BRITISH BANKERS' ASSOCIATION

Pinners Hall
105-108 Old Broad Street
London EC2N 1EX

Tel: +44 (0) 20 7216 8800
Fax: +44 (0) 20 7216 8811

BBA RESPONSE TO CESR ADVICE ON POSSIBLE IMPLEMENTING MEASURES OF THE DIRECTIVE ON MARKETS IN FINANCIAL INSTRUMENTS

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.

We welcome the opportunity to respond to this CESR consultation on behalf of our members.

The consultation paper is very complex, long and detailed and we will therefore concentrate in our response on areas where we have particular expertise and/or that are of particular relevance to our member banks. This cover letter highlights our members' key concerns. We expand on those further as well as providing more detailed points in our answers to the individual questions raised by CESR. Although we believe that we have identified the main issues it is conceivable that other issues may arise subsequently and we shall bring these to your attention as soon as is practicable.

In drafting implementing measures on MFID we would like to draw CESR's attention to the following:

- We are grateful to CESR for responding to industry concerns by extending the response deadline for parts of the CP linked to subjects covered by the 2nd mandate to 4 October and we will submit a further response to those parts of the consultation within that timeframe. Given the complexity of the issues covered in this response we would also welcome the opportunity for a second round of consultation. Furthermore we believe there must be willingness to re-visit the overall timetable if it should prove impossible for CESR to sufficiently develop its proposals and appropriately consult on its advice in the very tight time frame given.

- We fully support MFID's objective of creating European securities markets that are fair, competitive, efficient, have integrity and inspire confidence amongst users. However, this can only be achieved if the EU avoids over-prescription and excessively detailed legislation at Level 2 as they are likely to hamper innovation and competition in financial services across the EU. The new regime thus needs to be robust and durable yet flexible enough to respond to market developments without need for substantial Level 1 and 2 revisions. EU Standards should be appropriate for a large number of different firms and risk profiles, and whilst CESR should set general principles it should not set out to prescribe how individual firms run their businesses. CESR should approach Level 2 on the basis that it fleshes out the principles set out in the Level 1 Directive but leaves to Level 3 developing practical methods of delivering the requirements of the operational context.

- A one-size fits all approach will not work across such a varied range of markets and securities and all measures proposed need to be targeted and proportional. This necessitates CESR making a clear distinction between professional and non-professional (retail) markets as well as identifying different market models and targeting its standards and protections appropriately. Such an approach will ensure high overall standards of investor protection without disadvantaging EU markets against non-EU competition. We strongly support that CESR should make use of flexible wording such as "where appropriate" or "where relevant" in its final advice and do not believe that CESR should aim at "elaborating further more precise proposals before final adoption of its technical advice", as suggested in the consultation.

Grandfathering

CESR has invited industry comment on the issue of grandfathering provisions. Overall we believe that appropriate and adequate grandfathering provisions, especially with regards to non-professional (retail) customers, will be a key factor in achieving the objectives of MFID. Existing customers should be "grandfathered" into the new regime, including in respect of their customer classifications (Art 71.6). If CESR does not make adequate grandfathering provisions for instance with regard to client agreements this would be to the detriment of customers who would not only be subject to onerous new documentation requirements but ultimately would also have to bear the costs. Furthermore in our members' experience a significant number of existing customers will fail to return completed agreements due to inertia or lack of understanding of the consequences. This could mean that firms may have to cease servicing customers and transfer assets back to them although this would be against customers' best interests and implicit wishes. Thus, contrary to the objective of MFID, insufficient grandfathering provisions could lead to access to European securities markets being reduced rather than improved.

Transitionals

We similarly would like to express our strong support for adequate transitional measures and phased implementation for various aspects of the Directive which require the industry to make organisational and technological changes. Whilst we understand that it may be necessary to obtain political agreement to bring about such measures not already indicated in the Directive, we would urge Council, Parliament, Commission and CESR to cooperate to achieve this in the interests of financial markets across the EU. For instance we believe that an area where transitionals are required is changes to transaction reporting systems. These are closely interwoven with dealing, clearing and settlement and pre- and post-trade transparency systems. Any changes to any of those elements are likely to be complex and wide ranging involving extensive changes to IT systems across the EU. Our member firms believe that inadequate time for testing and implementing new systems could lead to systemic risk issues across the EU and some of our members have compared the magnitude of the changes arising from the MFID implementation to the Year 2K implementation project. Moreover, it makes sense to take into account the likelihood that the Transparency Directive will result in changes in transaction and information reporting requirements. Ideally both should be implemented together.

Professional vs Non Professional (retail) clients

We would also urge CESR to make a clear distinction throughout its advice between professional and non-professional (retail) markets and target its standards and protections appropriately. Unnecessary costs are created and investment returns are reduced if either too high levels of protection are provided for professional clients and/or non-professionals are overwhelmed with excessive and undesired information. Our members have quoted as examples CESR's extensive disclosure obligations to non-professional (retail) clients regarding conduct of business and best execution obligations.

Similarly with regard to Article 19, we believe there is no need for protecting professional clients over and above the obligation to "act, fairly, honestly and professionally." By definition professional clients are able to assess the suitability of investment services or financial instrument and can in fact request treatment as non-professionals if they so wish under Annex II.

As requested we have provided answers to the specific questions asked by CESR in the order in which they are discussed in the CP. However, bearing in mind requests to prioritise our members' concerns, we would like to draw specific attention to the following key concerns:

Conflicts of Interest and Inducements

Overall we believe the rules proposed are too detailed and many of the proposals in the text should be dealt with in the context of firms' internal arrangements rather than legislative text. As Article 13.3 and 18 of MFID already contain adequate detail, Level 2 proposals should be kept to an absolute minimum and certainly should not exceed the scope of requirements provided for at Level 1. For instance Level 1 text does not require the compulsory disclosure of a conflicts policy or the requirement for client consent suggested by the current Level 2 proposals.

We have particular concerns over CESR's proposals regarding information barriers. Whilst Level 2 should recognise information barriers as an acceptable technique for managing conflicts of interest, it should not set out where information barriers should be placed in companies. We have provided more detailed comments in our answer to CESR's question 6.3. Furthermore we do not believe that CESR should start from the presumption that in every single firm substantive conflicts of interest exist. CESR should acknowledge that where a firm has reviewed its conflicts and found that no conflicts exist, e.g. because it is a single service firm, there should be no further need for a detailed conflicts policy. Of course all firms should be obliged to conduct the review process at regular intervals, say every 12 months.

Our members also feel that the CESR's proposals regarding inducements such as soft commission are impractical. Firms may be able to provide annual updates on the sorts of inducements they give or receive but anything beyond this would invite confusion amongst customers and create a burden on firms that would provide few tangible benefits to either clients or regulators.

Transaction reporting

In MFID the obligations relating to transaction reporting apply to financial instruments traded on a regulated market, however it would appear that the CP envisages applying these obligations to all MFID financial instruments regardless of where they are traded. This would appear to exceed CESR's mandate and we would be grateful if CESR could review this point as a matter of urgency.

If CESR decides to introduce extensive reporting systems to markets not currently subject to such requirements, there is a strong need for transitionals or phased implementation to allow the creation of accurate and reliable systems.

We welcome CESR's intention to maintain existing reporting systems in the medium term in order to keep the cost burden on investment firms acceptable. We also welcome the objective of one-shop reporting for both regulatory and transparency purposes and the fact that CESR proposes the same content of transaction report at national level regardless of the reporting party. However, we believe that the list of transaction reporting fields currently proposed is far too lengthy and the inclusion of so many additional fields is likely to result in substantial additional costs to investment firms without CESR having demonstrated the benefit of such changes. An alternative proposal for the fields to be included is set out in Annex 2

CESR raises the possibility of harmonising existing national reporting channels and monitoring systems at EU level. Whilst we welcome in principle proposals and measures to increase the efficiency and effectiveness of markets we believe that a full cost benefit analysis and consultation will need to take place before all market participants can fully assess the impact of such proposals.

Record keeping

Our members have raised strong concerns over CESR's proposals to reverse the burden of proof by requiring investment firms to demonstrate that they have not acted in breach of the obligations under the Directive. We consider that the existing provisions of the Level 1 text and other sections of the Level 2 advice are sufficient to ensure adequate record keeping arrangements. It is also arguable that such requirements exceed the scope of Directive.

Our members urge CESR to review the current proposal to keep records of all telephone orders on a voice recording system for at least one year, especially if this applies to voice record orders which are not currently voice recorded. For example, telephone orders from non-professional customers given to local bank branches are not currently recorded. We would suggest that only tapes of telephone orders which are already being recorded should be subject to the requirements.

Information to clients and client agreements

The obligation to revise client agreements in accordance with implementing measures specified in the draft advice is an example of where it is imperative to put grandfathering arrangements in place. If grandfathering arrangements cannot be achieved then there is a need for adequate transitional provisions. For example firms will not be in a position to revise client agreements and send them to all existing customers immediately on the coming in force of MFID. For instance one of our member firms estimates that it has 26 million personal accounts across Europe and whilst not all of those will be subject to the provisions of MFID, the cost implications will be very substantial. Furthermore where CESR stipulates the need for client consent and signature (which appear to go beyond both Level 1 and the draft mandate) grandfathering arrangements should be made which state that it is not necessary to obtain client signature on amendments of agreements for existing customers. One of our members, for example, found that the average return rate of client agreements when signature is requested is around one third. Repeated requests provided only marginal improvements.

CESR seems to require a firm to provide all information in writing. We think it is good practice to give the client information on the risks and characteristics of the type of financial instrument he is interested it, i.e. generic information on the possible effects of illliquidity.

However, it is not practicable to require written information concerning the specific instrument, i.e. details about its liquidity, whether it is traded on regulated markets or its duration. We believe that Art 19.3 envisages giving this type of generic information ("standardized format"). In our reading, it leaves information on the specific product to be provided on request (possibly orally) or in the course of investment advice or through a public website. Additional requirements would pose severe problems for existing service models such as direct banking.

Client order handling

Most investment firms have developed sophisticated order-handling systems designed to ensure the fair and equal treatment of clients. Whilst these systems have arisen from a commercial imperative they are closely aligned with the objective of regulation in ensuring overall customer benefit. CESR should therefore allow such practices at the core of good business management rather than imposing over-prescriptive rules that are too inflexible to take account of evolving and improving market practices. We believe that there is no need for CESR to introduce further detail to its current draft advice.

For example order aggregation, which is carried out throughout the EU, should be permitted if aggregation will work usually to the advantage of the client base as a whole and there have been disclosures of the possibility that the effect of aggregation may occasionally work to an individual client's disadvantage. Aggregation of orders is generally only carried out for non-professional clients and the rationale for it is that small orders are more expensive to execute than larger orders. There is generally a benefit to clients whose orders have been aggregated due to reductions in execution, processing and settlement costs. Moreover the aggregation of orders may result in a higher price than would have been obtained for a smaller order.

The Role of the Compliance function

Our members agree with CESR that a firm must be able to demonstrate that the compliance function of a firm is independent. However, we believe that the way in which a firm demonstrates the independence of its compliance function may vary depending on the nature, scale and complexity of the business. In other words, whilst we agree with a general functional requirement for an independent and effective compliance function it should not be an organisational requirement. Thus for instance smaller firms should not need to have a separate compliance department provided compliance is otherwise managed in a way that evidences sufficient independence.

Safeguarding of Client assets

CESR should go no further than requiring a firm to exercise due skill, care and diligence in the selection, appointment and periodic review of the depository. This would include an annual review of the continuing appropriateness of its selection. In particular we feel CESR should not prevent investment firms from selecting unauthorised depositaries as this would substantially reduce consumer choice (since fewer banks will act as custodians). There are many jurisdictions around the world where there are still no regulatory obligations to safeguard client assets and the only way in which to hold securities for clients is through a local custodian. The global basis on which banks in Europe operate must be taken into account.

We would also urge CESR to desist from introducing requirements that suggest that an investment firm underwrites depositary and sub-custodian arrangements and underwrites any losses to the client especially if the burden of proof is reversed with the investment firm having to demonstrate it has acted with reasonable care and skill in the selection of the depositary.
We believe such arrangements would result in lesser choice and higher costs for investors as investment firms are unlikely to wish to take on such additional risks.

<u>Outsourcing</u>

The draft CESR advices outlines a number of options in relation to the outsourcing of investment services, using as starting point the current CESR standard requiring that delegation of portfolio management functions to non-EEA firms may only take place if a formal arrangement such as a Memorandum of Understanding between regulators exists. We consider this unduly restrictive and would in particular oppose any further extension of this provision to other investment services.

We support that outsourcing companies should retain full regulatory responsibility for their outsourced functions. However they should not be prevented from successful commercial operations, simply because regulators are not yet fully cooperating. Our members currently have a number of very successful outsourcing arrangements and these allow investors to benefit from potentially lower costs, cutting-edge technologies and the group's global expertise.

