FEDERATION
BANCAIRE
FRANCAISE

17 December 2004

**IMPLEMENTING MEASURES FOR THE DIRECTIVE ON MARKETS IN FINANCIAL INSTRUMENTS (MiFiD)**

**FIRST MANDATE OF CESR**
**Second consultation round**

**1.** The French Banking Federation (FBF) welcomes the second round of consultations on this question.

**2.** As a preliminary observation, the FBF notes that CESR provides no Level 2 advice for the issues addressed in pages 6 to 9 of the consultation paper. Instead, it makes do with general comments prefaced by "CESR considers…" or "CESR believes…".

This wording makes it impossible to infer exactly what conclusions CESR will draw concerning any Level 2 proposals it might make. If precisely worded proposals are subsequently put forward, they should be submitted for consultation.

**3.** Furthermore, the FBF insists on the need for total consistency between CESR's measures and those taken by the Committee of European Banking Supervisors (CEBS) and the Basel Committee on common topics such as outsourcing.

## 1. General questions from the first consultation

***a) Split between Level 2 / Level 3, the degree of detail and the calibration of rules***

**4.** The FBF is favourable to the case-by-case approach proposed by CESR for determining whether measures belong at Level 2 or at Level 3.

However, we have previously noted our concern that Level 2 should not be stripped of all content by assigning virtually every technical matter to Level 3. Although the guidelines put forward by CESR so far appear satisfactory from this standpoint, we believes it useful to reiterate our concern. A truly level playing field in Europe cannot be achieved if the margins of discretion left to the Member States are too wide. Obviously, this objective cannot be attained if both Level 1 and Level 2 set forth only general principles, the substance of which is given solely by Level 3.

***Transitional issues***

**5.** In the FBF's view, rather than dwelling on transitional measures, which will entail extra work and additional costs for professionals, it is more important to establish timeframes for implementing MiFiD that are consistent with the changes that will be necessary. This point is fundamental. As the FBF sees it, there are two complementary aspects of this problem.

The first relates to the deadlines for transposing EU-wide measures into national law. With a due date of 30 April 2006, and given that the final content of the implementing measures will probably not be known until the second half of 2005, the time allowed for national implementation appears short in view of the extensive changes in legal frameworks that will be called for.

The second aspect relates to the lead-times that financial market participants will have for modifying their internal procedures and adapting their IT systems to meet the requirements that will result from that new legal framework. On this matter, it should be emphasised that participants will not really be able to benefit from all this extra time if the clock starts running on the date by which transposition into national law is to have been completed. This is ostensibly the date at which the new legal framework in each Member State will be known to the industry.

**6.** For this reason, the FBF believes that the European Parliament and the Council should adopt a directive that would (i) grant Member States several additional months to transpose MiFiD, and (ii) allow a period of six months after transposition before the directive's provisions come into force.

## 2. Independence of compliance

**7.** CESR stresses its view that "the principle of the independence of compliance is key to ensure effective performance of its role" and further that "the issue should be approached from a functional rather than organisational perspective".

The FBF is obviously favourable to the sentiment expressed in this approach. However, because the issue is so important, CESR must define and carefully analyse the underlying principle when submitting its advice to the European Commission.

We consider that independence of the compliance function is an empty concept by itself. Independence is devoid of meaning if it is not accompanied by an allocation of human and material resources to the function and by internal procedures or reporting relationships within the organisation that can make that independence a reality.

The question is therefore whether or not CESR intends to address precisely these aspects. Because these are issues that can have a major organisational impact on firms, it is essential that CESR should organise a consultation on the proposal it intends to make to the European Commission, no matter which solution it favours, and should bring that advice into line with the measures that have been or will be taken by other authorities.

FEDERATION
BANCAIRE
FRANCAISE

**8.** CESR further states that "independence of compliance, where possible, should be achieved through the 'four eyes' approach, which implies that the persons responsible for the compliance function perform their monitoring duties independently of other persons and activities subject to their monitoring".

The FBF agrees with this principle.

**9.** The FBF is pleased that CESR intends to relax the rules for small firms and is contemplating two options: "the first is to impose outsourcing of compliance" and "the second is to allow some degree of flexibility to investment firms as regards the means to achieve the objective of independence of compliance; in this case the investment firm has to show alternative systems and means to ensure effective compliance".

