the MiFID **Implementing Directive**, the European Commission will have to examine whether this national discretion is appropriate. The Committee of European Securities Regulators (CESR) is laying the groundwork in 2008 by preparing a report for the Commission.

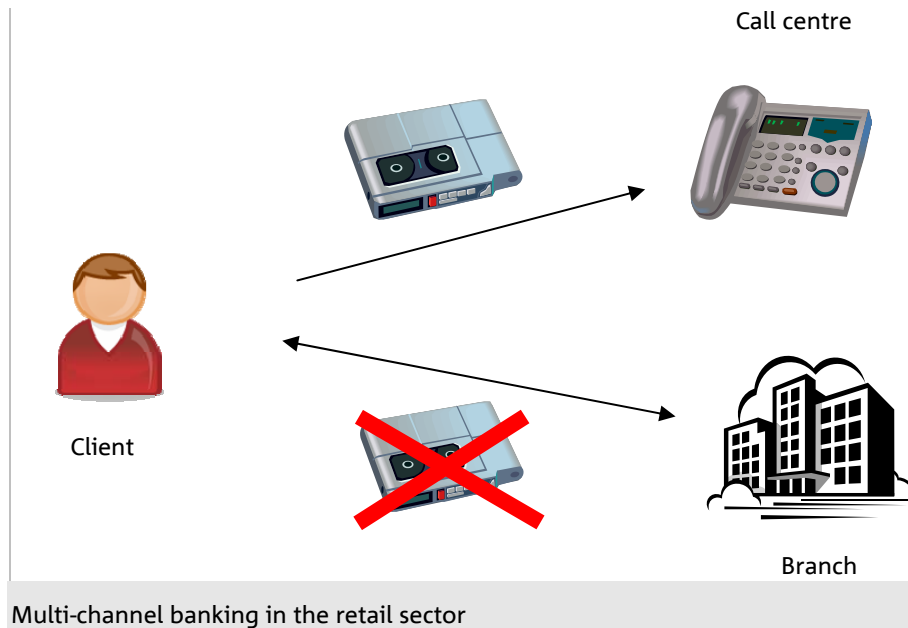
The intention of this paper is to analyse what effects the introduction of a voice recording requirement would have on German banks.

II. The situation in German banks today

As early as 1993 German banks agreed to make recordings of **interbank business**. This undertaking covers professional trading only and has been agreed to by all German banks and affected staff. In the retail segment, it has also become normal practice for banks to record **calls handled at call centres**. This concerns a fairly small, well-defined sector consisting mainly of direct banks and banks with multi-channel marketing. Clients have to give their prior consent to the recording. No other conversations are recorded. A clear distinction is therefore made at banks with multi-channel marketing strategies: calls answered at a call centre are recorded while telephone calls handled by a customer adviser at a bank's headquarters or branches are not digitally recorded or taped.

¹ A summary of developments is contained in the annex.

Naturally, however, a record is kept of every client order in paper or electronic format. To avoid misunderstandings, it is standard practice for bank staff to repeat the main points of an order to the client, who is then requested to confirm their accuracy orally. Afterwards, the transaction is duly processed, which includes being documented for supervisory purposes.



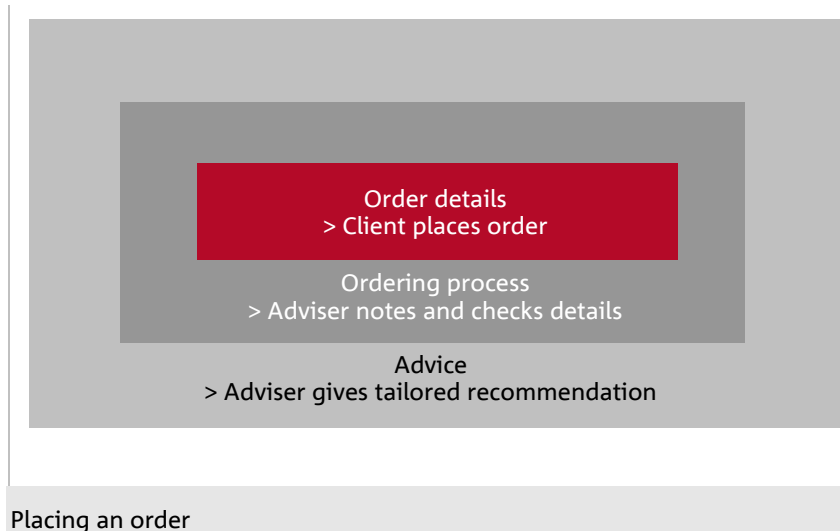
III. Regulatory purpose of requiring telephone voice recordings