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

Yours faithfully,

Michael McKee
Executive Director
British Bankers' Association

Angela Teke
Director
British Bankers' Association

DETAILED ANSWERS TO QUESTION RAISED IN THE CP:

COMPLIANCE AND PERSONAL TRANSACTIONS (ART 13 (2))

Q.1.1 *Must the compliance function in every investment firm comply with the requirements for independence set out in paragraph 2 (d) or should this degree of independence only be required where this is appropriate and proportionate in view of the complexity of its business and other relevant factors, including the nature and scale of the business?*

A flexible approach that is "appropriate and proportionate" to the nature, scale and complexity of the business should be implemented. It is the role of the senior management to ensure that the compliance function is appropriately managed and whilst we support the general principle of independence we do not believe that this should apply to all firms in the same way nor that the 2 criteria suggested are appropriate in all circumstances. For instance, strict interpretation of the 1st criterion could disqualify a firm from retaining a lawyer as compliance officer to provide legal advice or could possibly even mean that an accountancy firm could not provide audit services.

We also believe that the second criterion regarding the budget and remuneration of the compliance function is unnecessarily restrictive and possibly counterproductive to good risk management practices. Some of our members have already raised their concerns over this issue in their responses to the Basel Committee 2003 discussion paper on "The compliance function in banks". We agree that the remuneration of compliance personnel should not be directly linked to factors such as sales volumes. In particular we agree that any notion has to be avoided that less stringent compliance officers could be materially rewarded for their lack of diligence by business units glad to be subject to less intrusive monitoring. However, the current wording for instance could suggest that compliance officers could not benefit from a general salary bonus pool based on overall business profits, even if this is enjoyed by all other employees of the firm. A good and diligent compliance department is likely to increase the efficiency and value of a business and it would appear counter-productive and de-motivating to exclude good compliance personnel from benefits derived from this overall improvement in business performance.

To take account of these concerns we would suggest rewording Box 1, paragraph 2(d) as follows: *"Remuneration of compliance personnel must not be linked to specific business targets but may, however, be linked to the overall financial performance of the investment firm or to an aggregated performance result (such as the financial performance of a division or department) which includes the outcomes of individual investment business transactions".*

Whilst we welcome the principle of independence we do not believe that this necessarily requires a separate and distinct compliance function. In other words the obligation to have an independent compliance functions should be a functional requirement rather than an organisational requirement i.e. there would be no need in smaller firms for a separate Compliance Department provided compliance was otherwise managed in a way that included sufficient independence. For instance in a small firm it should be permissible for a person to act as compliance officer and hold other responsibilities as well.

Q.1.2 *May deferred implementation of requirements for independence be based on the nature and scale of the business of the investment firm?*

As explained above we do not suggest any formal and general independence requirements but welcome in principle all suggestions that focus on proportional and appropriate legislation. We would be grateful for further clarification from CESR regarding "deferred implementation" and other suggestions for transitional arrangements implied in the question. In principle we welcome the introduction of transitional arrangements in order to take account of the significant implementation burden faced by businesses over the next few years.

Q.1.3 *Should the current text of CESR Standard 127 be retained or should its scope be extended to the outsourcing of all investment services and activities or should paragraph 9(b) be deleted and reliance be placed on the status and responsibilities of the outsourcing investment firm?*

We would wish to see Paragraph 9(b) deleted as this places greater reliance on the responsibilities of the outsourcing firm. We believe that neither CESR Standard 127 nor the extension of scope are acceptable options. Leaving the responsibility and accountability with the firm delegating seems both logical and desirable. We believe that the requirement that delegation to a non-EEA firm can only occur if a Memorandum of Understanding between regulators exists would be unduly restrictive. Successful commercial arrangements should not be prevented simply because regulators are not yet fully cooperating under a formal MoU. Our members currently have a number of very successful outsourcing arrangements in countries such as those in the Far East and this allows investors to benefit from potentially lower costs and the group's global expertise.

In the formulation of its advice we would also urge CESR to take account of other consultations on the topic such as the papers produced by the Joint Forum and IOSCO. Consistency in both language and approach are essential in order to lessen the compliance burden on firms and increase transparency of regulation. We would urge CESR to take account of our response to the CEBS consultation on outsourcing. We have attached a copy of our response in Annex 1.

We would also like to make the following general comments regarding Box 1:

- **We believe that Paragraph 1(b) is intended to make reference to a 2-tier board system including a supervisory board, which is common in some EU member states. However, we do not believe the wording is sufficiently clear, especially for countries in which such structures are not common and could be misinterpreted as regulatory requirement for an external supervisory function, which our members would oppose. We believe that it should be the responsibility of senior management to decide whether issues arising from reports should be discussed with external auditors or other relevant parties. We also would request CESR to remove the explicit reference to external auditors in 4 (c).**

- **Regarding the wording of 3(d) which refers to compliance personnel's necessary "expertise, experience and qualifications" we would suggest rewording to: "*expertise, experience or completion of professional training*". Unlike some other professions such as accounting or law, even in advanced financial markets there are very few official compliance exams or qualifications.**

Many compliance officers have for instance legal or back-office backgrounds and acquire the necessary compliance skills and knowledge through in-house or on-the job training without actually sitting official exams, implied by the word qualifications.

- **On a more general note, and this applies throughout the CP, we urge CESR to avoid using the terminology of "must ensure" (e.g. section 1) as this places unreasonable expectations and liability on the firm and its senior management. Applying a strict liability to a subjective test ignores real life difficulties such as unforeseen staff sickness or force majeure events. Instead we would suggest wordings such as *"take reasonable steps to ensure*" or *"have procedures and controls designed to ensure"*. Even *"reasonably ensure"* - a wording in fact already used by CESR in text Box 2 (section 6) - would be preferable.**

OBLIGATIONS RELATED TO INTERNAL SYSTEMS, RESOURCES AND PROCEDURES (ARTICLE 13(4) AND (5) SECOND SUB-PARAGRAPH)

We would like to make the following general comments regarding CESR's proposals in Box 2:

- **We believe that the CESR's reference to "hierarchical controls" 2(e) is inappropriate and may arise from translation issues. In a number of companies flat hierarchies and matrix management structures have been very successful in achieving appropriate senior management involvement. CESR's proposal should be designed to ensure appropriate responsibility and escalation structures rather than enshrining the concept of "hierarchy" as the only appropriate model.**

- **We believe that the requirement in Paragraph 4 for financial reports to be "verifiable" is excessive and goes well beyond the requirements of internationally accepted accounting standards and principles. Certain elements of financial reports will be partly based on best estimates and assumptions and simply cannot be verified in full. A typical example of this would be for instance the book value of "goodwill" or depreciation. We believe that some of this difficulty may arise from translation difficulties and would urge CESR to revise the wording of its advice.**

We suggest the following alternative wording:

> ***"An investment firm must have accounting policies and procedures in compliance with applicable accounting standards and rules. Firms must have accounting information in a timely manner and the information included therein should be supported by adequate information for audit purposes. The accounts of a firm should not give a misleading view of a firm's financial positions. A firm's accounting procedures should include:…"[Text to continue as CESR text from "a documentation" to end Box 2 para 4).***

- **With regards to 5 (a) it is unrealistic to require that an investment firm's risk management policy should cover "the management and the control of ALL the risks inherent in the investment firm's activities" etc. We believe that a reference should be inserted regarding *"the control of material risks".* There are literally hundreds and thousands of potential risks a firm could face and whilst it is the role of risk management to identify, prioritise and manage the key risk factors it would be beyond human capability to identify every single one of them.**

- **In principle we support the inclusion of requirements for appropriate data integrity mechanisms and contingency planning in Paragraph 6 of the text. However, we feel that that the wording is unrealistic. Whilst companies can *"have procedures and controls designed to ensure"* it is impossible to "guarantee the integrity and confidentiality of information." For instance, a vast number of companies ranging from government offices to the largest banks and even Microsoft themselves have been attacked by malicious computer viruses which can affect both the integrity and confidentiality of information. It is in the interest of companies themselves to create robust IT systems but even the most advanced systems and controls could not guarantee them being absolutely resistant to either human error or malicious sabotage.**

- **We believe that the language of Paragraph 7, including references to "internal control" and "independent risk control and audit functions" should be revised as it is unclear and inconsistent with Box 1 references to the compliance function although the roles would appear to overlap at least partly. Either CESR should be specific how internal control is different from compliance or preferably the CP should consistently refer to the compliance function throughout.**

OBLIGATION TO AVOID UNDUE ADDITIONAL OPERATIONAL RISK IN CASE OF OUTSOURCING (ART 13.5 FIRST SUB-PARAGRAPH)

We would like to make some general comments regarding CESR's proposal.

- **CEBS and CESR have both published requirements for outsourcing. IOSCO and the Joint Forum are also undertaking work on outsourcing. It is vital that CEBS, CESR and IOSCO ensure that these requirements do not diverge. This is particularly important for banks as they will be subject to both CEBS and CESR requirements.**

- **We are not entirely sure that the notion in Paragraph 1 that all outsourcing "could otherwise be undertaken by the investment firm itself" is entirely logical. Outsourcing is done because firms either want to or have to e.g. by importing particular expertise. We believe that CESR has defined outsourcing very widely and we believe that the materiality test in Paragraph 2 should be strictly applied to eliminate certain activities from the scope such as payroll in the HR category**.

- **The requirement in Paragraph 7 for all investment firms to notify competent authorities of their intention to outsource should be subject to materiality requirements. It is unlikely that competent authorities would wish to be deluged with information on firms' insignificant outsourcing activities especially if they have little impact on firm's overall risk profile. It is also unclear what competent authorities would be required to do with such reports. Instead we would suggest that CESR requires all firms to comply with information demands from competent authorities. In addition many firms already inform the authorities of major outsourcing arrangements in the course of their normal dialogue with the supervisors. This would lessen the monitoring burden on authorities but would ensure that all regulatory concerns over outsourcing requirements would be addressed as and when they arise.**

- **We do not believe that section 9(b) on ensuring the ability and capacity of the investment provider should be included in the advice. It is part of responsibility of senior management to "take reasonable care" that appropriate service providers are selected. As this is done in the normal course of business we do not feel that a specific regulatory requirement ought to be introduced.**

- **We do not consider that the requirement of 9(f) to complete access to data in an outsourcing arrangement is realistic in all circumstances due to confidentiality and data protection requirements. Whilst the requirements may be reasonable where record keeping is the outsourced function, a number of firms for example have specifically outsourced certain sensitive data to an independent party that collates, pools and averages data on a confidential basis but for the benefit of all contributors. No individual statistics are made available and contributors themselves do not have access to the database or underlying data, merely rely on reports by the managing entity. Examples of this can be found typically in risk management. For instance a number of banks may provide individual operational risk loss events to a third party on a confidential basis as part of outsourcing their risk management function. The service provider supplies all banks with anonymised statistics and benchmarking data but for confidentiality reasons banks themselves do not have access to the database itself or specific statistics derived from their own data. The BBA itself runs such an operational risk database on behalf of its members. Another example would be a database on credit derivatives reference entities managed by a third party but funded and populated with data from a large number of banks.**

- **Overall we strongly support the overall Principle expressed in 6, namely that outsourcing does not release the investment firm from its regulatory obligations and cannot result in the delegation of senior management responsibility. However, we feel that the level of detail proposed in Box 2 and especially Section 9 is excessive and over-prescriptive. We do not believe that for instance stipulating the contents of service level agreement is appropriate for Level 2 advice and would urge CESR to defer those types of specifics to the work programme undertaken at Level 3.**

- **We also believe CESR is introducing potential uncertainty by referring to separate "service level agreements" alongside "outsourcing agreements". A general reference to *"written agreements setting out the responsibilities of the parties involved"* would be clearer.**

RECORD KEEPING OBLIGATION (ARTICLE 13 (6))

Q.4.1 *Should there be a separate obligation for the investment firm to be able to demonstrate that it has not acted in breach of its obligations under the Directive?*

We argue strongly that there should be no such obligation as the necessary safeguards are already provided by Art 13 (6) and requirements of the Level 1 text which states that a firm shall keep records "sufficient to enable the competent authorities to monitor compliance with the requirements under the Directive". Moreover, even if this is not sufficient, the text of Paragraph 2 (a), (b) and (c) of Box 1 are more than adequate and make the text of Paragraph 4 excessive and unnecessary. It should be deleted.

We also consider that the reversal of the burden of proof introduces in effect a presumption of non-compliance. This issue was debated at length during the ISD debate and rejected at Level 1 and we therefore do not feel that it should be reintroduced in the Level 2 debate. In the case of authorised individuals such clause could arguably work against the spirit of human rights legislation. Furthermore we would object to wording of the obligations, many of which are phrased as "do not". The difficulty of proving a negative is exponentially greater than proving positive action.

Q.4.2 *What should the nature of the record keeping requirements be in relation to i) capital markets business such as equity IPOs, bond issues, secondary offerings of securities ii) investment banking business such as mergers and acquisitions; and iii) general financial advice to corporate clients in relation to gearing, financing, dividend policy etc?*

We have no specific comments regarding the list of record keeping requirements listed in the Annex.