## 3. Record keeping and the burden proof

**10.** The FBF welcomes CESR's confirmation that "its proposal does not intend to reverse the burden of proof but, rather, to introduce obligations of record keeping". As the FBF emphasised during the first consultation, any proposal that would result in reversing the burden of proof would be unacceptable, given the complexity of proving a negative.

**11.** The FBF observes, however, that CESR's assertion seems to beg the question, because it is largely undone by the affirmation that "investment firms should always be able to conduct adequate and consistent audit trails to demonstrate compliance of their activity with applicable rules" and that this "requirement will enable the regulator to ascertain that the investment firm has complied with its obligations, particularly in case of shortcomings (i.e. no assumption of guilt)".

The FBF therefore hopes that CESR will explain precisely how that affirmation will not, in practice, reverse the burden of proof by requiring the investment services provider (ISP) to establish that it has met all its obligations.

**12.** The FBF believes that CESR must state clearly that mere inability on the regulator's part to prove a violation by an ISP cannot be turned into an obligation for the provider to prove that it has indeed followed the rules.

## 4. Tape recording requirement

**13.** Lengthening the retention period for recordings from six months (the retention period currently recommended by the French regulator) to one year would increase costs by about 30 per cent.

**14.** The French regulator has always considered the six-month retention period to be reasonable and sufficient, having regard to its supervisory role. Accordingly, the FBF feels that CESR should identify situations in which a longer period would have helped a regulator to carry out its controls, so as to fully justify the additional cost burden on the financial system.

FEDERATION
BANCAIRE
FRANCAISE

**15.** As we understand it, the key issue of cost applies not only to longer retention periods but also to the reception and transmission of orders, since recording equipment would need to be fitted to telephone order platforms. This requirement is not only expensive, as a European Banking Federation study of Italy has shown; it is also impractical, because clients demand confidentiality when talking to their bankers, and only part of their conversation is devoted to placing a stock market order. Recording systems may be obligatory for trading desks, but they are costly and difficult to put in place in bank branches. If a less restrictive solution is not found, the economic impact on order flow from individual investors would be substantial.

Since CESR is no longer mentioning the issue of the choice of storage medium, the FBF believes it desirable to reiterate its concern that ISPs should be able to store their information in different formats – electronic, paper, magnetic tape, etc. – in accordance with their own internal policies and future technological developments.

## 5. Outsourcing of investment services

**16.** CESR says, "The highest degree of convergence should be ensured, where possible, with works conducted by CEBS and other international fora on outsourcing".

The FBF certainly agrees. On the outsourcing question, the views of CESR and CEBS must be totally consistent with each other. Any divergence between them could have significant impacts on the organisational requirements for credit institutions, which in certain Member States are important players in investment services.

**17.** On the thorny issue of outsourcing, the impression is that regulators are still groping in the dark to find a way forward. In this context, the FBF points out that it would be particularly harmful if CESR, the first body to have to deal with this issue, were to propose rules that turned out to be excessively restrictive compared with those set later by other bodies. The risk is that firms would be forced into a more rigid mode of operation before being able to benefit from possible subsequent relaxation of the requirements.

The FBF therefore hopes that CESR will favour a flexible approach on this issue, even if it means tightening its approach later once the other bodies that will be dealing with the issue have adopted a clear position.

**18.** CESR states that “The scope of any parity with the UCITS Directive should be confined to the delegation of individual portfolio management” and that “The technical advice should be consistent with the provisions of the UCITS Directive, particularly as regards the distinction between delegate located in other EU countries or non-EU jurisdictions”.

The FBF agrees with these general policy guidelines.

**19.** Generally speaking, the FBF reiterates its view that the rules on outsourcing must take into account the extreme diversity of both the functions being outsourced and the firms doing the outsourcing.

Outsourcing is not only a recognised means of cost reduction but also, and probably more importantly, a means of improving the quality of client service. It is important that the option to outsource should not be curtailed without justification. From this standpoint, it would be desirable for CESR to take a more finely shaded approach, with rules that vary depending on the categories of clients affected by the outsourced activity or function and on the financial risk associated with outsourcing.

The need for protection, evidenced in the outsourcing restrictions placed on ISPs, differs between professional and retail clients. It also varies according to the degree of potential systemic risk represented by the outsourcing firm.

**20.** The FBF also points out that operational outsourcing can be done under several different kinds of legal arrangements. This is the case in France. It would therefore be of interest for CESR to provide guidance on which kinds of legal arrangements are permissible for outsourcing.