1. Monitoring investment firms

If statutory and regulatory requirements are to be effective, it must be possible to monitor whether supervised companies fulfil the requirements imposed on them. For this reason, Article 13(6) of MiFID contains a general requirement for investment firms to **keep records of services and transactions**. The records are to be kept primarily for the purposes of **internal auditing**, the functioning of which is highlighted in Article 13(5) of MiFID, and of **external monitoring**, which is carried out in Germany by auditors and the Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht* – BaFin). Article 13(6) of MiFID provides the legal basis for the possible changes to the rules in accordance with Article 51(5) of the MiFID Implementing Directive.

In principle, these requirements are met by the existing practice of keeping **written or electronic records of orders**. These records already make it possible, as long as the bank employee documents the order accurately, to monitor the **quality of execution** at an

investment firm in terms of how quickly an order is carried out and whether any specific instructions given by the client are complied with.



The only added value of a **voice recording** compared to this traditional way of keeping records is that it is possible to compare the client's oral instructions with the data entered into the bank's order execution system. The purpose of requiring voice recordings is consequently to enable errors by employees in the ordering process to be detected.

When the MiFID Implementing Directive was being drawn up, the European Commission took the view in its working document ESC/17/2005-rev2 that a recording should also be made of the advice provided to a client in connection with a telephone order. The purpose of extending the requirement in this way was to document the content of the advice as well. But this would have significantly exceeded the requirements applying to the documentation of advice provided in a face-to-face interview at a branch. There is no discernible reason why special documentation requirements should apply to one particular medium of communication.

2. Further regulatory objectives?

It would also be conceivable for the rule to serve another purpose: the **protection of the individual investor**. The banks' voice recordings would enable investors to verify that their bank had conducted itself properly. **Article 13(6) of MiFID currently offers no legal basis for such an objective**, however. On the contrary, the existence of specific rules on individual investors' information rights in other provisions – such as those governing best execution in Article 21 of MiFID, which in paragraph 5 contains a special requirement for investment firms to demonstrate best execution – makes it clear that MiFID is an instrument of supervisory law and does not as such aim at protecting the interests of the individual. Even if investor protection were deemed a desirable purpose in this context, therefore, it would be impossible to extend the protection offered by the rule without **modifying MiFID** itself.

In its Technical Advice of January 2005², CESR cites the protection of **market integrity** as a further objective. But it fails to explain how recording telephone conversations can help to improve the detection of market abuse. Recordings would naturally furnish proof of the identity of the caller and of the exact time when the order was placed. It is probable, therefore, that CESR's proposal was made for the same reasons as those which prompted the FSA in the United Kingdom to require voice recordings of telephone conversations (cf. Annex II.1). Conversations with retail financial advisers and asset managers are expressly exempt from the UK requirement, however.

The main objection is that preventing market abuse is **not an objective of MiFID**. Furthermore, making routine recordings of the spoken word with the aim of detecting criminal activities is a serious encroachment on basic liberties. This raises constitutional concerns and would consequently need to be considered very carefully – also and not least by the European Parliament. The rest of this analysis will therefore leave this aspect aside.

This leaves the objective of enabling supervisors to examine whether services have been provided in a proper manner.

² Cf. CESR's Technical Advice on Possible Implementing Measures of the Directive 2004/39/EC on Markets in Financial Instruments (Ref.: CESR/05-024c).

V. Considerable constraints on record-keeping obligations

One constraint on the state interference represented by record-keeping obligations is the **principle of proportionality**. Article 13(6) of MiFID restricts the potential form of a new rule on telephone voice recordings in that the records have to be “sufficient” to achieve the cited objectives. This makes it clear that not all procedures which would serve the intended purpose of the rule are permissible, but only those which place the least burden on investment firms and their customers. Costs and an erosion of data protection may be deemed burdens in this regard.