We would also like to make the following general comments:

- **With regards to 2(b) we believe that introducing a requirement to record orders on a voice recording system could cause operational difficulties and disproportionate costs for a large number of firms without necessarily enhancing investor protection. Whilst firms with large trading floors and centralised sales staff usually voice record, many other firms capture orders in other ways e.g. by manual data input. We would urge CESR to adjust this requirement by introducing a reference such as *"where appropriate and proportionate in view of the nature, scale and complexity of the business"* or stipulate more general requirements to *"appropriately document and capture client orders as received"*. This formulation would for instance capture a sales order received over the phone, recorded on paper and then transmitted over the phone to a broker in a recorded conversation. Alternatively, if CESR wishes to focus on voice recording, CESR should amend the paragraph as follows: *"where telephone orders are voice recorded keep these records for a period of at least one year".***

- **We would argue that CESR should drop the specific reference to reproducing records on paper in 2 (c) as this does not reflect current practices and increasing technological sophistication. Whilst it would be theoretically possible to print out the contents of e.g. a firm's client database on millions of sheets of paper it would be far more appropriate and desirable for a regulator to gain access to the relevant information in an electronic format thus facilitating specific searches etc. We also believe that an absolute requirement for regulators to be able to "reconstitute each stage of the processing of all transactions" is unrealistic. CESR's wording should be amended to a general requirement to *"keep an appropriate audit trail for all transactions and instructions"* or a general obligation should be placed on firms to demonstrate they have complied with the relevant conduct of business rules.**

- **As argued previously the word "ensure" in 2(d) should be replaced by *"take reasonable steps to ensure"* or *"have procedures and controls designed to ensure".***

SAFEGUARDING OF CLIENTS' ASSETS (ARTICLE 13 (7) AND (8))

On a general level we would urge CESR to proceed cautiously in this area given that the Clearing and Settlement debate which will have significant impact on the proposals is still open.

Q.5.1: *Where the jurisdiction in which financial instruments have to be held regulates the holding and safekeeping of financial instruments, should investment firms be required to sub-deposit their clients' financial instruments with such institutions in all cases or are there cases in which overriding considerations to the contrary mean that it would be permissible to use an unregulated depository*

We would ask CESR to further elaborate on the reason for asking this question. We also believe that the draft advice is open to misinterpretation and would seek clarification. Presumably if a firm unregulated for such activities operates in a jurisdiction that regulates the holding and safekeeping of financial instruments it would be in breach of local regulation. Clearly in this instance our member banks would not wish to do business with an unauthorised firm. However, our member banks would like the option to use an unregulated institution where authorisation to undertake such activities is not required by the competent authority in that jurisdiction or there are any other overriding considerations. There are many jurisdictions around the world where there are still no obligations to safeguard client assets but the only way in which to hold local securities is through a custodian subject to local law. It does not seem appropriate to preclude clients from having access to such securities if they wish to own them. In such instances all normal obligations in terms of due diligence and acting in clients' best interest should apply. Examples of such jurisdictions would include Russia or Brazil.

Furthermore there will also be jurisdictions where both regulated and unregulated depositories co-exist and in this instance our member firms would still like the flexibility to choose taking into account wider consideration of customer care and choice. Of course this would not discharge firms from appropriate due diligence procedures.

Q.5.2. *Should a requirement be imposed that the records of the investment firm must indicate for each client the depository with which the relevant clients' assets are held, or is it sufficient that the investment firm should maintain records of the amount of each type of asset held for each client and of the amount of each type of asset held with each depository and ensure that the aggregate figures correspond with each other in accordance with paragraphs 11(c) and 13(b)?*

Paragraph 4(b) (regular reconciliation between internal records and confirmation from third parties) of the General Principles of internal systems would seem to permit the latter option and this would represent sufficient comfort and protection. The extra level of detail in option 1 is irrelevant to the general safety of client assets and would impose a significant operational burden, costs of which are ultimately likely to be passed on to clients and end-users.

Q.5.2 (Additional question in Box 5): *Which appropriate systems and controls an investment firm has to put in place to ensure that only financial instruments belonging to clients who have given their consent are used in those arrangements?*

We do believe that CESR should focus on measures that are based on principles rather than prescriptive rules specifying systems and controls investment firms have to put in place. A variety of arrangements would be suitable in ensuring that only financial instruments belonging to clients who have given their consent are used. For instance blocking filters could be operated for clients that had not consented or firms could operate separate accounts for clients that had or had not consented. We therefore do not believe that CESR should specify appropriate systems and controls as long as firms comply with the principle which will be monitored by home state regulators.

Q.5.3: *If the client's assets may be held by a depository on behalf of the investment firm, should:*

a) the investment firm be (i) prohibited from purporting to exclude or limit its responsibility for losses directly arising from its failure to exercise all due skill, care and diligence in the selection and periodic review of the depository; and
ii) be required to accept the same responsibility for a depository that is a member of its group as it accept for itself, or

b) must the contract between the investment firm and the client state the investment firm will i) in any event be wholly liable for any losses the client suffers where the investment firm is directly or indirectly linked to the depository, and (ii) be liable in whole or in part, according to the circumstances, for any such losses unless the investment firm shows that it has exercised all due skill, care and diligence and periodic review of the depository.

Overall we express a clear preference for Option a, subject to a number of amendments. Option b appears to reverse the burden of proof and has to be rejected.

With regards to option a, we believe that the use of the word "all" in respect of due skill, care and diligence is a test that could never be met in the event of the failure of a custodian judged with hindsight. A better formulation would seem to be the use of the term *"appropriate or reasonable skill, care and diligence".* The hindsight test could also potentially pose a problem but at least due diligence would be established based on the circumstances at the time of the selection of the custodian. In respect of the group custodian point, it is unrealistic to believe that responsibility for a group custodian should be the same as for an entity itself. The group structure may mean in practice that the group company operates effectively as a third party entity. On this basis the provisions should be such that due diligence applied to group custodians should be at least as rigorous as that applied to third parties.

If CESR chooses option b serious detrimental unintended consequences should be expected. For instance enshrining those obligations in contracts could cause inconsistencies across the EU due to different local interpretations of contract law. Furthermore these proposals are suggesting that the investment firm underwrites the depositary (including the sub-custodian) arrangements and underwrites any losses to the client.

Investors choose to invest in securities and thereby accept the inherent risks associated in return for potentially higher returns. However, one of the risks, the risk with custody, would have to be borne by the participants in the custody chain with firms involved in custody obliged to guarantee the performance of sub-custodians. If an investor chooses to invest in securities of a risky emerging market, the custodian will be obliged to find a sub-custodian in the emerging market. However, it would appear counterintuitive that whilst the investors bears all other associated risks such as issuer default, regulatory risks etc, the custodian would be obliged to solely carry the risk of the sub-custodian defaulting. Furthermore the concept of "directly or indirectly linked" is not explained and introduces uncertainty into the text and its thinking. Our members believe that such references should be removed.

CONFLICTS OF INTEREST (ARTICLES 13.3 AND 18)

The BBA and its members have extensive experience of dealing with the issues raised in this area having worked on the Market Abuse Directive and the first Mandate given to CESR in relation to disclosures on conflicts by issuers and firms and their analysts ad well as the Forum Group report on Research Analysts and conflicts of interests and various FSA consultations on conflicts of interest.

We consider that Art 13.3 and 18 of MFID contain adequate detail and that there was no need for extensive detail at Level 2. Consequently we would very much welcome CESR taking the view that further detail should be limited to the absolute minimum.

We welcome CESR's intention to "set out flexible principles of general applications across the whole range of business models" with a view to encouraging innovation". However we strongly believe that the current draft text is far too prescriptive and detailed to allow CESR to meet its overarching objective. We also believe that the current proposals do not take account that where a company has clearly identified that there are no conflicts of interest there should be no further requirements for implementing a conflicts policy.

Q.6.1: *Should other examples of methods for managing conflicts of interest be referred to in the advice?*

As CESR points out, it is important that the arrangements a firm employs to manage conflicts of interest are tailored to the nature, scale and complexity of its business. Whilst we feel that the examples by CESR are potentially relevant we do not feel that it would be either possible or desirable to produce an exhaustive list of methods for managing conflicts of interest. We therefore do not propose that CESR should refer to any other methods.

Q.6.2*:* a) *Should paragraphs 8(a) to (f) (or the final list of measures for managing conflicts of interest adopted in response to question 1) be stated as examples of arrangements that may, depending on the circumstances referred to in paragraph 5, be effective methods of providing an appropriate degree of independence in respect of persons engaged in different business activities?*

b) Alternatively, should there be a requirement for an investment firm to include these measures in its conflicts policy to the fullest extent possible unless it is able to demonstrate that it has implemented alternative arrangements for effectively preventing conflicts of interest from adversely affecting the interests of clients? If the answer to question (b) is yes, which of these measures should be subject to the requirement referred to in that question?

Paragraphs 8 (a) to (f) should be provided as examples only – and it would be preferable for the examples to be set out in Level 3 regulatory guidance rather than in Level 2 rules. They should not be legally prescribed as Level 2 rules would be too restrictive and limit the ability of supervisors and firms to develop flexible business approaches designed to achieve the overarching objective of proper management of conflicts of interest.

In our members' experience other legal systems in other jurisdictions do not seek to prescribe in detail in primary law the sorts of conflict management approach which must be adopted. Instead they set the legal requirement that conflicts must be managed and leave most of the detail to regulatory rules or guidance and to internal business controls.

Q.6.3: a) *Is it appropriate for an investment firm that publishes or issues investment research to maintain information barriers between analysts and its other divisions?*
b) If so, which divisions should be separated by information barriers in order to prevent analysts' research from being prejudiced?

It is important to be clear about what the existence of information barriers means. In Paragraph 7 there is a reference to "separation" between different parts of a firm. If this means complete separation, so that there can be no contact between the different parts, then this goes much too far. Our members consider that it is appropriate to have strong information barriers between some parts of a firm. The parts of a firm where it is important to have information barriers in place are between research departments, on the one hand, and investment banking and fund management on the other hand. However, in both cases, this does not preclude certain types of controlled contact. In particular it is well established amongst regulators worldwide that a research analyst can "come over the wall" and become involved in an investment banking transaction in appropriate circumstances and subject to appropriate compliance procedures.

We consider that information barriers should only be mandated by regulators between analysts and i) and ii) since there are a range of more flexible rules and techniques which can ensure a proper distinction between proprietary trading and an analyst without the need for formal information barriers. Indeed it is appropriate for analysts to have access to proprietary traders for a range of reasons – particularly in illiquid fixed income markets. See, for example Part 6 of the BBA/LIBA/IPMA/ISMA guidance on FSA Rules relation to analysts (see Annex 3 attached).

Fixed income research is much more focused on the relative value of one bond compared to another and less focused on information specific to the company whose bonds are being traded.

The likely consequence of restricting access to traders would be to "wall off" research analysts from all other parts of a firm – something which is ultimately likely to result in analysts becoming more expensive, fewer analysts being employed and, overall, less financial information being available to investors.

CESR should bear in mind that regulators have in place a range of other rules which are suitable techniques for dealing with any risks that proprietary traders may act improperly. These include front-running rules and market abuse rules.

This is another area where Level 2 should not set out where information barriers should be placed. This is better dealt with at Level 3. Level 2 should, however, recognise information barriers as an acceptable technique for managing conflicts of interest.

Q.6.4: *Should the derogation from the requirements in paragraph 16 (f) (i) to (v) be available if:*

a) the investment firms complies with the requirements in paragraphs 17, 18 and 19 of the first option set out below

b) the investment firm complies with the requirements in paragraph 17 of the second option set out below?

Both options a) and b) should be available. Option a) is likely to be more relied upon by smaller firms and option b) by larger firms. If a choice has to be made between the two options our members prefer option b).

