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FEFSI COMMENTS ON

CESR'S ADVICE ON POSSIBLE IMPLEMENTING MEASURES OF THE DIRECTIVE 2004/39/EC ON MARKETS IN FINANCIAL INSTRUMENTS

2nd Set of Mandates

The European investment management industry, represented by FEFSI[1] welcomes the opportunity to respond to CESR's draft technical advice on possible implementing measures of the Directive 2004/39/EC on Markets in Financial Instruments[2].

FEFSI believes that the adoption of the MiFID undoubtedly represents a significant step forward towards a single market for financial services and the proposed Level 2 regulation can become a further important step in this direction if it is done correctly, in particular in setting European standards in the field of distribution with respect to transparency, marketing communication and advice.

The European investment management industry will be affected by this part of CESR's work on the implementation of the MiFID at different levels:

- Some parts of the advice concern investment management firms that offer individual portfolio management services and which are represented by FEFSI;

- Investment management companies under the UCITS that carry out individual portfolio management as well as collective portfolio management services are also concerned by these rules;

- Finally, a significant number of units/shares of funds are distributed through intermediaries, who in the future will be subject to the MiFID (as investment advice is no longer considered as "ancillary" activity).

[1] FEFSI, the European Fund and Asset Management Association, represents the interests of the European investment management industry (collective and individual portfolio management). Through its member associations from 19 EU Member States, Liechtenstein, Norway, Switzerland and Turkey, FEFSI represents the European asset and fund management industry, which counts some 41,100 investment funds with EUR 4.7 trillion in net assets under management. For more information, please visit www.fefsi.org.

[2] CESR/04-562 of 21 October 2004

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GENERAL COMMENTS

No inappropriate "detailism"

Already when commenting on the Call for Evidence with respect to the Commission's preliminary mandate in January of last year[3], FEFSI underlined that CESR should contemplate the possibility that technical advice can also consist of recommending that no detailed rules be drafted, or that some issues are best left to the market place or participants to agree on – with or without the option of European regulators endorsing industry standards where feasible. From our point of view, Level 2 rules should be principle-based and only when necessary and/or if regulators estimate that this is not sufficient and may distort competitive forces should details be elaborated. Overly detailed and prescriptive Level 2 rules necessarily lead to "over-regulation".

We therefore welcome the Commission's statement that *"Particular attention should be paid of the level of detail required by market participants to be included in Level 2 legislation"*. We urge CESR to take this qualification to heart.

Fair competition between the various investment instruments

CESR's rules on market communication, reporting and advice must establish a level playing field, wherever possible, for all comparable financial instruments/products distributed by a firm subject to the MiFID and thus provide for an equal treatment of all financial products at the point of sale.

Lastly, we consider it extremely important that the CESR technical advice takes into account:

- The nature of the client who is to benefit from the investor protection envisaged. The levels of protection should vary quite considerably depending on the professional or private/retail nature of the (potential) clients, whereby it is imperative that the former benefit from a lighter regime than the latter.
- The nature of the product that is recommended by the investment adviser; in particular, the level of protection that needs to be built into the advice /suitability process should depend upon whether the product being discussed is itself regulated and supervised or not.

SPECIFIC COMMENTS

The areas where in our eyes shunts must be set in the right direction to ensure that the specificities of individual portfolio management are taken into account and that a maximum level of consistency between the new MiFID and the UCITS Directives is achieved were already highlighted in our response to the Call for Evidence.

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3 CESR/04-021 of 20 January 2004

Our attention has focused on three key areas:

- **Article 4 (1) No.4 on the definition of investment advice;**

- **Article 19.1 on the general obligation for the investment firms to act fairly, honestly and professionally and in accordance with the best interest of the client;**

- **Article 19.4 and 19.6 on suitability test and execution only business.**

1. Definition of "investment advice" (Article 4 (1) No. 4)

We welcome the provision of draft Level 2 advice by CESR on this issue as it is useful to differentiate "advice", as defined in Article 4 (1) No.4 of the MiFID, from other types of communications to investors and in particular to differentiate from and between "general recommendations", "marketing communications", "information given to the clients" and simple offers.

However we are conscious that this will be rather complex as definitions vary from country to country, thus rendering the formulation of common notions across all CESR jurisdictions challenging.

