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BBA RESPONSE TO CESR ADVICE ON POSSIBLE IMPLEMENTING MEASURES OF THE DIRECTIVE ON MARKETS IN FINANCIAL INSTRUMENTS (2nd Consultation on 1st set of Mandates – due 17 December 2004)

The British Bankers' Association represents more than 260 banks carrying on business in the United Kingdom. The majority of these banks come from outside the United Kingdom and our members cover the whole range of investment services covered by the Directive. The BBA is also member of the European Banking Federation (EBF) and supports the EBF response to this consultation.

We welcome that CESR has decided to issue a second consultation on issues arising from the 1st mandate to which we responded in detail. However, given the short consultation period in the pre-Christmas period and the overlap with other CESR consultations about other aspects of MFID, it has been difficult to explore all issues raised by the second CP in depth with our members. Our detailed comments are attached to this letter.

With the exception of CESR's proposals on tape recording of client orders which are likely to cause very substantial costs to our members, we welcome most of the feedback that CESR has given on "intermediaries" issues in this consultation. However, without the benefit of the precise Level 2 text it is difficult to comment in more detail. Often, seemingly small nuances or even drafting errors in the Level 2 text can make a significant difference to the successful application and implementation of MFID, which will change the EU financial services landscape in years to come.

CESR's feedback on the "intermediaries" part of the First CP is extremely general and this makes it difficult to assess whether the CESR position is acceptable to our members or not. We would urge CESR to include the full revised Level 2 articulated text in future second consultation papers, thus allowing the industry a thorough assessment of CESR's proposals. At this late stage of the consultation process CESR has given no indication on how its thinking has progressed on the issues addressed in the 1st consultation paper but not mentioned in the limited second consultation document. This is causing considerable concern to our members since a number of CESR's proposals in the first consultation paper raised important issues which would cause great practical difficulties for our members.

For example the requirements for customer agreements, e.g. the requirements for two-way customer agreements and the absence of grandfathering arrangements would have a serious impact on member firms. Our comments made in our 1st consultation response continue to apply.

We welcome the fact that for the “markets issues” CESR has provided the full proposed text of the advice. However, in view of the short consultation timescale we would encourage CESR to denote any changes to the advice text of the 1st consultation more clearly (e.g. by putting amended or additional text in bold or italics or by “red-lining”) as this would make the task of comparison and assessment easier and quicker.

We would be happy to discuss with CESR any questions arising from our response.

Yours faithfully,



Michael McKee
Executive Director
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Angela Teke
Director
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1) Transitional issues

Consultees are invited to express their views on the proposed way forward for the finalisation of the technical advice. CESR seeks practical and concrete exemplification of difficulties envisaged by market participants in the implementation of the new proposed advice. In particular CESR wishes to receive information on the timing of what is practicable in terms of systems changes needed to implement these proposals.

As stated in earlier submissions we strongly support an extension of the MFID implementation deadline. Without a significant extension of the current implementation deadline of April 2006, we fear that the Directive will miss its objective of integrating investment services and enhancing competition among execution venues in Europe. The implementation of the Directive, with more than 30 comitology measures will require substantial alterations to technology and practices of market participants. However, the precise nature of these changes will not be clear until Level 2 measures have been adopted, thus leaving banks only a year to make fundamental changes to the way they do business. We would therefore urge CESR, to work in close cooperation with Commission and Council to achieve an extension of the implementation deadline until the end of 2007. We support the EBF's letter to the Commission and CESR dated 31 August 2004 and the EBF's letter to the Dutch Finance Minister dated 12 November 2004.

2) Independence of Compliance

Consultees are invited to express their views on the proposed approach and in particular their opinions on the last option, with concrete proposals on the best way to achieve the objective of independence of compliance other than by compulsory outsourcing of the function in case of very small firms. Consultees are also invited to provide criteria to clearly define these small firms.

We welcome the fact that CESR has decided to approach the independence of the compliance function from a functional rather than organisational perspective. We also welcome the fact that CESR acknowledges the fact that a separate compliance department may not be practical in some firms. However, we do not believe that specifying criteria to define small firms would be helpful and would encourage CESR to focus instead on a flexible approach that is appropriate and proportionate to the nature, scale and complexity of the business.