Our members consider, however, that as they stand the drafting of both options will need some revision to make their operation work practically*.*

The BBA would also like to make the following remarks regarding the wording of Box 6

<u>Identification of Conflicts</u>

- **In Paragraph 1, we would suggest removing the comment that the conflicts policy should "include all reasonable steps to identify…" The process through which the policy is made might be able to include all reasonable steps to identify conflicts but the policy itself cannot.**

- **Paragraph 1(a) taken literally could be taken to apply to a firm's charging structure. Any charge to a client is a profit for the firm and arguably a "detriment" to the client. For the avoidance of doubt we would therefore suggest to specifically exclude the normal commercial relationship with clients from this clause.**

- **With reference to Paragraph 1(c)(iii): fee rebates are not necessarily fee-sharing arrangements but the drafting would imply this. We would suggest amending the wording to the effect that fee rebates should only be covered to the extent that they represent fee-sharing arrangements.**

- **Paragraph 2: We would suggest adding proprietary venture capital activity (including portfolio management) unless this is already covered by the corporate finance definition.**

- **Paragraph 3 is unclear and there is concern if it requires very detailed records to be maintained. The paragraph refers to "categories" of persons and "types" of financial instruments. The obligation may be acceptable if it is very high level but if it is more detailed and would, for example, require day to day tracking of individuals and specific securities it would be impossible to operate. We would prefer an obligation to review the conflicts of interest policy periodically to ensure it meets the requirements of this rule on a continuing basis. Furthermore this review should be retained on record and be accessible to inspection.**

<u>Conflicts Policy</u>

- **Paragraph 5: We suggest adding *"types of client it conducts business with"* to the list of characteristics that must be taken into account when creating the conflicts policy.**

<u>Inducements</u>

- **We believe that the terminology could be misleading. It should be noted that "inducement" is not a term defined in MIFD although the CESR CP provides a definition. Our members felt the term "inducement" could be interpreted in 2 different ways. One interpretation considers inducements to refer to illegal benefits that a firm or its staff are prohibited from receiving. It would be very difficult for senior management and compliance departments if there was some suggestion that "inducements" were permissible in some circumstances in firms. It would be better to use the term *"Gifts and benefits"* as it is the receipt of gifts and benefits which seems to be what paragraphs 9 to 11 are focused upon and it is common practice for most firms to have policies about what gifts and benefits are permissible and what are not. If CESR intends this interpretation, the term "*additional remuneration, gifts or benefits or incentives*" should be used instead of "inducements". We would also suggest removing the words "only if they reasonably assist the investment firm in the provision of its services to its clients". The key is that any gift or benefit should not conflict with the duty to act in the best interests of the clients. Whilst we would encourage individual firms to address such issues in their conflicts policy we do not feel that a strong case for regulatory intervention is given.**

  Alternatively, the term inducement could be read as to refer to practices such as "soft commission" in line with the original CESR Investor Protection standards. In either case the requirement to inform a client "at least once a year, of the relevant details of such inducements" is impractical if it means that a firm is expected to be able to somehow give anything other than a general description of the sorts of "inducements" it receives (e.g. soft commission, prepayment etc). In particular a firm may provide a range of different services to one client some of which may be affected by inducements, others of which may not. A different client may use different services affected in a different way. To oblige firms to establish the resulting variable geometry and try and give differentiated information to clients according to the menu of services which they have selected is to invite confusion among customers and a burden on firms that gives little tangible benefit to clients or regulators. We would propose that 11 (b) should be deleted, or, in the alternative redrafted as follows: *"b) at least once a year, in general terms, of the nature any inducements which it gives or receives."*

<u>Disclosure</u>

- **Art 18(2) of MIFD does not require that there should be written consent when a firm discloses. The requirement for written consent in Paragraph 14 is beyond the "competence/jurisdiction" of CESR and/or Level 2. Disclosure of a conflicts policy should be capable of being done by means of posting the policy on the firm's website. This approach has already been adopted in relation to the requirements for policies in the Market Abuse Directive implementing measures. We would also urge CESR to bring its advice in line with the Distance Marketing Directive, taking into account for example the DMD's provisions on post-transaction disclosure for telephone dealing.**

<u>Investment Research</u>

- **Paragraph 16: We also believe that the provisions should narrow the concept of "distribution" or otherwise this rule will potentially refer to firms that produce research for internal purposes only.**

<u>FAIR, CLEAR AND NOT MISLEADING INFORMATION (ARTICLE 19(2))</u>

We would like to make a number of general comments regarding this Box 7.

- **Paragraphs 1, 2 and 3 apply to any communication and there is no requirement for it to be a marketing communication. This means that the requirement not to omit material information etc could apply to summary and full prospectuses for firms, including reports and accounts. We are concerned that an advertising provision could be used to second-guess the content and presentation of e.g. mandatory Prospectus Directive material and this appears unhelpful. Some text is required to make it clear that this provision is limited to conduct of business communications.**

- **We are also concerned that although MFID is a maximum harmonisation Directive, the requirements of Paragraphs 5 and 8 are worded as minimum requirements, thus allowing national regulators to impose more onerous and divergent requirements.**

- **8(a) (i) and (ii) implies that investment instruments such as for example UCITS funds are inevitably illiquid because they are not traded on a regulated market or MTF and we feel that the wording should be adjusted to avoid such implications.**

- **Paragraph 13 forbids investment firms to "use simulated historic returns in information provided to a retail client or potential client." This requirement is contrary to normal business practice and in fact at least one competent authority/regulator uses simulated historic returns in its own information material. It would be illogical to forbid investment firms to use assumptions widely used by their own regulator.**

- **Paragraph 15 (d): This should be amended to the effect that information provided to the client should not *"deliberately"* mislead the client or *"not be intended to mislead the client".***

INFORMATION TO CLIENTS (ARTICLE 19(3))

The BBA would like to make the following general comments regarding Box 8.

- **On page 55 of the CP CESR states that: "Member States may impose additional requirements in relation the subject matter of the advice". We do not know whether this is, or is not, the true legal position in EU Law as a result of the text of MFID. However, even if this is the case that it is an accurate statement of EU law we would strongly discourage the member states from imposing additional requirements in view of the very detailed nature of the requirements in Box 8 and the overarching objective of achieving a more standardised approach across the EU as a whole. If individual member states impose additional divergent information requirements this will be harmful to the development of a single market.**

- **Box 8 requires a firm to provide all information "in writing". The definition of "in writing" on page 8 of the CP does not treat providing information on a website as "written". It is not obvious to us that EU law level 1 text requires that all the information in Box 8 must be provided "in writing" and where there is no level 1 objection to do this we do not think that CESR should require this. It should be sufficient to provide this information by other means, e.g. a website, a diagram or oral information provided to the client.**

- **Throughout the text, the concept of "provided" should be replaced by the concept of *"made available"* as this provides greater flexibility for both firms and clients. This would also bring the provisions in line with other provisions such as the rules for the UCITS 3 summary prospectus.**

- **Paragraph 6j: We do not believe that a requirement to specify in which language the documents are provided is helpful or necessary. By necessity if the client can understand the information of redress in one language one would expect that the other documents would also be accessible in at least this language, if not others. It is in firms' own interest to be able to communicate with their clients as efficiently and effectively as possible.**

- **Paragraph 7c requests investment firms to provide before the commencement of services "the total price to be paid by the retail client to the investment firm…including all fees, commission charges and expenses... or where an exact price cannot be indicated the basis for the calculation of the price enabling the retail client to verify it". The difficulty is in relation to timing where an advisory client is paying commission. It will not be possible to disclose the actual commission ahead of the provision of advice nor indeed the basis for the calculation of commission at this stage. This disclosure can only be made towards the end of the advisory process when a particular product is recommended since commission will vary depending on the product. However, we believe that there are other ways of making sure that clients have access to adequate information regarding charges. For instance under current proposals, in the UK clients will be given a menu at the start of the process which will list the maximum commission the firm will charge for particular categories of products and the market average commission for those products. Given the practical difficulties outlined above, we believe that in this aspect CESR should amend its advice to the effect that commission should be disclosed *"before effecting a transaction".***

- **Paragraph 15: We believe that the provisions of this paragraph should only refer to retail clients.**

CLIENT AGREEMENT (ARTICLE 19(7))

We would like to make the following general comments regarding Box 9:

- **Some of the elements of CESR's draft advice, e.g. the need for client consent would appear to go beyond Level 1 text and the mandate which are concerned with the contents of customer agreements rather their methods of acceptance. We would urge CESR to review its advice as not to exceed the scope of Level 1 provisions.**

  Furthermore, the requirement that a client agreement must be signed and returned to the firm is a significant problem if it applies to amendments to existing customer agreements. In some jurisdictions such as Germany and Italy, some types of amendments are deemed sufficiently significant to make the agreement a new client agreement and trigger the need to obtain a fresh client signature. Experience shows that chasing existing customers for signatures on a new customer agreement is a thankless, labour intensive and often unsuccessful task. If CESR insists on making provisions for customer acceptance, grandfathering arrangements should be made which state that it is not necessary to obtain client signatures on a new agreement for existing customers. Obviously, we would not wish MiFID implementation to raise questions about a firm's ability to continue a client relationship.

- **Paragraph 3. It would be impossible to draft agreements in a manner that every single client could understand. There are many statistics that indicate that a substantial percentage of the population in EEA countries has basic literacy problems. We would therefore suggest rewording as follows *"the client agreement must be drafted in a manner that is clear and understandable for the average retail client".* Alternatively CESR may just refer back to the requirement that communications to all clients should be *"fair, clear and not misleading".***

- **We are also concerned that although MFID is a maximum harmonisation Directive, the requirements of Paragraph 4 are worded as minimum requirements, thus allowing national regulators to impose more onerous and divergent requirements.**

- **Paragraph 10 (e) we suggest inclusion of the word *"discretionary"* prior to management. We do not believe that clients wish to be informed of the delegation of ancillary administrative and other services that have little impact on the portfolio management activity.**

- **We would be grateful for further information from CESR on its intention to "consult subsequently on the professional client agreement."**

REPORTING TO CLIENTS (ARTICLE 19 (8)

We would like to make the following general comments regarding Box 10:

The wording of Paragraph 8 and 9 of Box 10 is unclear. Paragraph 8 should express more clearly that the statement of client assets needs to be sent only once. For example, if a monthly statement is sent it is not also a regulatory requirement for there to be a further annual statement aggregating the information already given in the monthly statement. This would be unnecessary duplication.

In paragraph 9, members were particularly unclear about the meaning of paragraph 9(b). It is clear that paragraph 9 is intended to assist firms and allow them to comply with paragraph 8 by means other than a periodic statement or by providing some of the information separately from the periodic statements. Whilst we support this concept in principle, it would be helpful if CESR could give firms a better idea what sorts of additional material might be acceptable.

Q.10.1: *What type of reporting requirements relating to the provision of investment advice should be included in the advice to the Commission? When should such requirements apply and what concrete requirements should be imposed?*

We believe that the provisions of Box 10 and other parts of the CP are already sufficient and that there is no need for any other reporting requirements. We would also seek clarification from CESR that the advice is restricted to retail clients. In our view these requirements are not appropriate or proportionate for professional or market counterparty clients.

BEST EXECUTION (Article 21)

THIS PART OF THE SUBMISSION WILL BE SUBMITTED ON 4 OCTOBER

Q.1: *Are the criteria described above relevant in determining the relative importance of the factors in Article 21 (1)? How do you think the advice should determine the relative importance of the factors included under Article 21 (1)?*

Q.2: *Are there other factors that firms might wish to consider in determining the relative importance of the factors? Do you think that the explanatory text clearly explains the meaning of all different factors in respect of financial instruments?*

Q.3: *How might appropriate criteria for determining the relative importance of the factors in Article 21.1 differ depending on the services, clients, instruments and markets in question? Please provide specific examples.*

Q.4: *Please provide specific examples of how firms apply the factors in Article 21(1) to determine the best possible results for their clients.*

Trading Venues To Be Included In Execution Policy And Obligation To Monitor And Update Execution Policy

Q.1: *What investment services does your firm provide?*

Q.2: *How many venues does your firm access now? Does your firm expect to access more venues after the Directive becomes more effective?*

Q.3: *What factors does your firm consider in selecting and reviewing venues?*

Q.4: *Please provide specific examples of costs you consider in evaluating venues.*

Q.5: *How do costs affect your decisions about venue selection?*

Q.6*: Do you take account of implicit costs such as market impact? Is the question of implicit costs only relevant to firms that act as portfolio managers?*

Q.7: *What specific events have led your firm to re-evaluate venues in the past? Please provide examples of how your firm has changed the venues that it access as the firm, its clients, or markets have changed.*

Q.8: *Have we identified the key criteria?*

Q.9: *What data is available to carry out these reviews? If no data is available, are market solutions likely to provide it?*

Q.1*: What kinds of monitoring arrangements do firms use now?*
Q.2: *How frequently do firms monitor execution quality?*

Q.3: *What data is available to aid firms in their monitoring obligations? What does the data cost?*

Q.4: *In what respects does the frequency with which firms monitor execution quality depend on the types of instruments, clients, markets and investment services in question? Please provide specific examples.*

Q.5: *What, if any, market data do firms consult in order to monitor execution quality?*

Q6: *What additional data do firms expect to use after the Directive's transparency requirements become effective?*

The Timing Of Venue Assessments

Q.1: *How frequently do firms review the venues to which they direct orders on behalf of clients?*

Q.2: *Do firms re-evaluate their trading venues:*

-whenever there is a material change of any of the trading venues?
-whenever there is a material change at the firm that affects its execution arrangements?
-whenever the firm's monitoring indicates that it is not obtaining the best possible result for clients on a consistent basis?