### 6. Conflicts of interest and the segregation of areas of business

**21.** For the FBF, CESR's broad-brush presentation of its approach raises many questions, since we consider Chinese walls to be vital in the management of conflicts of interest.

It is particularly paradoxical that CESR can say, without further elaboration, that "information barriers, such as Chinese Walls, should not be mandatory, but other means should at least be as effective". While the FBF is not opposed to this approach, it nevertheless observes that, in the past few years, financial institutions in France have erected increasingly elaborate Chinese walls. Given the costs associated with building and maintaining these barriers, it is altogether astonishing that CESR could address this issue without adding anything to what was said in the first consultation.

**22.** The FBF points out that CESR should in any case ensure that its proposals here are consistent with Directive 2003/125/EC of 22 December 2003 which, in implementing the Market Abuse Directive, addresses conflicts of interest in the context of investment research.

### 7. Investment research

**23.** Here CESR says that “in reality there are different situations which deserve different treatment” and that “clear disclosure should be imposed where firms do not fully comply with all requirements”.

The FBF stresses that CESR's remark is couched in very general terms.

It is regrettable that CESR gives no indication of the changes it might have in mind for the language it proposed in the first consultation. Observing that "responses from consultation were not unanimous" should not prevent CESR from indicating the direction in which it is leaning, considering the feedback it received on that occasion. The FBF still hopes to see proposed new language from CESR. And in any case, we reiterate the observations we made during the first consultation.

### 8. Methods and arrangements for reporting financial transactions

**24.** The FBF acknowledges CESR's pragmatic approach to the issue of trade reporting. For cost reasons, it is necessary to rely heavily on existing systems, which will doubtless allow the authorities to fulfil their role of overseeing the integrity of European markets.

We agree that, in future, CESR should explore the possibility of greater convergence with European reporting channels, taking into account "cost-benefit implications for markets, investment firms and competent authorities".

**25.** The FBF strongly supports CESR's proposal to introduce Level 3 measures to avoid superfluous reporting. In our view, one way of achieving greater simplification would be to waive the home-authority reporting requirement for remote members of a regulated market or multilateral trading facility (MTF) in another Member State. Naturally, the waiver would apply solely to trades effected on that market or facility, provided that the venue in question already reports to its own competent authority. Provision could then be made for the competent authority of the regulated market or MTF to forward the information in question to the remote member's competent authority.

With more and more ISPs accessing markets on a remote basis, this simplification measure would reduce service providers' costs without detracting from the quality of the information reported to regulators. In view of current legislation, however, such a measure cannot be taken for granted.

**26.** CESR says that “Reporting channels approved by the competent authority would have to be operated by an entity that is subject to monitoring by the competent authority in respect of compliance with the conditions set out in paragraph 1”.

The FBF wishes to point out that the concept of "monitoring" needs to be precisely defined. If taken *stricto sensu*, then it would seem that entities would not be permitted to supply reporting services unless they were subject to control by the authority to which the reports are submitted. If CESR does indeed intend to adopt that interpretation, even though this activity does not constitute an investment service, it would create a problem that should be examined in greater depth. In the FBF's view, it would be entirely feasible to adopt a purely contractual solution whereby the entity that assumes responsibility for reporting agrees to submit to CESR-mandated inspections, especially those relating to its technical capabilities.

We consider this point to be quite important. It is necessary to foster competition in this sphere and to allow all types of suppliers, particularly data vendors, to develop reporting systems.

FEDERATION
BANCAIRE
FRANCAISE

**9. Criteria for assessing liquidity in order to determine the most relevant market in terms of liquidity for financial instruments**

**27.** On the whole, the FBF endorses CESR's proposals on the use of proxies, subject to the exception discussed below (§30 *et seq.*). As CESR points out, this is a simple way of tackling a complex issue. Provided the key aim is to turn towards the authority with the greatest vested interest in ensuring efficient market surveillance, then CESR's choice of proxy categories is appropriate. This is particularly true for the processing of derivatives, given the close interaction between these instruments and their underliers.

The FBF has no comments to make on items 1 to 7 of the Draft Level 2 Advice..

**28.** Regarding item 8 of the Draft Level 2 Advice, the FBF believes it would be clearer if the situations in which the alternative method of computing the "turnover" and/or "volume" criteria were listed from the outset.