VI. Consequences

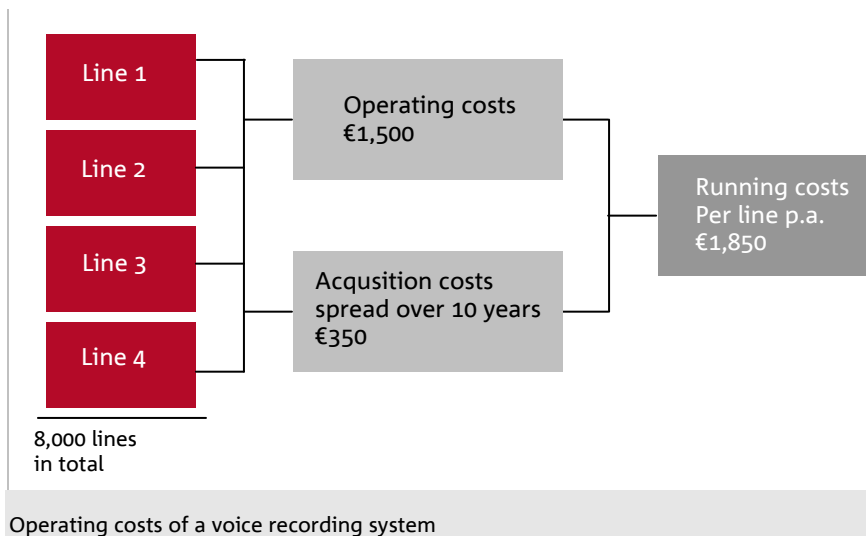
The introduction of a requirement to make voice recordings would necessitate **substantial investments** by affected banks. As well as the one-off costs of setting up a voice recording system, costs would be generated by training staff, corresponding with clients, regular maintenance and storing the records.

A **survey of selected member banks** covering big banks, regional banks focussing on retail banking and banks offering extensive private banking services found that the following costs would be incurred:

1. One-off and ongoing costs of a voice recording system

A technical system would have to be installed which ensured that recordings were reliable and accessible. **Every telephone line** which could be used to receive a client order would need to be **connected to the voice recording system**. Various technical solutions are conceivable. Depending on the number of affected telephone lines at individual branches, it would have to be decided whether individual or server solutions would be more cost-effective.

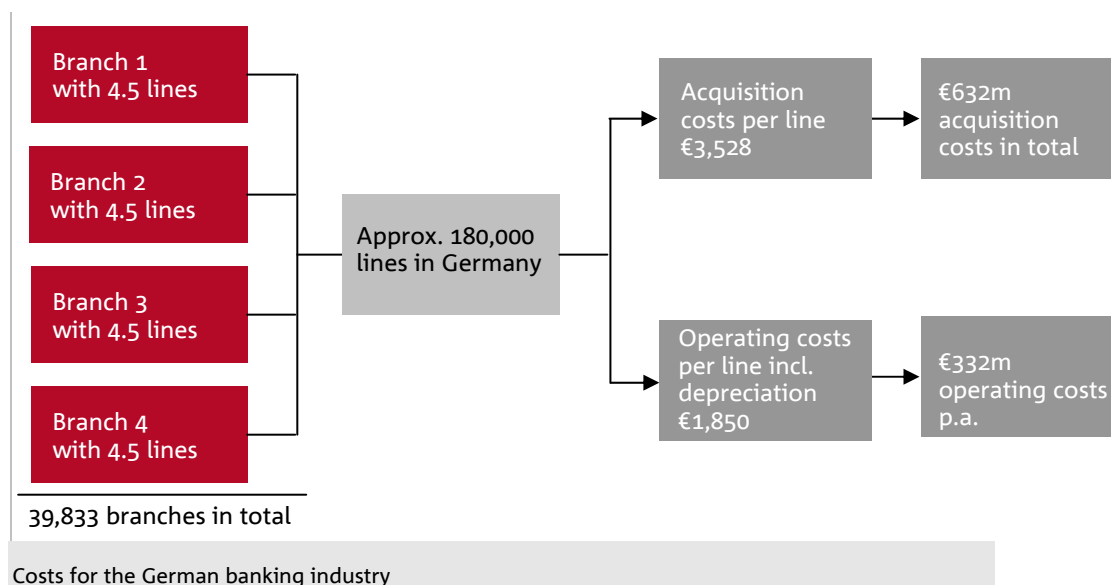
Many banks would use a combination of the two. The average **one-off acquisition cost per telephone line** was put at **€3,528** by the surveyed member banks. At a big bank with around 8,000 telephone lines needing to be connected, acquisition costs totalling approximately €28.2m would be incurred. On top of this would come **operating costs**, especially for maintenance. According to our figures, these are estimated at an average of around €1,500 per telephone line per year. Assuming that the one-off acquisition costs were written off on a straight line basis over a period of ten years, operating costs of around **€1,850 would be incurred for each line every year**.