The quest for common notions must in our view accommodate definitions that apply across a multitude of financial services directives, starting with the unspecified distinction between "advertising" and "marketing" under the UCITS Directive. The e-Commerce and Distance Marketing Directives also build on these notions without necessarily clarifying their definitions. In fact the e-Commerce Directive permits a differentiated cross-border treatment of UCITS products on the Internet, whilst it is practically impossible to distinguish between "marketing" and "advertising" in the "virtual" world. Any definitions considered for the MiFID must be consistent and coherent for the purposes of these other directives or risk themselves becoming internal market obstacles rather than promoters.

In addition, from our point of view it would be of particular importance to underline that, in relation to the *simplified prospectus* included in the UCITS Directive, neither the document itself nor any of its contents should be considered in any way to constitute "advice". It only constitutes a "*marketing communication*".

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?*

FEFSI Members agree with CESR's approach: Article 4 (1) No.4 restricts the definition of investment advice to personal recommendations *"in respect of one or more transactions relating to financial instruments"*. When providing advice on a particular transaction, the term "services" seems to refer to the type of service that surrounds the transaction, as it is often impossible to separate it from the transaction itself. The scope of the directive should not be excessively extended.

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 contacts 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"?*

Not every communication of an opinion in a bilateral relationship should be regarded as investment advice. We therefore agree that a personal recommendation has to be held out as being suited to or based on a consideration of the client's personal situation. A financial adviser has to collect the necessary relevant information regarding the overall financial situation of the customer he is advising and take into account his individual requirements. "Relevant" refers to the scope of this process, which should reflect both the nature of the fund product and its materiality to the overall financial situation of the client. For example, offering a long-term plan requires a more in depth knowledge about the overall financial situation of the customer than a relative small investment in a particular fund, obviously not representing a material part of the client's disposable assets.

"Good advice" should mean some form of maintaining the customer relation and giving additional information and advice in changing markets. However this condition should primarily be defined by the agreement between customer and financial adviser and the latter should apply the "comply or explain" rule.

Particular attention should be drawn in cases where a disclaimer is used. The financial adviser could formulate a very specific recommendation and avoid having this categorised as advice by simply including a disclaimer at the bottom of the page. The inclusion of a disclaimer should not be effective in isolation, but other circumstances surrounding the communication should be taken into account. We believe that the CESR wording was intended to cover this event by the phrase "implicit recommendation".

On the other hand it should be made clear that a recommendation does not necessarily have to show a disclaimer in order to qualify as non-personal. EU regulation should not encourage intermediaries to make excessive use of disclaimers in order to protect themselves from regulatory burdens, as an abundance of disclaimers will render them ineffective in the end. Instead a recommendation is to be considered non-personal as long as there are no unambiguous hallmarks for personal quality.

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

We believe that according to the definition provided in the Level 1 text it is reasonable to restrict "investment advice" to recommendations of specific financial instruments. The wording of article 4 (1) 4 cannot be read to cover advice that is generic. Even when generic advice is provided, it is likely that such generic advice will be followed or combined with specific recommendations, which will lead to the client taking a specific investment action.

However, whether a financial instrument is suitable or not has to be regarded in the context of the client's overall portfolio. This may not, in every situation, extend to a full financial plan for the client every time products are discussed. However, the adviser should have sufficient information regarding the client's financial information, expectations and attitude to risk, to ensure that the product passes the suitability test. A derivative instrument, e.g., will have a totally different impact if it is a hedge for a long instrument than if it is a standalone investment. Asset allocation is clearly part of the suitability test.

2. The general obligation for the investment firms to act fairly, honestly and professionally and in accordance with the best interest of the client

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

We agree with CESR's proposed measures on Article 19 (1) even though the term "investment strategies" that is used in the first paragraph of the draft advice is not clear and might create confusion with respect to its exact content.

3. Suitability test, appropriateness test and execution-only business

FEFSI agrees with CESR's draft advice regarding Article 19 taking into account in particular:

- The nature of the financial instruments being offered or considered;
- The retail or professional nature of the (potential) client.