Q.3: *What difficulties would firms face in reviewing their execution arrangements in response to each of the forgoing events?*

Q.4: *Do venues make firms aware of material changes in their business?*

Q.5: *Please provide examples of instances in which firms have changed the venues that they use.*

Information to The Clients On The Execution Policy Of The Firm

Q.1: *At present, how many venues do firms access directly? Indirectly?*

Q2: *Should an investment firm be required to provide clients and potential clients with information on the percentage of a firm's orders that have been directed to each venue?*

Q3. *For example, should an investment firm be required to disclose to clients and potential clients what percentage of its client orders were executed in the trading venues to which the firm directed most if its client orders (to cover at least 75% of transactions executed)*

Q.4: *How frequently should investment firms make this information available to clients? On a quarterly basis for example?*

Q5: *Should firms be required to update the information to reflect recent usage? How frequently?*

Q6: *Are there any other categories of information that a client or potential client needs to be adequately informed about the execution services provided by the firms?*

Q7: *Should the information provided by portfolio managers and firms that receive and transmit orders be different from that provided by brokers? What are the key differences?*

Q.8: *Have all key conflicts of interest been identified?*

Q.9: *When should firms be required to provide required disclosure to clients and potential clients?*

Q.10: *Is there any reason to impose different timing requirements for disclosure under Article 21 than are required in the Level 2 measures under Article (19.3)*

CLIENT ORDER HANDLING (ARTICLE 22 (1))

Q.1*: Do you agree with the definition of prompt, fair and expeditious execution of an order from a client? Do you think that it is exhaustive? If not, can you suggest any elements to complete this concept?*

We agree with this wording in principle, although we are not entirely clear why CESR consults on the Level 1 text. If by this question CESR enquires whether we agree with the text of paragraphs 2 to 7 of Box 11, we agree, subject to the following comment in relation to paragraph 7. The primary rule in paragraph 6 should be to execute non-professional orders sequentially. However, there are a variety of situations when this may not be appropriate and would not disadvantage the client. Some of these circumstances would occur for reasons other than market conditions or the characteristics of the order. In view of this we would suggest that it would be preferable to make the text of paragraph 7 a little less prescriptive. We would propose changing the wording to: *"or for other reasons do not disadvantage the client."* This wording mirrors the approach of paragraph 8 on aggregation and gives an appropriate balance between the interests of clients and firms' need for operational flexibility. We also would urge CESR not to introduce further prescriptive and detailed rules in addition to the advice already given for example with regards to aggregation which is permissible under the current wording and should remain so. Our remarks to Q.5 refer.

Q.2*: Do you think that the details of the orders included under paragraph 2 of the draft technical advice should apply also to professional clients?*

Our members support the extension of the above provisions to both professional and retail, i.e. non-professional clients.

Q.3: *Which arrangements should be in place to ensure the sequential execution of clients' orders?*

We do not believe that reference to specific arrangements or procedures should be made at Level 2 and that paragraphs 6 and 7 are sufficient to ensure sequential execution of client orders. National supervisors should ensure that regulated firms' procedures and processes ensure the sequential execution of clients' orders.

Q.4: *Do you agree with the reference in paragraph 7 of the draft technical advice to prevailing market conditions that make it impossible to carry out orders promptly and sequentially?*

Yes, we agree in principle. However, we would suggest a slight linguistic change: "do not apply where the characteristic of the order and/or prevailing market conditions make this impossible or *are* otherwise in the interest of the client."

Q.5*: Do you think that the possibility that the aggregation of client orders could work to the disadvantage of the client is in accordance with the obligation for the investment firm to act in the best interest of its clients?*

We agree that the aggregation of client orders is compatible with the obligation for the investment firm to act in the best interest of its clients. Whilst it is conceivable that aggregation may not always achieve the best possible price for individual clients, over the whole of the order book substantial benefits such as reduced clearing and settlement or processing costs can be achieved, thus benefiting the average rather than the individual client.

Q.6: *Do you think that the advice should include the conditions with which the intended basis of allocation of executed orders in case of aggregation should comply or should this be left to the decision of each investment firm?*

We strongly believe that the above conditions should be left to the discretion of individual investment firms.

Q.7: *Do you consider that CESR should allow the aggregation of client and own account orders? Do you think that other elements (i.e. in respect of the arrangements in order to avoid a detrimental allocation of trades to clients) should be included?*

Our members believe that the aggregation of client and own account orders should be allowed. However, we feel that whilst firms should be allowed to aggregate they should be required to make appropriate disclosures to clients regarding their existing aggregation arrangements and the possibility that the effect of aggregation may sometimes work to the individual client's disadvantage. This could for instance include a section in a company's general terms of business outlining its aggregation arrangements and policy.

Aggregation of orders is carried out throughout the EU mostly for non-professional clients as small orders are more expensive to execute than larger orders and there is generally a benefit to clients whose orders have been aggregated due to their reduction in settlement and execution costs. As the price of a security may move between the date an order is placed and the date when the order is executes, sometimes the revised price is lower than it would have been at the time when the order is given (but it could equally be higher). Usually any lower price is offset by the lower settlement costs and aggregation works to the overall advantage of the client. Moreover the aggregation of orders may result in a higher price than would have been obtained for smaller orders – again another potential benefit for customers of aggregation arrangements.

We do not believe that any other elements should be included.

Q.8: *Do you think that paragraphs 15 and 16 of the draft technical advice should only apply to retail clients?*

Yes, we believe that paragraphs 15 and 16 should only apply to retail i.e. non-professional clients.

We would also like to make the following general comment regarding Box 11:

- **In Paragraph 2, CESR's draft advice suggests that the investment firm must ensure the order is "clear and precise". We do not believe this requirement is helpful or necessary as it would be very difficult for investment firms to demonstrate compliance. As long as the investment firm understands what the client wants, records and executes it appropriately, there should be no need for such requirement and we would suggest deletion of it.**

PRE-TRADE TRANSPARENCY REQUIREMENTS FOR REGULATED MARKETS (ARTICLE 44) AND MTFs (ARTICLE 29)

THIS PART OF OUR RESPONSE WILL BE SUBMITTED ON 4 OCTOBER

Q.12.1: *Do consultees agree with the specific proposals as presented or would they prefer to see more general proposals?*

Q.12.2: *Is the content of the pre-trade transparency information appropriate?*

Q.12.3 *Do consultees agree on the proposal regarding the depth of trading interest and access to pre-trade information?*

Q.12.4: *Do consultees agree on the proposal exemptions to pre-trade transparency> Are there other market models which should be exempted?*

Q.12.5: *Do consultees support the waiver for "crossing systems" as defined in paragraph 13? Could pre-trade transparency for crossing systems have a negative impact on liquidity or create the potential of abusive behaviour?*

Q.12.6: *Do consultees support the same minimum size of trade for the waiver to transparency pre-trade and delayed publication post-trade? Are there circumstances in which the two should be different?*

Q.12.7: *Do consultees have a preference for one of the options proposed for defining the block size, are there other methods which should be evaluated?*

POST-TRADE TRANSPARENCY REQUIREMENTS FOR REGULATED MARKETS (ARTICLE 45) AND MTFS (ARTICLE 30) AND FOR INVESTMENT FIRMS (ARTICLE 28)

THIS PART OF OUR SUBMISSION WILL BE SUBMITTED ON 4 OCTOBER

Q.13.1: *Do consultees support the method of post-trade transparency (trade by trade information), should some other method be chosen (which)?*

Q.13.2: *Do consultees support the inclusion of "aggregated information" in paragraph 223 or should it be left for market forces to provide on the basis of the information disclosed under paragraph 21. If it is included what should the content be?*

Q13.3: *Do consultees support the two week period for which the post-trade information should be available?*

Q.13.4: *Should some minor trades be excluded from publication (and if so, what should be the determining factor?*

Q.13.5: *Do consultees agree on the method of defining the time limit in paragraph 24 and is the one minute limit capable of meeting the needs of occasional off-market trades?*

Q13.6: *Do consultees support the view that only intermediaries who have created a risk position to facilitate the trade of a third party should benefit from deferred publication or should all trades which are above the block size be eligible for deferred publication?*

Q.13.7: *Should the identifier of a security be harmonised and if so to what extent? What should be the applicable standards (ISIN code, other?)*

Q.13.8: *Should more information be available on stock lending? If so, which should be the content? Are there other similar types of activities which should be covered?*

Q.13.9: *Should CESR initiate work, in collaboration with the industry and data publishers, to determine how best to ensure that post-trade transparency data be disseminated on a pan-European basis?*

ADMISSION OF FINANCIAL INSTRUMENTS TO TRADING (ARTICLE 40)

THIS PART OF OUR RESPONSE WILL BE SUBMITTED ON 4 OCTOBER

Q.14.1: *Do consultees agree on the requirements for admission to trading? Should more (qualitative and/or quantitative) criteria for admission to regulated markets be specified in the level 2 measures. If yes, which?*

Q.14.2: *Do consultees agree on the role proposed for RMs in order to ensure that the issuers fulfil their disclosure requirements?*

METHODS AND ARRANGEMENTS FOR REPORTING FINANCIAL TRANSACTIONS

The BBA welcomes the objectives relating to transaction reporting of achieving greater convergence of supervisory rules and practices across Europe and allowing supervisors to fulfil their supervisory duties in terms of market integrity and investor protection.

In particular we endorse CESR's intention to "refrain from unnecessary new requirements that would involve radical changes to existing arrangements and would bring about excessive additional costs for the entities concerned". It would be very costly to implement new IT systems across Europe, especially as reporting systems are at different stages of maturity.

Ideally transaction reporting should deliver the possibility for firms to choose a pan-European one-stop shop to which all transactions can be reported. Firms should have the option of reporting to the regulator where they do most of their business and also to exchanges or ATSs which are prepared to transmit transactions on that exchange or ATS to the regulators. The national regulators and the exchanges should be responsible for exchanging transaction data amongst themselves where it is necessary for one regulator to have information about transactions to another regulator or exchange. We would also hope that over time the common transaction reporting content could be used for clearing and settlement purposes as this would have a substantial positive impact on the efficiency of market operations. Moreover, it makes sense to take into account the likelihood that the Transparency Directive will result in changes in transaction reporting requirements. Ideally both should be implemented together

In MFID the obligations relating to transaction reporting apply to financial instruments traded on a regulated market, however it would appear that the CP envisages applying these obligations with regard to all MFID financial instruments regardless of where they are traded. This would appear to exceed CESR's mandate and we would be grateful if CESR could review this point, which was raised at the open hearing in Paris, as a matter of urgency.

Q1: *Should competent authorities be able to waive the requirement for investment firms to report transactions in electronic format? Should such an exemption be limited to exceptional cases, and what cases would those be in your view?*

Overall the BBA supports harmonisation and standardisation of reporting requirements and report delivery methods as far as possible and feasible. Electronic reporting is one of the key ways of achieving this.

However, we feel that that there may be a few circumstances where CESR should consider granting an exemption from electronic reporting. One such exception could be technical problems with a company's electronic reporting mechanism for instance due to integration problems following a merger (in this case the exemption should be time limited). Another example might be where new types of instrument are being developed in a new or existing market. Finally there may be limited scope for exemption for firms undertaking occasional trades outside established venues such as exchanges.
For instance a small retail stockbroker may occasionally purchase or sell debt securities (e.g. Eurobonds) on behalf of his clients from a dealer in the OTC market. As this would be an occasional transaction and most eurobond trading takes places outside regulated markets full electronic reporting would not be cost effective for firms and limit choice for investors.

Each such exception would have to be considered on a case-by-base basis and it is essential that those investment firms that report in non-electronic formats are subject to the same regulatory scrutiny and supervision. It is important the level 2 provisions allow sufficient flexibility for suitable provisions at Level 3.

Q4: *Do you agree with the set of the general minimum conditions suggested? If you do not agree, what other general conditions would be more appropriate in your view? In particular, taking into consideration the responsibilities of investment firms on the one hand and third parties and other reporting channels, on the other, do you think that CESR should include the requirement of a standard-level agreement between an investment firm and a reporting channel in the list of general minimum conditions, or would this be better addressed at level 3. What is your view on the border line as to the responsibilities for reporting if done by a third party acting on behalf of an investment firm or by a reporting channel?*

These high level suggestions seem reasonable and appropriate at first sight. We welcome the move to apply the same criteria to transaction reporting systems and parties across the Member states. However, we believe that writing a provision for service level agreements into level 2 is too detailed and any such requirements should be dealt with at national level.

Q2: *In respect of bond markets and commodity derivative markets, new systems for reporting financial transactions will probably have to be put in place in many member states, in order for investment firms to be able to meet the requirements of the Directive and Level 2 advice. To what the extent should the implementing measures allow market participant more time to implement these proposals (transitional regime?) What could be legitimate reasons for such a possibility?*

In our previous submissions on the topic we have highlighted the need for a light-touch regime regarding those markets. Given the very tight implementation deadline of 30 April 2006 and the absence of comprehensive reporting mechanisms for some derivatives and OTC bond markets there would appear to be a need for as much time as possible and we strongly recommend a transitional regime that will allow such an infrastructure to be put in place. There are a number of legitimate reasons for a transitional regime such as the substantial cost of implementation, the fact that these markets are mostly used by professionals and there is therefore a lesser consumer protection rationale and the need for establishing systems that are accurate and reliable rather than merely rushed through to fulfil regulatory requirements.

Q3: *To what extent should CESR investigate the possibility for future convergence between national reporting systems? What are the advantages and disadvantages of harmonising at EU level the conditions (including format and standards) with which all the reporting methods and arrangements have to comply in order to be approved, instead of, as proposed by CESR, harmonising the conditions at a national level? What impact might harmonisation have on existing national reporting channels, national monitoring systems and on the industry?*

We believe that at this stage CESR should confine itself to the current proposals for the short and medium term. A long-term goal could be reporting towards a "central hub" which would in turn disseminate transaction reports to the relevant authorities.