We do not believe that CESR should stipulate compulsory requirements for the outsourcing of the compliance function. We strongly support option ii) suggested in the CP, namely that CESR allows some degree of flexibility to investment firms as regards the means to achieve the objective of independence of compliance, provided the firm can show alternative systems and means to ensure effective compliance, for example by the use of independent compliance consultants to carry out a periodic review of the effectiveness of the compliance function.

The comments made in our response to the CESR 1st Consultation paper continue to apply (See pages 5 and 7-9 of previous response).

3) Record keeping and the burden of proof

Consultees are invited to express their views on the proposed approach.

We strongly welcome the fact that CESR has stated that it does not intend to reverse the burden of proof in its record keeping requirements and that there is no assumption of guilt by the regulatory authorities with regards to investment firms' failure to carry out obligations. Furthermore we welcome the fact that CESR has made it clear that record keeping obligations should vary according to the nature and complexity of the investment business carried out by the firm. Our comments raised in our response to the 1st consultation apply (see pages 4 and 11-12). For example, whilst we welcome in principle requirements for appropriate record keeping, in its draft advice CESR should refrain from using overly onerous language and for example replace wording such as, "a firm must ensure" with "a firm shall take reasonable steps to ensure".

4) Tape recording requirement

Consultees are invited to express their views on the proposed approach and in particular to provide evidence of marginal costs for a shorter period of record-keeping requirement than the one proposed.

As CESR acknowledges, the majority of respondents (including our members) has opposed the requirement to tape clients' orders origination from phone conversations. We do not believe that CESR should introduce requirements very clearly opposed by the industry as a whole, without having provided a clear cost-benefit analysis and evidence of substantial investor protection benefits. The onus should be on CESR to substantiate the need for these requirements and that the benefits outweigh expense.

In our members' view the period of record keeping (e.g. 6 months vs 1 year) is the lesser factor in increasing the marginal cost, instead substantial costs will arise from introducing recording equipment into delivery channels such as retail branches which are not currently subject to such requirements but capture orders adequately in other ways such as manual data input.

We believe that CESR should make the requirement to voice record optional and contingent on the nature and complexity of the business. This would allow enough flexibility for regulatory authorities to request voice recording for e.g. large centralised sales department or trading floors but to waive it for very small outlets with only occasional order flow.

As CESR requested we have attempted to obtain some concrete cost estimates from our member banks. One member bank, with a UK wholesale focus, for example estimates that based on business areas that are currently tape recording, tape retention costs in the UK would be in excess of Euro 250 000 per annum or around EUR 125 000 for 6 months. Another global investment bank estimates annual costs of over 1.1 million Euros per annum (based on storage costs of Euro 530 000 and maintenance costs of Euro 575 000 for tape recording client orders in 7 European trading centres). In addition to this the bank estimates that it would have to purchase additional internal hardware and servers for Euro 1.9 million, leading to additional costs of Euro 3 million in the 1st year of MFID implementation.

Even more dramatic would be the costs of introducing tape recording equipment in UK retail banks with large branch networks most of which are not currently tape-recording client orders. Our members estimate that introducing tape recording equipment into business areas currently not recording client orders would amount to between £40 000 (for a 128 channel recorder) and £9000 (for a 16 channel recorder). Given that some of our larger member banks have over 1600 branches in the UK alone (the vast majority of which are not currently tape recording) additional cost of introducing tape recording equipment into the branch network (disregarding other business units which may also be affected) could amount to between £14.4 million and £64 million for an individual bank (excluding storage and destruction costs). Based on BBA statistics of 9 Major British Banking Groups excluding Northern Ireland (MBBG), these institutions alone had a network of 10 600 branches in the UK in 2003. Thus, even introducing the most basic recording equipment into the majority of those branches (which do not cover the whole industry) would result in very high additional industry costs for retail banks without CESR having demonstrated any tangible benefit from such proposals.

5) Outsourcing of Investment services

Consultees are invited to express their views on the proposed approach.