As far as the nature of the financial instrument being offered or considered, we believe that it is important for CESR to recognise that there are a number of financial products which from the investor's point of view serve a similar purpose (e.g. investment funds, certain types of life insurance, certificates, structured bonds, etc.) but where, at present the regulatory requirements are significantly different. From FEFSI's perspective, we believe that such products should be treated in the same way with respect to, for example, transparency and product information.

As far as the differentiation between clients is concerned, we believe the needs of retail and institutional investors are significantly different and we acknowledge the fact this has been taken into account in the CESR's thinking.

Suitability test (Article 19.4)

We would like to repeat that the suitability cannot be referred to an instrument in an isolated view but the portfolio context has to be regarded.

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 financial instruments envisaged have the lowest level of 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 the consideration of his personal circumstances?*

Concerning the minimum information to be obtained from the client regarding his knowledge and experience in the investment field, we can only underline that judging investor knowledge is a very complex issue and a very multi-faceted process. One of the aspects that might be sensible to take into account when matching the characteristics and needs of the investor is risk-taking ability and tolerance. However, we believe that it will be very difficult to lay down fixed and detailed rules.

FEFSI considers that it is not sufficient for the financial adviser to only passively collect information, which is provided to him by the client. The information collecting process - in particular with respect to the relevant financial situation of the client - must be done by actively asking the right questions to the client or potential client.

We would agree with CESR's approach that a client who is not able to provide any information, because he lacks knowledge and experience in the investment field should at least get cautious advice towards a low risk product. However, we are concerned that the assumptions made by CESR in Question 4.1 seem to go too far, especially in the case where the investment firm is required to assume that the assets provided by a client are his only liquid assets.

On the other hand FEFSI is of the opinion that when the client refuses to provide all information requested by the investment firm or the information provided is insufficient the client should be warned of the fact that he would receive the advice that is considered suitable depending on the extend of information that the adviser has at his disposal. The advice that is provided when the circumstances mentioned above occur may not be the most suitable for the client.

FEFSI also believes that CESR's draft advice does not sufficiently take into account and relevantly deal with portfolio management. In the case of portfolio management the type of financial instruments will not be relevant in determining the nature and extent of information required. A portfolio manager has the valuable knowledge and experience, which allows the client to have access to a wider range of instruments suitable to the client's agreed objectives. It is the knowledge and experience of the portfolio manager that is relevant not the knowledge and experience of the client about specific financial instruments.

With respect to the extent to which the information has to be obtained by the investment firm, FEFSI supports CESR's draft advice as far as the need to differentiate between retail and professional customers is concerned. Professional clients should be deemed to have sufficient knowledge and experience, as well as an understanding of their own financial situation and objectives to exercise their own judgement in determining whether a specific product or service is suitable. Professional clients are entitled to ask for a higher level of protection when they deem they are unable to properly assess or manage the risks involved.

- **Appropriateness test (Article 19.5)**

Given that the 'appropriateness test' stipulated in Article 19.5 of the MiFID covers the provision of investment services other that investment advice and portfolio management, it is not considered to be a priority for FEFSI.

- **Execution only (Article 19.6)**

We welcome CESR's technical advice, which recognises that UCITS as highly regulated, supervised and transparent savings vehicles, explicitly listed in Article 19.6 of the MiFID are by definition always considered "non-complex" financial instruments for the purpose of this rule.

However, not only UCITS but also other collective undertakings are to be considered as non-complex as long as they are subject to equal standards of regulation and supervision. It would therefore be helpful if CESR would make clear that according to Article 19.6, other sufficiently regulated and supervised collective investment undertakings are to be considered as non-complex financial instruments.

Concerning the definition of a service as "execution only" the main criterion should be the fact that the distributor makes explicit reference that he does not provide advice. Internet based “fund supermarkets”, fund brokerage and direct banks are seen as examples of this category, since these financial players provide apart from fund product information no further advice to the customer and they usually target the so-called “self-directed clients”.

One of the criteria for determining that a service was provided “at the initiative of the client” should be the fact that the client seeks to or considers to act on a very specific product or type of product/instrument and that the client wishes to persevere despite the disclaimer that the service is provided without advice.

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In conclusion, FEFSI is appreciative of the consultation paper for the second set of mandates and we look forward to the scheduled possibilities of public hearings and consultations.

We hope that you find these comments helpful and we would welcome an opportunity to explain them in more detail should you desire such.

24 January 2005