a) Implications for the banks

At the end of 2007 there were 39,833 bank branches of various sizes in Germany³. In a bank with a strong focus on securities trading, a lot of telephone lines would need to be connected to the voice recording system – say between ten and 17 per branch. There are also banks whose business model places less emphasis on securities trading. Nevertheless, unless they were covered by a de minimis rule, these branches would also have to be connected to a voice recording system. It may be assumed that two to three lines would be involved in these cases. Averaged over all firms in Germany, between four and five telephone lines would need to be connected per branch. If calculations are based on a statistical average of 4.5, the **one-off acquisition costs for the entire German banking industry would total €632m**. The estimated annual running costs, assuming straight-line depreciation over ten years, would be **€332m for the whole of Germany**.

³ Source: Deutsche Bundesbank, Statistical Supplement 1 to the Monthly Report, August 2008.

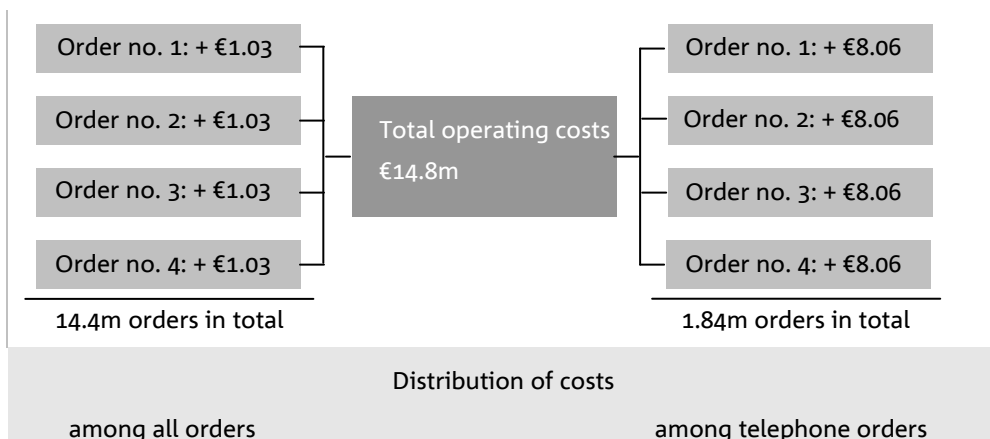


The FSA in the UK also looked into the costs associated with making voice recordings (see Annex II.1). Its estimates differ quite considerably from the findings of the German survey. The study in the United Kingdom was based on different basic assumptions, however, such as that 80% of the telephone lines affected by the FSA's rule already had voice recording equipment in place. On top of this, telephone calls from clients to asset managers and retail financial advisers are exempt. If this is taken into account, the FSA actually assumes far higher acquisition and operating costs per telephone line than those estimated for German banks.