In line with the majority of respondents our members believe that the outsourcing firm should retain regulatory responsibility for the outsourced function with appropriate emphasis on due diligence to be carried out in appointing service providers. Our members are also opposed to extending the rules on outsourcing to other services than portfolio management and we welcome the fact that CESR does not currently intend to do so.

Our members do not believe that CESR should endorse the current wording of CESR Standard 127 on investor protection as it is unduly restrictive and less flexible than the provisions on outsourcing set out in the UCITS directive. Even the UCITS Directive requirements are too rigid for discretionary investment management. (See the comments of the Investment Managers Association (IMA) to this CP)

In our previous response we urged CESR to take into account other Directives and work on outsourcing conducted by other bodies such as the Joint Forum, CEBS and IOSCO and we therefore welcome CESR's commitment to ensuring convergence with other work on outsourcing and alignment with other Directives as appropriate. However, without sight of the exact wording of the CESR Level 2 advice we are not in the position to comment in more detail.

The comments made in our response to the CESR 1st Consultation paper continue to apply (See pages 6 and 10-11 of previous response).

6) Conflicts of interest and the segregation of areas of business

Consultees are invited to express their views on the proposed approach.

As stated in our response to the 1st consultation our members favour an approach which leaves suitable flexibility for investment firms to choose appropriate methods of managing conflicts of interest. For example, whilst information barriers are an acceptable technique for managing conflicts, CESR should not set out where information barriers are to be placed in companies. We also do not believe that CESR should focus on physical barriers but on separation arrangements and procedures (physical or otherwise) that are commensurate with the risk of information being passed on. Furthermore there should be no initial regulatory presumption that significant conflicts of interest exist in all companies. In our view Articles 13.3 and 18 of MFID already contain adequate detail with little need for additional rules at Level 2.

Regrettably CESR has provided no further update on where it thinks that information barriers should be placed in investment firms. We would like to reiterate our earlier comments that there should be no mandatory information barriers between analysts and proprietary trading departments. For example in illiquid fixed income markets controlled contact between those departments is well established and "walling off" research analysts from other parts of the firm is likely to result in reduced information flows to investors. (See pages 16 and 17 of our response to the 1st consultation paper).

In principle we welcome CESR's acknowledgement that there should be discretion as regards the means to manage conflicts. We also welcome CESR's statement that information barriers such as Chinese Walls are not the only effective means of controlling communication and therefore should not be mandatory. However, without sight of the exact wording of the CESR Level 2 advice we are not in the position to comment in more detail.

7) Investment Research

Consultees are invited to express their views on the proposed approach.

Our members welcome in principle CESR's statement that there are different types of investment research. It is important that firms are also given the flexibility to categorise their products as objective or non-objective and that it is made clear to the reader of the piece of research, which category it falls into and what it means.

It should be noted that firms may classify research as non-objective for reasons other than from a desire not to have to comply with regulatory requirements. For example, small firms may find it difficult to establish adequate information barriers between analysts and traders and larger firms may take the view that they do not wish to categorise some types of primary research as independent although their production follows the same control process as objective pieces. However, without sight of the exact wording of the CESR Level 2 advice we are not in a position to comment in more detail.

The comments made in our response to the CESR 1st Consultation paper (See pages 3 and 15-19) continue to apply.

8) Methods and arrangements for reporting financial transactions

Consultees are invited to express their views on the proposed approach.

In principle our members welcome that fact that CESR has paid special attention to existing arrangements for transaction reporting and has refrained from proposing unnecessary new requirements that would bring about excessive additional costs for the entities concerned. In the medium to long term we also welcome alignment, where appropriate, of existing arrangements in order to ensure a more consistent and efficient approach for reporting of financial transactions across Europe. We also welcome CESR's objective of not providing detailed and inflexible advice but to propose "a good and workable framework of general minimum conditions" regarding the conditions with which all reporting channels have to comply in order to be approved.

In line with the majority of previous respondents, we welcome CESR's decision to remove requirement 1h) for a standard-level agreement between investment firms and reporting firms. It will be in interest of firms to ensure appropriate arrangements but we believe that those should not be enshrined at Level 2 but dealt with at national level. We also welcome further work at Level 3 by CESR to remove from investment firms unnecessary double reporting requirements to both reporting channels (approved by competent authorities) and competent authorities.