Similarly, the reason for separating items 8 and 9 of the Draft Level 2 Advice is unclear.

**29.** Regarding item 10, the FBF believes that any such procedure should be conducted under CESR supervision. This would be necessary to settle disputes that may arise in connection with the "clear demonstration" referred to in (c). It is also necessary to determine when to use the turnover method and when to choose the volume method, since the results are not the same.

**30.** From the FBF's point of view, item 11 of the Draft Level 2 Advice", taken in conjunction with item 21 of the Explanatory Text, raises a crucial issue. Apparently, the list of competent authorities will not be made public, on the grounds that "CESR recommends to publicly identifying neither those markets nor the competent authority that has been designated as the competent authority of the most relevant market in terms of liquidity for a specific financial instrument, in order to avoid interfering with competition between markets and to avoid unwanted impact on the industry".

This decision is hard to understand, for two reasons. First, the motives for not divulging the most liquid markets under the proxy method are unclear. Second, as regards the most liquid markets under the turnover or volume methods, determining the venues in which liquidity is actually present is vital so that ISPs can implement effective and efficient best execution policies – a point made by the FBF in its response to the consultation on best execution.

Therefore, unless CESR decides that liquidity is not relevant to best execution policy, there is no reason for not publicly disclosing the venue or venues which, in CESR's view, are the most liquid. The decision to keep the information confidential is all the more surprising since CESR's concern "to avoid interfering with competition between markets and to avoid unwanted impact on the industry" seems totally baseless. Declaring that, on the basis of objective criteria, a venue is the most liquid market in terms of turnover or volume is hardly likely to distort competition.

**31.** Whatever the circumstances, the FBF believes that CESR should not use the reporting issue to pre-empt much-needed answers to the issue of best execution. As we have said before, CESR must provide market participants with a tool that allows them firstly to benchmark best


18 Rue La Fayette, F-75440 Paris Cedex 09, France
Tel +33 (0)1 4800 5252 . Fax: +33 (0)1 4246 7640 . www.fbf.fr

FEDERATION
BANCAIRE
FRANCAISE

execution policies by comparing venues across Europe and secondly to establish the extent to which each venue is able to deliver "on a consistent basis the best possible result for the execution of client orders".

Intermediaries need such a tool, otherwise only firms with ample human, technical and financial resources would be able to implement reliable and efficient policies. More importantly, it would allow clients to weigh up different best execution policies in total transparency.

In any event, it would be entirely inappropriate for CESR to gauge the quality of ISPs' best execution policies using a yardstick – i.e. the most liquid market on the basis of turnover or volume –that has not been disclosed to the market.

- ***Draft advice on Cooperation and Exchange of Information related to transaction reporting (Article 58)***

**32.** By and large, the FBF has nothing to say on this issue, apart from the observations about remote members in §25.

**10. The minimum content and the common standard or format of the reports to facilitate its exchange between competent authorities**

**33.** Although this is chiefly an issue for the authorities, it also interests ISPs because of its impact on the way that Europe's regulators carry out their supervisory role. Accordingly, harmonising the different information fields needed by each regulator and setting a minimum level of information to be exchanged between regulatory authorities will provide market participants with an adequate level of security.

That said, the FBF wishes to stress that the issue of implementing a system of information exchange must be assessed in the light of the reporting requirements already applicable to ISPs; it must not unduly add to their regulatory burden.

**34.** The FBF welcomes CESR's decision not to require ISPs to disclose "client/customer identification" as part of their reporting requirements. That information is meaningless until such time as the situation is harmonised at European level, with a single identifier being assigned to every client.

**35.** Regarding the additional Level 3 work proposed by CESR, the FBF has no objections, on condition that the general principles are clearly stipulated at Level 2.

There are two such principles:

- The need to achieve an adequate level of harmonisation. Many ISPs belong to corporate groups that operate across Europe and use common reporting tools. It is therefore vital that the reporting requirements imposed by different authorities are not superimposed onto these intra-group procedures.

FEDERATION
BANCAIRE
FRANCAISE

- It must be made clear at Level 2 that the deliberations to be conducted by CESR at Level 3 will address issues of costs and implementation deadlines resulting from the adaptations that are bound to result from these discussions.

French Banking Federation
18 Rue La Fayette, F-75440 Paris Cedex 09, France
Tel +33 (0)1 4800 5252 . Fax: +33 (0)1 4246 7640 . www.fbf.fr