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Working for the Investment Community

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For the attention of:
Mr Fabrice Demarigny
Secretary General
Committee of European Securities Regulators
11-13 Avenue de Friedland
75008 Paris
France

Dear Fabrice

CESR Provisional Mandates on the New Investment Services Directive

I am writing to provide some first views from our community with respect to these mandates published on 20th January 2004. We have confined our comments primarily to those Articles which relate to conduct of business rules, as it is in that area that our member firms have the majority interest.

APCIMS-EASD has 224 member firms operating on more than 400 sites, with £240 billion under management and administration for the private investor. They act for the 12 million UK investors when they buy and sell shares, the membership ranges from the execution only internet sites through to the high net worth specialists and collectively they undertake more than half the agency trades in UK equities on the London Stock Exchange.

We will be contributing to all aspects of the CESR consultations and are grateful for the opportunity to contribute.

General Points

While we welcome the increase in time that has been given to the ISD mandate and the published timetable we would urge:-

(i) that the direct consultation with the industry on the proposals are initiated earlier than the current June date. If CESR issues its draft in June then it is in effect only giving three months to the industry for comment, view and response. Whilst we accept that there is a longer overall process, nevertheless, we believe it would be very beneficial if the drafts were issued for formal consultation earlier;

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(ii) that CESR undertakes an impact study (cost benefit study), possibly through national regulators, so that there is a knowledge of where concerns may lie or specific problems are likely to be experienced in a country, a sector, or both, and work undertaken to bring about a practical and cost-effective resolutions in advance of the recommendations being finalised; and

(iii) that at all stages of the consultative process, CESR publishes the comments that it receives and provides reasons as to why it accepts some proposals and rejects others. Whilst appreciating that this puts a burden on CESR, we consider that it is vital, particularly in relation to the principal comments, that CESR receives and is fundamental in ensuring that there is an ongoing climate of confidence and trust maintained with the industry.

<u>Conduct of Business Obligations when Providing Investment Services to Clients – Article 19</u>

All existing customers should be grandfathered with new conduct of business requirements only applying to new customers following the implementation of the ISD.

Article 19 lays down the general conduct of business obligations which investment firms have to comply with when providing investment services to clients. We note that CESR has been asked to define, where relevant, the exact content of each of the obligations on the basis of:-

- The nature of the services offered or provided to the client or potential client, taking into account the type, object, size and frequency of the transactions.
- The nature of the financial instruments being offered or considered.
- The retail professional nature of the client or potential clients.

Our comments are as follows:-

- The identification of a client as being either "retail" or "wholesale" should relate to the relationship the firm has with its customer. Rather than try to make a differentiation according to size of transaction, which can be wholly misleading, we would propose that CESR looks at a proposition whereby firms draw up a policy on how they make a distinction between retail and wholesale within a broad statement of principles issued by CESR. This information would then be supplied to potential customers. The default position would be retail. National regulations are responsible for determining if the firms' policy conforms to CESR principles and that retail/wholesale decisions are appropriate within that policy.
- If a client is designated as retail (the current UK expression is 'private client') then the customer is entitled to receive all the protections under the Conduct of Business Rules. If the customer decides for other reasons that they do not wish to be retail, then they can be designated differently provided that there has been full discussion with the firm and that the customer is fully informed of what protections will be given up as a consequence. We are concerned that such specifics as size of transaction and the frequency of trading could result in an individual being classified as wholesale and a clearly wholesale client such as the treasurer operating in a small company, being classified as retail.

- The financial instruments that an investor can be involved with is clearly very broad. It would include cash market investments (bonds and equities, either directly or through collective investments), warrants derivatives etc. The specific choice of instrument for a particular customer clearly relates to its suitability for that person. Rather than preventing an individual from participating in a particular investment, we would propose that CESR considers a process whereby a firm has the responsibility to classify a retail customer who it is advising in accordance with their appetite for risk. We recognise that some instruments in some countries have a different risk designation than in others. For example, a derivative product (which includes retail covered warrants) in the UK is designated as high risk by the FSA and so is only available to those clients who are prepared to hold a high-risk investment and have signed a client risk warning agreement accordingly. This is not universally the case across the EU. The process could therefore be as follows:-

  (i) The decision is taken as to whether the client is retail.