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

Consultees are invited to express their views on the proposed approach.

In line with other respondents to the first consultation paper, there appears to be support amongst our members for a proxy based approach rather than computing a liquidity measure for each financial instrument admitted to trading on a regulated market.

A proxy approach is perceived as simple and transparent. We note that CESR intends to state that for the computation of liquidity in order to determine the most relevant markets in terms of liquidity, the competent authorities need to consider trading on all markets not just regulated markets. However, in the first instance data is only likely to be readily available for regulated markets, so we agree that initial calculations need to be based upon figures for these markets.

We welcome that CESR has removed the requirement in 11 to make available to the public (rather than just competent authorities) an up-dated list of competent authorities being the competent authorities of the most liquid markets for a specific financial instrument. We believe that the publication of such a list could have had anti-competitive effects.

With regards to Level 3 measures we welcome that CESR proposes to address specific cases (such as simultaneous IPOs in more than one Member State) where the proxy approach does not work, at Level 3 on a case-by-base basis rather than at Level 2.

10. Draft Advice on Cooperation and Exchange of Information related to transaction reporting (Article 58)

Consultees are invited to express their views on the proposed approach.

In its consultation CESR proposes further work at Level 3 in order to determine the maximum time period for transaction reports from investment firms and branches to be forwarded to other competent authorities in accordance with Article 25 (3) and (6) immediately after the details of these reports have been transformed into the harmonised format of transaction reports. We agree with CESR that these time periods should be set at Level 2 rather than 3.

In its second consultation paper CESR suggests that the competent authority of a regulated market where the transaction took place should be permitted to receive information about the transaction from remote members of that regulated market.

The competent authority of the market where the transaction took place would then forward this information to the competent authority of the home Member State and to the competent authority of the most liquid market in terms of liquidity. A consequence of this approach would be to waive the obligation on a remote member to report to his home Member state. Overall this approach seems sensible in principle although our members would welcome further details, in particular a regulatory impact assessment and cost benefit analysis, before making a final assessment. In the medium to long term our members would encourage CESR to develop proposals to facilitate a pan-European reporting model with one-stop reporting to a single point of contact.

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

Consultees are invited to express their views on the proposed approach.

We support long term greater convergence of standardised data exchange between supervisors. We note CESR's statement that in the "short to medium term this would not be useful either from a data-quality perspective or from a cost-benefit point of view".

We also welcome that CESR has decided to leave the technical aspects to Level 3 to allow best fit with current arrangements and reporting mechanisms. Furthermore we agree that not all information received by competent authorities needs to be exchanged and that appropriate information exchange mechanisms should be agreed between competent authorities rather than placing additional burdens on investment firms. We also note the work which CEBS is carrying on with a view to using XBRL as a common language for reporting data between banking supervisors and would support CESR's consideration of whether this work, and the XBRL language, could be of use to CESR also.

In our previous response our members had indicated that the original list of information fields proposed by CESR was excessive and would require significant systems changes without clear cost benefit having been demonstrated. We welcome CESR's acknowledgement that all of the information fields in Annex A do not need to be reported in a unanimous way in all transaction reports, especially where it is not appropriate to the nature of the transaction or the information may be obtainable through other means. We therefore support CESR's decision to allow competent authorities to waive the obligation on an investment firm to report some of the individual fields in Annex A. In our members' view, transaction reports should contain the following 8 fields: Firm, Counterparty (if known), Security, Time/date, Price, Size, Buy or Sell, Market/ATS.

Whilst in our earlier response we had indicated some support for the inclusion of a client identifier, more recent feedback has revealed that the majority of our members do not support the introduction of this for the time being.

We therefore support CESR's decision to give flexibility to Member States and not to recommend the introduction of a pan-European client identification code for the time being. Our members would also urge CESR to seek early clarification of the scope of the commodity derivative definition to allow full assessment of the potential impact on transaction reporting regimes.

On a general note we urge CESR to take account of the cost burden that any new and additional pan-European proposals requiring systems changes will impose. CESR should aim to minimise the frequency and number of changes required to systems through regulatory impact assessment and implementation planning.