For instance some of our member firms currently use 4 or more different reporting media for standard transaction reporting from their clearing and settlement systems and the creation of a central hub would eliminate the need for firms to maintain separate interfaces linking to their operating systems. However, before any such proposals are implemented there is a need for thorough consultation, cost benefit analysis and impact assessment. CESR also raises the issue of common database on page 133 of the draft advice. Whilst we welcome proposals that increase the effectiveness and efficiency of markets in the medium to long-term, in principle, we would need to see more detailed proposals and cost-benefit analysis before being able to provide more specific feedback.

Q5: *What other issues, if any, should CESR take into account when responding to the Mandate regarding the "methods and arrangements for reporting financial transactions"?*

We believe it is important that firms are allowed to rely on other reporting systems and mechanisms such as those employed by their brokers.

<u>CESR PROPOSAL TO DETERMINE MOST RELEVANT MARKETS IN TERMS OF LIQUIDITY</u>

Q1: *Do you agree with the approach to use proxies as suggested above? If you do not agree, what other approach would be more appropriate in your view?*

Q2: *Do you agree with the suggested proxies? If you do not agree, what other proxies would be more appropriate in your view?*

The BBA welcomes CESR's proposal to "create a model that allows comparison of activities in different markets that is easy to implement, consistent and takes into account cost benefit issues."

We also agree with CESR that liquidity is neither static nor can liquidity in different markets with varying market structures and models be easily calculated and compared.

It is therefore essential to create a model that is flexible enough to take account of changing and developing liquidity positions whilst avoiding the costly annual computation of liquidity for every single instrument listed on regulated markets in the EEA.

In particular we welcome CESR's analysis that in share markets "the existence of multiple trading platforms has not let to fragmentation of liquidity". This is a point we have raised throughout our submissions on the ISD/MFID and welcome CESR's statistical analysis which has provided further evidence for this.

In its calculation CESR has used 3 different liquidity criteria, namely

a) **Volume (amount of financial instruments traded in a defined period of time)**
b) **Turnover (amount of financial instruments traded in a period of time multiplied with respective prices)**
c) **frequency of transactions (number of transactions being concluded in a defined period of time)**

We agree with CESR that frequency of transactions is the least appropriate criterion. Our members prefer volume as the liquidity criterion. CESR acknowledges this is at least as suitable as turnover. Frequent changes in the most liquid market should be avoided and our members welcome CESR's suggestion to avoid too frequent computation of liquidity for instruments not covered by the proxy approach.

We also welcome CESR's recommendation to consider all markets not just regulated markets as this will improve competition and innovation across trading platforms. The most liquid market in a security is the member state where most of the transactions are completed regardless of whether it is conducted on a regulated market, OTC or MTF. Care needs to be taken how volumes and other liquidity measures are calculated by exchanges, ATS etc in order to avoid e.g. double counting of buys/sells.

Given the difficulties and cost in calculating the liquidity we welcome the use of proxies in principle.

Q3: *Do you agree with the suggested revision procedures? If you do not agree, what other revision procedures would be more appropriate in your view? In particular, do you agree that the launch of the review procedure should be at the discretion of competent authorities? If not, what other factors should trigger the launch of the review procedure? Do you agree that the time period to be taken into account when applying the criteria "turnover" and or "volume" and the definitions of such criteria can vary according to the financial instrument under consideration? Do you agree, therefore, that the time-period cannot be determined in a Level 2 legal text and should be defined under Level 3 arrangements for cooperation between competent authorities? If not, please provide suggestions regarding the time period that should be taken into account?*

Whilst we appreciate that there should be some scope for a revision procedure (and indeed Level 1 text requires this) we would strongly advise against a process that is unduly complex and onerous. Cooperation and transparency between regulatory authorities will be essential in making the suggested process work.

In terms of the revision procedure we appreciate that CESR wants to take account of changes in rapidly developing markets and make sure that the most appropriate authority is responsible, however too many changes must be avoided in the interests of market security and stability. We would also suggest that CESR would seem the right body to oversee this and make the ultimate decision which market was "the most liquid" by setting up consistent decision guidelines. CESR's comments regarding Art 58, hint at a "mechanism for finding solutions at Level 3 for cases of disagreement between competent authorities" and we would welcome any further clarification on this point which is also of relevance to other directives.

Q4: *There are specific cases, such as simultaneous IPO in more than one Member State, where the proxy approach does not work. Should such cases be addressed at level 2, and if so, in more general terms leaving the details to Level 3, or in a more detailed way already at Level 2? Are there other cases to the one mentioned?*

We do not believe that these cases should be addressed at Level 2.

Q5: *What other issues, should CESR take into account when responding to the mandate concerning the "criteria for assessing liquidity in order to define the most relevant market in terms of liquidity for financial instruments"?*

We have no other comments to make.

MINIMUM CONTENT/STANDARD FORMAT OF TRANSACTION REPORTS

Q1: *Do you agree with the approach to standardise/harmonise the list in Annex A to this draft advice at a national level in order to be able to keep reporting systems that are already in place? If you do not agree, what approach do you think would be more appropriate?*

We welcome CESR's intention to maintain existing reporting systems in order to keep the cost burden on investment firms acceptable. We also agree that the content of the transaction report should be the same at national level regardless of the reporting party and welcome the objective of one-shop reporting for both regulatory and transparency purposes.

In principle the reporting fields should only cover that information which is essential and required at short notice. Data which is not required on the first day of reporting should not be included as it can be requested at a later date if it is required e.g. for a regulatory investigation.

MFID enshrines extensive record keeping requirements for authorised firms so these can be relied upon for information required on an ad-hoc basis. We believe that the current list of fields proposed is far too lengthy and additional benefit derived from their inclusion has not been demonstrated by CESR.
No cost benefit analysis has been conducted by CESR, and the inclusion of such a large number of additional fields is likely to result in substantial additional costs without additional benefits having been demonstrated.

Q2: *What are the advantages/disadvantages of moving towards harmonisation at EU level as regards the standards or format of the list in Annex A to this draft advice? To what extent would a harmonisation at EU level of the standards or format of the list in Annex A to this draft advice impact the existing national data collection mechanisms and national transaction databases? Do you see merits in having an EU harmonised regime for the content and format of transaction reports, taking into consideration whether future and immediate long-term benefits could compensate the initial costs of harmonising the transaction reports?*

We believe that changing existing national data collection mechanisms would have substantial cost and resource impact and should not be attempted without a thorough cost benefit analysis. The current proposal of harmonisation at national level achieves objectives of efficiency and transparency without imposing undue cost burdens on the industry.

Q3: *Do you agree with the proposed fields in Annex A and B to draft advice? If you do not agree, what other fields would be more appropriate in your view?*

Regarding the Instrument Security Code, we would prefer a common security identifier rather than ISINs which are not specific enough to be useful for regulatory, transparency and settlement purposes. We have suggested a list of appropriate data requirements previously (see our April 2004 response to Q2 of CESR's Consultative Paper on Transaction Reporting attached in Annex 2)

CESR should also take into account the work of the Reference Data Coalition and the Reference Data User Group. However, CESR will have to bear in mind that whilst most market participants welcome harmonisation and standardisation in principle, CESR will need to allow enough time (including transitionals and phased implementation) so that investment firms can implement the necessary systems changes.

Q4: *How would you define the field "agent/proprietary"?*

In the UK companies that trade on behalf of a client, define themselves as agents and quote 'A' in the capacity field. Proprietary is where firms trade on behalf of their own book and quote a dealing capacity of 'P'. This allows the FSA and the Recognised Investment Exchange (The London Stock Exchange for cash, equities and many bonds) to see in what capacity they have dealt.

Q5: *What are the advantages/disadvantages of requiring the field "client identification code" in transaction reports, bearing in mind the objectives of transaction reporting? What are your views on making the client/customer identification field mandatory in transaction reports? What are your views on the idea to promote a pan-European code for client/customer identification? Do you see any legal impediment to the introduction of such a code in your Member State?*

The advantage of quoting the client identification code is that it allows the regulator to monitor who is trading on behalf of whom e.g. in the case of take-over attempts. For the ease of consistent reporting we believe that the client identification fields should be a mandatory requirement With regards to operating a pan-European client code, there is already a global code being developed by the BIC, so it is extremely important that Europe should mandate to use the BIC instead of developing its own client codes and that there should be transitional arrangements to permit the introduction of BIC codes first.

Q6: *What other issues, if any, should CESR take into account when responding to the mandate concerning the "minimum content and the common standard or format of the reports to facilitate its exchange between competent authorities"? Will this approach serve the objectives pursued?*

We welcome CESR's objective that "the sharing of information between authorities is a matter for the competent authorities and should not require any further involvement of investment firms." We also welcome initiatives designed to improve interaction and cooperation between competent authorities. However, in developing common formats and information exchanges, CESR needs to ensure that there is a real value and utility to the information being exchanges. Documentary evidence is only a useful adjunct but not a substitute to human beings interacting with each other in a meaningful and cooperative way.

As the statutory powers and jurisdictions of regulators in different member states vary significantly, we would like to encourage CESR to work further on developing common approaches to information sharing at Level 3

OBLIGATION TO COOPERATE (ARTICLE 56(2))

Q.18.1: *To what extent do you agree with the additional situations outlined in paragraph 11?*

We have no specific comments regarding this question.

Q.18.2: *In determining whether a regulated market is of substantial importance, do you consider the factors listed in paragraph 22 and 23 appropriate and are there any other factors which you believe CESR/competent authorities should take into account?*

In principle the proposed factors do not seem unreasonable and we feel there are no significant other factors that should be taken into account.

Q.18.3: *To what extent should the overall size/nature of the economy of the host Member State and other economic factors such as sectoral figures in relation to the issuer's activity, employment figures be taken into account as a factor to include in paragraph 23?*

We believe that an additional factor that should be taken into account is the relative size and significance and liquidity of the financial markets of the host member state (rather than the economy as a whole).

COOPERATION AND EXCHANGE OF INFORMATION (ARTICLE 58)

Q.19.1: *Do you agree with the general conditions with which all the competent authorities designated as contact points would have to comply? If you do not agree, what other general conditions would be more appropriate?*

Q.19.2: *Do you agree with the proposal for when and how often transaction reports should be exchanged? If you do not agree, what other alternatives would be more appropriate in your view?*

Q.19.3: *What other issues if any, should CESR take into account when responding to the Mandate concerning the "exchange of transaction reports between competent authorities designated as contact points"?*

Q.19.4: *Is the split between level 2 and level 3 appropriate*?

With reference to Questions Q19,1 to 19.4, we strongly welcome all initiatives to enhance cooperation between Member states designed to enhance regulatory transparency and minimise the burden on investment firms. We have no other specific comments to make.

Q1: New systems and databases for the exchange of transaction reports will probably have to be put in place by the competent authorities designated as contact points in order to be able to meet with the requirements of the Directive. Do you think that the implementing measures should allow for the possibility of competent authorities to have more time available for setting up such systems, and why? How long should such a period be?

As outlined previously we welcome transitionals in principle. However, if additional implementation time is granted this must be extended to *both* investment firms and competent authorities.

Q2: *What could be the advantages/disadvantages of a common database, as explained in paragraph 44 above, in particular taking into account cost-benefit considerations? Could a common database be useful for other information to be exchanged between competent authorities? Should a common database be created at Level 2 or Level 3?*

Overall our members can see the potential benefits of such a common database. However, we would need more details, in particular a detailed cost-benefit analysis before making a final judgement. Given the wide ranging impact of such proposals, a full and thorough consultation will be required. We believe such consultation and implementation should be undertaken at Level 3 unless practical considerations make this impossible.

Q.3: *CESR considers undertaking more detailed work on the issue of a mediation mechanism in case of disagreements between competent authorities. Such a mechanism would not only cover the situation envisaged by Article 16(2) and (4) of the Market Abuse Directive, but might be a more general approach by CESR at Level 3. Do you have any views whether such a mechanism would be appropriate for areas of the Directive (e.g. concerning the identification of the most liquid market or exchange of information)? Are there any other areas of the Directive where such a mechanism should apply?*

We welcome CESR's in principle proposals to undertake more detailed work on the issue of a mediation mechanism between competent authorities. However such a mechanism must not interfere with the right of the entities involved to seek recourse to legal remedies and it should be developed in a way that it does not create a conflict of jurisdictions.

As previously outlined in our response to CESR's CP on its role at Level 3 of the Lamfalussy Process, a mediation agreement could take a variety of forms. For example all CESR members should sign up to a mediation agreement through which, with the mutual agreement of the members concerned, the Chairman of CESR would appoint another member of CESR (which might include himself) to mediate between the disputing members with a view to resolving any dispute between them. The process would be consensual and would usually be used for bilateral disputes or disputes between a small number of members. In circumstances where the dispute evidenced an issue which was of wider interest the mediator could also refer the more wide-ranging issue for consideration and decision at a CESR Chairman's meeting. We also consider that it would be useful to have a senior non-CESR figure who could act as an ombudsman or mediator between a firm and a CESR member in circumstances where the firm was unhappy about a decision by its host regulator. The examples given, e.g. identification of the most liquid market would seem suitable areas for a mediation mechanism.