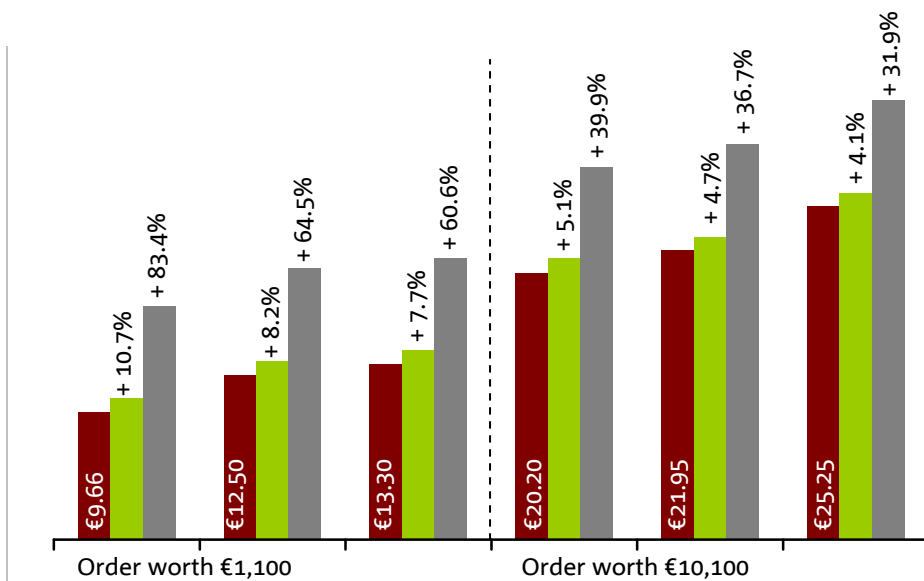
b) Distribution of costs

Ultimately, the costs would have to be distributed among client orders. If it assumed that around 14.4 million orders are received annually at the 8,000 telephone lines which would be connected to the voice recording system, and if the costs were divided amongst all orders, whether placed by telephone or other means, the **additional cost of each order would be at least €1.03**. If the costs were divided only among telephone orders, the **cost of each order would rise by €8.06**.

Dividing the costs among all orders would ignore the principle of cost causality. Clients placing their order over the counter or by fax would be **subsidising telephone orders**. If the costs were distributed only among telephone orders, there would be an exorbitant increase in fees. This method of placing orders would become completely unattractive; clients using it would be **discriminated against**. Neither alternative offers a client-friendly solution.



The effects of distributing the costs can be illustrated with a few practical figures. In February 2008, the German consumer watchdog *Stiftung Warentest* published the results of a survey looking at the commission charged for securities orders. One of the items investigated was fees charged by German banks for the purchase of shares worth €1,100 and €10,100.



Effects on fees for share orders

- Current fees charged by the three least expensive suppliers for share orders placed by telephone worth €1,100 and €10,100⁴
- Fees after costs are distributed among all orders
- Fees after costs are distributed among telephone orders only

⁴ Source: Finanztest, issue 2/2008.

The least expensive commission on an order worth €1,100 was €9.66; the second and third least expensive were €12.50 and €13.30 respectively. For an order worth €10,100 the lowest commissions were €20.20, €21.95 and €25.25. If the cost of making voice recordings is added to these figures, the fees rise by between 4 and 83 per cent.

2. Cooperation with tied agents

MiFID also permits the use of tied agents. Logically, orders received by these agents over the telephone would need to be recorded too. This would drive costs up even more. First, it would be more expensive to install the system because individual solutions would mostly be involved. And second, the average number of orders placed via agents is far lower than that received by banks direct. The additional cost per order would be much higher than the costs incurred at branch offices.

3. Informing clients

When considering the practical implementation of a voice recording requirement, it should be borne in mind that Article 10 of the European Data Protection Directive **requires clients to be informed**. This would incur further costs (account statement printer, printing costs, postage), which were not, however, calculated for the purposes of our survey.

4. Handling all telephone orders at call centres?

One possible solution might be to handle all telephone orders at a single point of contact or call centre. This approach would avoid the costs of making voice recordings at branches. But it ignores the fact that clients who currently phone their advisers **do not wish their orders to be handled anonymously**. This is borne out by the experience of banks using multi-channel solutions. Many clients dislike not only the anonymity of a call centre, but also the associated security measures which are needed, such as the initial PIN inquiry. A solution of this kind would therefore be of only very limited usefulness.