  (ii) The retail client, in discussion with the firm, decides what risks they are prepared to be exposed to. The firm has to present to the individual what their risk designations are and what investments they consider to be suitable for the particular risk categories. **NB: These might differ from one type of firm to another.**

  (iii) Firms should be clear on what services that they offer and to what types of client. For example, some firms may offer advisory and discretionary services only to clients with sums of money greater than £250,000 to invest, meanwhile others will take on clients with a much smaller amount of money. Others will offer a range of services including pensions, mortgages, school fees and general investments, some may only offer execution only services.

  (iv) There needs to be a clear customer agreement at the outset of the relationship.

Publicity and Marketing Communications – Article 19.2

Marketing communication is a wide definition. There is a distinction between marketing communications and a personal recommendation. We consider that marketing communications should be considered to be communications either to non-clients or to clients who have signed up for a service other than that in the communication.

A marketing communication must be clear, fair and they have to contain information about the firms. They can only be legal if it is sent by a regulated firm or has been approved or vetted by a regulated firm. If such requirements have not been met, then the entity or individual who has published it would have committed an offence.

Appropriate Information to be Provided to the Clients or Potential Clients – Article 19

The firm should be required to provide information about itself which is sufficient for a client to decide whether or not it wishes to elect to use that firm's services. For example, the firm should specify whether it undertakes execution only business, advice based services or both, whether it can deal in equities, derivatives or other products, and all in a simple and coherent way. It should specify that it is regulated and by which authority, the costs of the services that it offers and provide information on where an individual could complain should they wish to complain about the service.

The firm would need to have a policy on risk from which it can present to the customer, firstly, the general investment risk categories and, secondly, the financial instruments that it considers to be appropriate. It should determine the individual's appetite for risk and inform them of the various execution venues that it uses. All information should be provided at the outset of a relationship and thereafter the client should be sent, on an annual basis, an update of the information the firm holds on the client as well as the valuation of their portfolio.

Client Records and Client Reporting

A firm should provide annually a client with information that it holds on them, including name, address, risk category where appropriate, a summary of the investments that the client has, a valuation of their investments and the name of an individual within the firm whom they should contact if they wish to discuss issues.

Best Execution Obligations – Article 21

Any best execution regime has to be able to facilitate a variety of dealing scenarios and alternatives. Best execution should include not just the price of the equity but also other aspects of the trade, particularly clearing and settlement costs. Firms should notify their clients of their execution policy.

When CESR consults on best execution rules we believe that it should include the following principles:-

(i) A concept of "reasonableness". It is clearly not reasonable for a small firm to be connected to a large number of venues whilst it could evidently be reasonable for a large multi-national entity to be connected to every exchange in Europe. We would define reasonable as the firm having the ability to check the prices on the exchange at which the security is mostly traded, plus an alternative venue should this be warranted by the liquidity available. It also needs to be recognised that it may well be that under this definition an exchange could provide the worst overall price for the trade as some clearing costs can add significantly to the cost for small and agency trades.

(ii) Firms should have a general obligation to execute the trade immediately unless there are practical reasons why not – for example, market volatility such as happens at the start and the end of the trading day on many exchanges. There must be "safe harbour" provisions for firms who exercise this discretion. Safe harbour provisions could be defined by CESR as discretion allowed in accordance with defined market practices. National regulations would then constrict these specific definitions.

(iii) Customers should be notified on a one-way basis of the execution venues that a firm uses.

(iv) Customers should be provided with a notification advising them of the details of each trade in direct equities.

(v) Firms should be required to keep the trading information for up to three years so that the customer can challenge best execution at a later date.

(vi) Firms should be required to have a policy on conflicts of interest which is made available to all clients.

Client Order Handling Rules – Article 22

Firms should have an obligation to trade immediately unless there are good reasons for postponing the trade or unless agreed with the customer. This allows firms flexibility to avoid the market in volatile conditions such as market opening.

Grandfathering

All existing customers should be "grandfathered" into the new regime. To replace existing customer agreements with new agreements will be time consuming and very expensive with that cost being borne by the customer. In the transition period between "old" and "new" contracts it will not be possible to act on behalf of the client. Moreover clients are very unlikely to respond to requests for a signature on new terms and conditions. Clients could be significantly disadvantaged especially if custody assets are held in a dematerialised form and firms were precluded from acting on their behalf pending a new signature.

Consumer Protection

If consumers are to feel that they can safely invest in the market, then not only do they have to have the security that firms are well regulated but also that there is reasonable redress available to them should something go wrong. We would support a proposition that firms have to advise all their clients how to complain should they have a concern as part of the standard terms and conditions.

With best wishes

Yours sincerely

Angela Knight
Chief Executive