ANNEX 1:

BBA Response to CEBS Consultation Paper on High Level Principles on Outsourcing (July 2004)

General

The BBA acknowledges that the High Level Principles (HLP's) are a work in progress and, in that context, urges CEBS to be cautious in trying to develop the concepts of "core and strategic activities".

Currently outsource service providers in the UK are unregulated (unless they are performing a controlled function, e.g. selling, trading, etc.). However CEBS appears to suggest that it might be useful to change this. The BBA would be reluctant to support such a stance as it could increase the costs of outsourcing, reduce the number of providers, stifle innovation and act as a barrier to entry for new suppliers.

The BBA believes, as a general point, that an institution should retain the prerogative and power to outsource, on the basis of its own risk and cost/benefit analysis, with ongoing monitoring by the bank of its outsourcing arrangements being required to ensure that the associated risks are managed effectively. Specifically we feel that all outsourced processes will be captured by the Basel Committee's operational risk framework with associated management standards and capital charge

Part 1: Definitions

The BBA agrees that there are a number of possible definitions of outsourcing and that it is difficult to agree a definition which would be acceptable across the EU. However, if there is to be consistent treatment of outsourcing, then there must be clarity of definition. Without this clarity there will be no consistency of treatment of "strategic and core" nor of "material" outsourcing as referred to in the HLPs.

In this context, the BBA believes that the definition provided is too generic in nature to facilitate the objective of convergence. The definition of outsourcing should, in our opinion, only refer to a typical core banking activity, framed from the outsourcing institution's perspective and be based on the transfer of a material internal activity by an institution to a third party entity. It should also recognise a distinction between intra group outsourcing and outsourcing to authorised or unauthorised financial institutions.

Part 2: High level principles addressed to institutions

I. Strategic and core management responsibility cannot be outsourced

Outsourcing practice need to be examined in the context of the size and complexity of the institution as well as changing market practices.

The High Level Principles state that CEBS does not expect to see outsourcing of strategic or core management responsibility "except for in exceptional cases". As noted above, the BBA believes that this is an excessively conservative position. The current FSA policy on outsourcing has no restrictions on the types of activity that can be outsourced. If principle I is to be introduced this would be a retrograde step in the UK. We therefore believe that this restriction does not strike an appropriate balance between regulatory concerns and legitimate commercial imperatives to outsource.

In cases where the outsourcing service provider is an institution authorised by, and under direct supervision of a supervisory authority of an EU member state or a country with equivalent standards, we consider that it should be possible for processes that are considered "strategic or core" to be outsourced.

III. An outsourcing institution should take particular care when outsourcing material activities, i.e. activities of such importance that any weakness or failure in the provision of these activities could have a significant affect on its ability to meet its regulatory responsibilities and/or to continue in business. In such cases the outsourcing institution should pre-notify its supervisory authority.

The CEBS principles usefully raise and define the issue of materiality. We support an approach which is focussed on whether or not the outsourcing is material. Where it is not material, banks should be free to outsource where it is commercially sensible to do so. It will be important for there to be convergence among supervisors in determining the sorts of activities which will be regarded as material.
The condition that "an institution may not outsource services and activities that are covered by the institution's authorisation unless the outsourcing service provider has an authorisation which is comparable…" is, in our view, too restrictive. We believe that it should be permissible to outsource elements of activities which are covered by the banking licence to a non-licensed service provider, provided such elements are not in themselves subject to a licence requirement.

V. The outsourcing institution should have a policy on its approach to outsourcing, including contingency plans and exit strategies.

The BBA agrees that a firm should have a policy on outsourcing. This should be internal bank policy which a supervisor can review on request.

VII. All outsourcing arrangements should be subject to a formal and comprehensive contract.
The BBA considers that such contracts should clearly define the outsourcer's rights to audit the outsourced process .The right to information of the supervisory body should stem from the auditing rights given to the credit institution by the outsourcing agreement. The Principles should specify that, in the context of 'offshoring', any legal requirements governing the transfer of data across borders should be complied with.

VIII. In managing its relationship with an outsourcing service provider an outsourcing Institution should ensure that a service level agreement (SLA) is put in place

Whilst the BBA believes that it is good practice for SLAs to be in place with an outsourcing service provider, we also consider that there may be times when an SLA is not necessary. As a result we suggest that this principle should be made less prescriptive. For example we suggest that an outsourcing institution should have SLAs 'where appropriate'.

Part 3. Other supervisory principles on outsourcing

IX Supervisory authorities should aim to establish a right to information, and to conduct, or order, on-site inspections in an outsourcing service provider's premises.

The BBA considers it too far-reaching to give the supervisory authority the right to cancel an outsourcing agreement. This would represent intervention between parties in a contracted agreement and, in our view, may not be legally acceptable.

Reliance should be placed on the relevant audit work (see above).Whilst, at the moment in the UK, the FSA have the power to cancel an arrangement 'in extremis' this would only happen where an arrangement has been extremely badly managed.

X Supervisory authorities should take account of concentration risk, where one outsourcing service provider provides outsourcing services to several outsourcing institutions.

The BBA would encourage CEBS to further develop its ideas on concentration risk whereby a number of financial institutions outsource all processes of a particular type to one or two outsourcing service providers as an individual supervisors' review will not cover this risk. We suggest that CEBS, in conjunction with other supervisors, investigate the feasibility of a "global assessment" of outsourcing arrangements to be made across jurisdictions to identify those service providers who could pose critical and connected risks to institutions.

XI Supervisory authorities should take account of the risks associated with 'chain outsourcing' (whereby the outsourcing service provider sub-contracts elements of the service to other providers)

The BBA agree that the sub-outsourcing of activities to third parties (sub-contractors) should be treated like a primary outsourcing measure. However we feel that this would be very difficult to implement in practice and that therefore this principle should be narrowed to include only 'key sub-contractors' i.e. those that would have a material impact on the provision of the outsourced service.

Steve Freeman
Director
BBA

ANNEX 2:

BBA Response to CESR Consultative Concept Paper on Transaction Reporting (April 2004)

Dear Sir,

The British Bankers' Association is the principal trade association for banks operating in the London financial markets and for United Kingdom banks. Around 75% of our members come from outside of the UK including many from elsewhere in the EU.

We welcome the opportunity to respond to CESR's Consultative Concept Paper – particularly in view of our very active engagement in relation to the negotiation of the Investment Services Directive both directly and through the European Banking Federation.

We have attached our answers to the questions asked by CESR but have one or two comments which we consider it useful to set out in this covering letter. These are as follows:

- Ideally transaction reporting should deliver the possibility for firms to choose a pan-European one stop shop to which they can report their transactions. Firms should have the option of reporting to the regulator where they do most of their business and also to exchanges or ATSs which are prepared to transmit transactions on that exchange or ATS to the regulators.

- We support the idea of common transaction reporting content which could also be used for clearing and settlement purposes. In defining the content of these reports CESR should only incorporate essential data for the purposes of clearing, settlement and initial regulatory monitoring. Data which is not essential but which could be useful after the event in market abuse investigations, for example, should be dealt with separately by requests for such information after the event by the investigators. The essential data will be sufficient to permit the market abuse investigators to spot transactions which may be suspicious.

- We consider that "the most liquid market" should be measured by the volume of trades (by number of securities – not by number of transactions) done across different exchanges, ATSs etc.

We hope that these comments are of assistance and would be very happy to discuss them further with you.

Yours sincerely

Michael McKee

Michael McKee
Executive Director
Wholesale Banking and Regulation

Answers to Questions Asked by CESR

Q1. Do you agree with the approach suggested above to determine the methods and arrangements for reporting financial transactions in one set of criteria applicable to both, the conditions for a trade matching and reporting system to be considered valid to report transactions to competent authorities and the criteria allowing for a waiver? If you do not agree, what other approach would be more appropriate in your view?

The approach set out is very high level and much will depend on the detail but, in principle, the approach appears to be the right one. Much could be gained from having one set of data. However, in developing one set of data CESR should consider that if this data is to be trade reported quickly it needs to include as few fields as possible. Data that is not required within the first day of reporting should not be included (e.g. ultimate client). If this information is subsequently required (e.g. for market abuse investigation purposes) it can be sought at a later date from the relevant firm by investigators.

Q.2 What requirements should such an inventory contain?

Transaction reports should only contain details of the following:

- Firm
- Counterparty – if known
- Security
- Time/date
- Price
- Size
- Buy or sell
- Market/ATS etc

Q.3 What other issues, if any, should CESR take into account when responding to the Mandate concerning "the methods and arrangements for reporting financial transactions"?

CESR should give firms simple but practical reporting options. Ideally firms should be able to report to one national regulator (preferably the regulator where the bulk of the transactions are carried out) and, where they are dealing on an exchange or ATS
which has acceptable reporting systems to that exchange or ATS. The national regulators and the exchanges should be responsible for exchanging transaction data amongst themselves where it is necessary for one regulator to have information about transactions reported to another regulator or exchange.

Q.4 What would general criteria for measuring liquidity be?

The criteria should be as simple as possible – both for ease of measurement and to avoid complications in liaison. The best proxy would seem to be volume of a security traded in a particular venue (number of securities traded rather than number of transactions). The most liquid market would be the market on which the highest volume traded. To avoid frequent changes of "most liquid market" this should not be measured too frequently – it should be half yearly or yearly rather than, say, monthly.

Care needs to be taken in how exchanges, ATSs etc calculate volume. There may be a risk of double counting of buys/sells. A standard approach to measuring volume of trades would be needed.

Q.5 What specific criteria could be useful in measuring liquidity? Should they be prioritised?

See Q.4.

Q.6 What could be an appropriate mechanism for assessing liquidity in a simple way for the purposes of this provision?

See Q.4 Exchanges already calculate their volumes. Provided there was an adjustment of the way in which these are calculated to ensure that a common approach was being taken and that the statistical processes were of an appropriate quality then these figures should be used. CESR would seem to be the right body to oversee this and make the decision about which market was "most liquid".

Q.7 What other considerations should guide CESR in its work regarding the assessment of liquidity in order to define a relevant market in terms of liquidity?

No comment.

Q.8 Do you agree with the approach proposed by CESR for determining the minimum content and common standard/format for transaction reports? Are there other approaches that could usefully be considered?

Yes, in principle we agree. It is important to try and keep the fields required to a minimum. That should be possible with regard to trade reports (e.g. reports sent to an exchange within a few minutes of completion of a trade) and transaction reports (i.e. reports sent to a regulator by the end of the day). Ideally those reports should be matched with information required for clearing and settlement purposes – and if this could be done there could be scope for substantial savings.

As mentioned above this data should also be useful for the purposes of market abuse investigations by competent authorities. However, CESR must be careful to differentiate between information essential for transaction reporting, clearing and settlement and other information that could subsequently be useful for market abuse investigators but which is not essential for transaction reporting, clearing and settlement. The latter information should <u>not</u> be required in transaction reports because it will only be needed some time after the event and can be separately obtained by a request to the firms concerned.

Q.9 Apart from the types of information set out in Art. 25 par. 4 and the Mandate, what other information might be usefully included in transaction reports?

The exchange, ATS or other on which the transaction was completed.

Ideally a common security identifier would be developed rather than ISINs. The work of the Reference Data Coalition and the Reference Data Users Group should be taken into account here.

Q.10 Do you agree that the content of transaction reports has to be equal irrespective of the entity reporting the transaction? What considerations would justify a different treatment of reporting parties?

Yes.

Q.11 Do you agree that this preliminary assessment on the scope of the implementing measures is appropriate, and with the approach suggested above to determine the criteria under which the operations of a regulated market in a host Member State can be considered as of substantial importance, or would you consider another approach more appropriate?

We agree with the preliminary assessment of the scope of the implementing measures. However, proportionality is an overriding EU law obligation and therefore an important consideration in relation to any implementing measures which the Commission may adopt. In view of this we support CESR's plan to carry out an initial fact-finding exercise before proposing criteria.

Q.12 What relevant criteria should be taken into account in order to assess the substantial importance of the operations of a regulated market in a host Member State?

A regulated market should not generally be regarded as having "operations" in a host Member State unless it has actually established a physical presence in that Member State. Consequently it should be clear that where an exchange only has remote members in a particular Member State then it does not have "operations" in that Member State.

"Substantial importance" suggests a fairly high threshold – say 35% or above over a range of significant securities which are mainly traded in the host Member State.

As the most liquid securities of stocks domiciled in the host Member State are usually regarded as the most important it could be expected that "substantial importance" would need to embrace both coverage of a substantial number of those securities (e.g. 35% plus of the CAC, DAX or FTSE principal stocks and 35% of the trading in those securities i.e. a need for a double majority).