5. Exemption for infrequently used telephone lines

In its Technical Advice of January 2005⁵, CESR proposed that investment firms should be able to apply for an **exemption for telephone lines on which there is only a low frequency of orders**. In practice, this exemption would not be particularly helpful. First of all, it would be necessary to define exactly what is meant by “low frequency”. The banks would then have to compile corresponding statistics and update them regularly. In addition, an exemption would have to be requested for each individual line. The

⁵ Cf. CESR’s Technical Advice on Possible Implementing Measures of the Directive 2004/39/EC on Markets in Financial Instruments, Box 5 (Ref.: CESR/05-024c), cf. Annex I.3.

associated red tape could only be worthwhile if it resulted in an exemption being granted for an entire branch. Such an exemption could naturally not apply indefinitely, however, because the frequency of orders might change over time. The bank would therefore need to ensure that statistics were also regularly compiled on the use of exempt telephone lines. Initially exempt lines might then have to be connected to the voice recording system at a later date. The time and effort involved in monitoring the situation and making any necessary adjustments would **outweigh the benefits of the exemption**.

6. Confidentiality

A further point to consider alongside the quantifiable costs referred to above is the clients' desire for conversations about their finances and investments to be confidential. The implications in this area should not be underestimated, especially if supervisors also required recordings of the oral information and advice preceding an order. It is highly probable that **advisory services** for high net worth individuals and **asset management** would be damaged particularly seriously by a voice recording requirement. Banks also face fierce competition from firms in countries outside the EU, **to which assets risk being diverted**. This damage would be irreparable.

VII. Better regulation

The European Commission and supervisory authorities are committed to the **principle of better regulation** when shaping the regulatory environment. This means that, before introducing new rules, alternative forms of regulation must be considered, including the decision to retain the status quo. When **comparing the various alternatives**, account has to be taken of their benefits and drawbacks and, in particular, the associated **burden** on market participants and the **bureaucratic costs** involved.

As an alternative to voice recordings, consideration should be given to an **approach based on organisational measures** of the kind essentially already in place under existing law. To ensure that an employee's record of a transaction is consistent with the client's orally placed order, banks need to have **clear organisational guidelines**, and their staff need to **follow these guidelines rigorously**. The guidelines should be supported by **accompanying organisational measures** such as a systematic evaluation of customer complaints to detect possible irregularities.

Given the far higher costs of introducing mandatory voice recordings, it would seem appropriate for regulatory action to focus on ensuring compliance with organisational measures of this kind. This could be achieved by supervisors applying administrative practices based on Article 13(2) of MiFID. **No modification of the legal framework is necessary.** Important arguments in favour of this solution are its cost neutrality and the lack of implications for data protection. In the experience of our member banks and the banking industry ombudsmen, moreover, customer complaints in this area are extremely rare.

VII. Conclusion

In view of the high costs, the erosion of client data protection and the availability of alternative organisational measures which have not as yet resulted in any shortcomings in supervising investment service providers, an obligation to make voice recordings would be disproportionate and is thus to be rejected as a violation of better regulation principles. There is consequently no reason to introduce a mandatory pan-European requirement to record telephone conversations.

Annex

I. History of European legislative proposals on voice recordings

The requirement for an investment firm to keep records of all services and transactions is set out in Article 13(6) of the Directive on Markets in Financial Instruments (MiFID):

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.

Article 13(10) of MiFID empowers the Commission to adopt implementing measures with regard to the requirements. The Commission requested CESR to provide technical advice on these measures.

1. CESR's first consultation paper

In June 2004 CESR publishes its first consultation paper on this advice and proposes that telephone orders should be recorded and that these records should be kept for one year.

In complying with the obligation in Article 13 (6) of the Directive, an investment firm must keep records of telephone orders on a voice recording system for a period of at least one year.

CESR acknowledges that this is a difficult issue given the costs involved but takes the view that the reduction of the usual five-year retention period offers sufficient relief. National competent authorities are to be able to impose more stringent rules.

2. CESR's second consultation paper

In November 2004 CESR issues a second consultation paper, in which it draws attention to its existing Standard no. 15 requiring investment firms to tape client orders placed by phone. A clear majority of CESR members are in favour of voice recordings. Market participants are invited to supply information about the costs of keeping records for various periods of time.

3. CESR's technical advice to the Commission

January 2005 sees CESR publish its technical advice, together with a feedback statement on the consultation process. CESR recommends the Commission to require voice

recordings of all telephone conversations on lines used for giving and accepting orders. It proposes that records should be kept for at least one year and that national supervisory authorities should be able to grant exemptions in certain circumstances.

In addition, an investment firm must keep records of all telephone conversations on lines used for giving and/or acceptance of orders on a voice recording system for a period of at least one year. Where, in view of the low frequency of orders given and/or received by an investment firm on a global basis or on any of its telephone lines, the requirements (...) would not be proportionate, the competent authority may exempt that investment firm from that requirement on a global basis, or as applicable, in respect of that telephone line.

The other rules on keeping records also need to be observed. This means ensuring that the records can be readily reproduced on paper and that supervisors can access them and reconstitute the processing of each transaction. It must also be possible to recognise any changes or corrections.

In the feedback statement CESR notes market participants' concerns about the costs. It nevertheless believes that voice recordings are necessary in the interests of investor protection and market integrity. CESR takes the view that, in spite of the additional start-up costs, these are outweighed by the benefits; no figures are supplied to support this position. Reducing the retention period to less than one year is seen as counterproductive. The capability of reproducing the records on paper is considered indispensable, though the production of routine transcripts is not deemed necessary.

4. Working document ESC/17/2005 of the European Commission

In May 2005 the Commission publishes the first in a series of working documents on implementing CESR's recommendations. Article 13 reads:

1. An investment firm shall not carry out a client order unless the order includes all the information necessary to carry it out, and the firm can provide evidence that this information corresponds to the client's instructions in relation to that order.

4. Where the order is received by an investment firm by telephone, the firm shall record on a voice recording system the telephone conversation during which the order is given. This recording (and only this recording) will constitute the evidence required by paragraph (1).

The accompanying explanatory note states that recordings of telephone conversations are essential for reasons of investor protection and in order to facilitate the supervision of investment firms' activities. The Commission does not consider it necessary to give national supervisors the option of waiving the requirement. It points out that the costs of voice recording systems are reasonable and that, depending on the level of sophistication, prices start from under €100. In the view of the Commission, even the cheapest systems would enable investment firms to comply with the rules.

5. Working document ESC/17/2005-rev1 of the European Commission

This version drops the statement that the recording and the recording alone will constitute the required evidence. Otherwise, the proposal remains unchanged.

6. Working document ESC/17/2005-rev2 of the European Commission

The Commission takes up CESR's recommendation to provide for an exemption and specifies that not only the order itself has to be recorded, but also the associated advice:

"4. Where a retail client order is received by an investment firm by telephone, the firm shall record on a voice recording system the telephone conversation, to the extent that it relates to the order in question or to ancillary matters (such as any advice given or disclosures made in connection with the order). Where, in view of the low frequency of orders given and/or received by an investment firm on a global basis or on any of its telephone lines, the requirement in paragraph 4 would not be proportionate, the competent authority may exempt that investment firm from that requirement on a global basis, or as applicable, in respect of that telephone line."

7. Working document ESC/17/2005-rev3 of the European Commission

All the provisions in Article 13 concerning voice recordings are deleted.

II. Implementation in other member states

1. United Kingdom

The UK Financial Services Authority (FSA) issued new rules on recording telephone conversations in March 2008⁶. Their purpose is not to ensure the documentation of due execution but to detect and deter market abuse⁷. Recordings have to be kept for six months. Some conversations with asset managers are exempt from the rules under certain circumstances (e.g. if conversations with a client are infrequent) and no conversations with retail financial advisers have to be recorded.

2. Italy

Italy has required investment firms and capital investment companies to make voice recordings of telephone conversations since 1988⁸.

Intermediaries have to record telephone orders. The rules do not specify whether the entire conversation should be recorded or only the portion in which the order is placed. Further guidance is provided in Article 29 of a joint implementing regulation issued in February 2008 by Consob and Banco d'Italia. This states that the recordings have to be kept for at least five years and that they must be readily accessible by regulators.

⁶ FSA Policy Statement 08/1, March 2008.

⁷ Page 3 of the statement.

⁸ Articles 57 and 76 of Regolamento Intermediari No. 16190, Consob, 29 October 2007. Article 57 reads: *(Registrazione degli ordini telefonici ed elettronici)* 1. Gli intermediari registrano su nastro magnetico o su altro supporto equivalente gli ordini impartiti telefonicamente dai clienti, e mantengono evidenza degli ordini inoltrati elettronicamente dai clienti.