Q.13 What other indicative elements should CESR take into account when drafting its technical advice in this field?

An important consideration when exchanging information cross-border is the security and confidentiality of any information supplied. The ISD imposes confidentiality obligations on regulators in relation to the exchange of information but the implementing measures could also usefully require that information exchanged electronically between regulators across borders should be exchanged in a secure fashion.

We are supportive of a more standardised approach to information requests and more common understandings about when it is appropriate to obtain assistance from another regulator. The statutory powers and jurisdiction of the regulator are important – these vary significantly from one CESR member to another. It is suggested that CESR should identify areas where all CESR members have a broadly equivalent jurisdiction and powers and focus on these as the areas of primary importance in developing a common approach. In areas where some CESR members do not have powers but a common approach would be useful consideration should be given to the extent to which it is possible for CESR, EU institutions and other member states to encourage the relevant Member State to extend the powers of the CESR member to permit a common approach.

While we are supportive of a more standardised approach the watchword needs to be effectiveness, rather than bureaucracy. It is important that a search to find common approaches or forms does not inhibit real co-operation. Consequently an important consideration in developing common formats and information exchanges must be whether there is genuine utility in the information being supplied. In our experience providing documentary information is generally only a useful adjunct to real human beings co-operating with each other in a helpful way.

For this reason we would generally support the development of common approaches though Level 3 rather than Level 2 because this will be more flexible and there is less risk that legal requirements will hinder genuine regulatory co-operation.

Q.14 To what extent should CESR take into account the nature of the information to be exchanged in order to set up different categories of information and corresponding procedures for exchange of information (i.e. routine, case specific)?

See Q.13

Q. 15 To what extent do you agree with the approach outlined above? In particular, are there any issues which you believe would be more appropriately dealt with at Level 3? What other considerations should guide CESR?

See Q.13

ANNEX 3:

BBA/LIBA/IPMA/ISMA guidance on FSA Rules relation to analysts (MAY 2004)

BBA

LIBA

ISMA

IPMA

BRITISH BANKERS' ASSOCIATION
Pinners Hall
105-108 Old Broad Street
London, EC2N 1EX
Tel: 020 7216 8800
Fax: 020 7216 8811

LONDON INVESTMENT BANKING ASSOCIATION
6 Frederick's Place
London, EC2R 8BT
Tel: 020 7796 3606
Fax: 020 7796 4345

INTERNATIONAL SECURITIES MARKET ASSOCIATION
Rigistrasse 60
PO Box
CH-8033, Zurich
Tel: 00411 363 4222
Fax: 00411 363 7772

INTERNATIONAL PRIMARY MARKET ASSOCIATION
36-38 Cornhill
London EC3V 3NG
Tel: 44 20 7623 9353
Fax: 44 20 7623 9356

14 May 2004

POLICIES FOR MANAGING CONFLICTS OF INTEREST IN CONNECTION WITH INVESTMENT RESEARCH

1. Introduction

1.1 This note seeks to provide assistance to members on compliance with the requirements of the FSA, set out in COB 7.16.7R and the associated guidance, relating to policies for the management of conflicts of interest in connection with investment research.

1.2 The note identifies the areas which members will need to cover, or may wish to consider covering, in their policies, and suggests measures that may be appropriate for addressing the issues arising in each such area.

1.3 It will be for members to decide on the appropriate scope and terms of their policies in the light of their individual circumstances.

1.4 A firm may wish to consider making clear that its policy is prepared for compliance with the FSA's Conduct of Business (COB) Rules and that it is not intended to create third party rights or duties that would not already exist if the policy had not been made available, or to form part of any contract between the firm and any client.

2. Relevant materials

2.1 The primary rule to which this note is addressed is that set out in the FSA's COB 7.16.7R. This rule applies to a firm that publishes or distributes investment research where either –

(a) the firm holds the research out (in whatever terms) as being an impartial assessment of the value or prospects of its subject matter; or

(b) it is reasonable for those to whom the firm has published or distributed the research to rely on it as an impartial assessment of the value or prospects of its subject matter.

Some clarification of FSA's interpretation of certain aspects of COB 7.16R is available in its Policy Statement (PS) 04/6.

2.2 Firms are also reminded that the FSA's definition of "investment research" is widely drawn and may include written material that has traditionally been prepared by the firm's sales and trading personnel. The definition is also the subject of industry guidance issued by BBA/LIBA/ ISMA/IPMA. See also paragraph 4.7 below.

2.3 In relation to paragraph 2.1(b), the FSA has made clear that it does not expect firms to publish material categorized as not being impartial simply in order to avoid the need to operate proper conflict management policies and procedures. Firms which publish such material will therefore need to conclude that the circumstances in which it is produced are such that it is not appropriate to characterize it as impartial, for example because of reporting or remuneration structures or the physical location of the author of the material. Such material will need to be clearly distinguishable from research that it held out as impartial.

2.4 A firm to which the rule applies is required to establish a policy for identifying and managing effectively the conflicts of interest which may affect the impartiality of its investment research, to make a record of the policy and retain it for at least three years after it ceases to have effect, to take reasonable steps to ensure compliance with the policy, to make the policy available on request and to take reasonable steps to ensure that it remains appropriate and effective.

2.5 Firms should note that it is not an express requirement that the policy be published but that the policy must be made available upon request. Firms may nevertheless wish to publish the policy, for example by posting it to an appropriate website, as there is no restriction on who can make the request.

2.6 The basic obligation to prepare and maintain a policy is supplemented by specific requirements that the policy must provide for systems, controls and procedures to manage conflicts of interest effectively in at least nine specified areas, and these specific requirements are amplified by guidance setting out the FSA's views on what should be included. These areas are considered in the following paragraphs of this note. The rule states that the firm's policy must make it clear to what extent it relies on Chinese walls or other information barriers within the firm.

2.7 The rule requires the policy to be appropriate for the firm, and the FSA's guidance indicates that this entails taking into account matters such as the firm's size and structure, the COB classification, experience and expertise of its clients, the nature of the investments covered by its research and the nature of its business. There may therefore be cases where it is appropriate for a firm to deal in somewhat different ways with different product areas, provided that the reason for the distinction has been thought through and can be explained.

This does not however extend to excluding products areas[1] from the policy altogether. It is also open to a firm's management to conclude that no conflicts exist, though in these circumstances it is required to publish a statement to that effect; this situation is unlikely to arise in relation to an integrated investment bank.

2.8 A substantial amount of other recent material is potentially relevant to the preparation and distribution of investment research. A list of some of the most important such material is set out in the Annex at the end of this note.

2.9 In drafting their policies, firms should of course bear in mind the overriding general requirement of integrity and ethical behaviour, proper market conduct and management of conflicts generally in the FSA's Principles for Businesses.[2]

3. Identification of conflicts

3.1 Under the FSA's principles-based approach, firms are responsible for identifying and managing any conflicts of interest arising in their business that might compromise the impartiality of the firm's research analysts and their research. A firm's senior management will need to review the mechanisms used by the firm for identifying and managing conflicts and to be satisfied that the management techniques adopted by the firm are appropriate. Each firm should consider what mechanisms and procedures are required to promote and ensure compliance with its conflict management policy.

3.2 The FSA's guidance does not expressly amplify the requirement for a firm to identify conflicts, but it is clear, both from the terms of the guidance and from other FSA published material, that the possible conflicts which a firm should consider include conflicts between recipients of its research and its corporate finance clients (in particular issuers of investments covered by its research), its investment clients (in particular sales and trading customers), the proprietary trading and investment banking activities of the firm itself and its affiliates, and the personal interests of its officers and employees. Despite having implemented appropriate policies for identification of conflicts with recipients of its research or its clients, a firm may not be aware of all such conflicts because it may not be familiar with all recipients' and clients' interests, and that a firm can manage only those conflicts of which it is aware.

3.3 Possible mechanisms that firms should consider for identifying and managing conflicts include some or all of the following –

(a) internal guidance and training on the identification of possible issues of conflict as they arise;

---

1 Except products which are not "designated investments" and are not therefore covered by the rule and guidance, for example certain forward foreign exchange products and certain commodity derivatives. However, firms will need to consider whether communications relating to foreign exchange and commodities, or other assets underlying certain derivatives, constitute "investment research" within the FSA's definition, because they contain analysis of factors likely to influence the performance of designated investments.

2 See Principles 1, 5 and 8; also principle 7 of IOSCO's principles for addressing sell-side securities analyst conflicts of interest (September 2003).

(b) escalation procedures for ensuring that issues identified are referred to and considered at the appropriate level within the firm; and on use of and reducing the risk of inappropriate exercise of influence;

(c) use of its control room to monitor potential conflicts arising out of the publication of research in the period before, during and after investment banking transactions (see section 7 below);

(d) appropriate internal arrangements (which may include physical separation, Chinese walls and other information barriers) for regulating the flow of information between and within business areas;

(e) editorial guidelines and procedures for supervisory and compliance review of research prior to publication;

(f) policies identifying which employees or groups of employees may publish research categorized as impartial and which may not.

4. Supervision and remuneration of analysts

4.1 The FSA's guidance states that a person whose responsibilities might reasonably be considered to conflict with the interests of recipients of research (investment banking staff involved in raising capital for a corporate client being expressly mentioned by way of example) should not usually be responsible for –

(a) day to day supervision of an analyst;

(b) decisions on the coverage, timing or content of research; or

(c) determining an analyst's remuneration.

4.2 The guidance on day to day supervision will generally mean that firms should ensure that analysts who publish research are not directly supervised by, and do not report directly to, investment banking or sales and trading personnel. Firms should not deliberately structure their reporting lines in order to achieve indirectly what they should not do directly. This does not necessarily mean that both those supervising analysts and investment banking or sales and trading personnel cannot report to the same person at a more senior level, or that those responsible for supervision of analysts cannot report to senior sales and trading personnel; the appropriate reporting structure at more senior levels will depend on the structure and circumstances of the firm, the nature and range of its businesses and the need to comply with other regulatory requirements regarding supervision. However, firms will need to consider whether such reporting structures could in fact prejudice the analyst's impartiality.

4.3 The guidance on decisions on coverage, timing and content indicates that such decisions should generally be made by senior research personnel, but this does not preclude those responsible for such decisions from taking into account input from other business areas.

4.4 The timing of publication of pre-deal research will in practice be dictated by the timetable for the transaction as well as the firm's policy regarding any quiet period prior to the commencement of the issuer's marketing of the transaction[3].

4.5 On remuneration, the guidance also states that this should be structured so as not to create, or reasonably suggest the creation of, incentives inconsistent with impartiality. It expressly discourages the linkage of remuneration to a specific transaction or to recommendations in research, but confirms that remuneration may be linked to general profits of the firm. Depending on the firm's structure and circumstances, it is also possible to base remuneration on an aggregated result which includes other activities, including the results of investment banking transactions.

4.6 The guidance does not deal more specifically with factors to be taken into account in determining an individual analyst's remuneration; it seems reasonable to continue to regard as relevant personal factors such as productivity, quality and accuracy of research, experience and individual reputation and evaluations by investor clients and employees in other parts of the firm with whom analysts interact, provided that these factors are not assessed in a way which is likely to put analysts under improper pressure.

4.7 It is unlikely that research published by sales and trading personnel could be categorized as impartial if the author reports directly to sales and trading personnel and is remunerated by reference to specific transactions or the level of business or profits of his or her sales or trading desk.

5. Analysts' activities

5.1 The guidance states that an analyst should not be involved in activities in a way which suggests that he is representing the interests of the firm or a client if this is likely reasonably to appear to be inconsistent with providing an impartial assessment of the value or prospects of relevant investments. It states that it is likely to be inappropriate for a firm's policy to allow it –

(a) to use an analyst in a marketing capacity, for example by appearing with investment bankers at sales pitches for investment banking mandates, if this would give a reasonable perception of lack of impartiality in the analyst's research;

(b) to allow an analyst to act in a way which reasonably appears to be representing the issuer of a relevant investment, for example at roadshows relating to issues or allocations of investments.

In order to add value to investor clients, an analyst may wish to put himself or herself in a position to respond to queries about the issuer's roadshow presentation. Firms may therefore conclude that passive participation in the audience at a roadshow in a manner which could not reasonably be perceived as an endorsement of the issuer does not compromise the appearance of impartiality. Firms will need to consider their approach to this aspect of analysts' activity especially carefully, given the heavy regulatory focus on this issue.

---

[3] The FSA has not itself imposed a mandatory quiet period around the time of an offering of securities.

5.2 The foregoing restrictions do not entail a general restriction on contacts between analysts and investment banking or sales and trading employees, or between analysts and investment clients of the firm. The guidance expressly confirms that a firm's policy may allow it to use an analyst's knowledge and information to assist it to research corporate finance business opportunities and to provide ideas to sales and trading staff, and that an analyst may advise the firm's investment clients. Nor does the guidance preclude involvement of analysts in securities offerings, and interaction with investment banking and sales and trading colleagues for that purpose, so long as this does not give rise to a reasonable perception of lack of impartiality in the analyst's research.

5.3 Accordingly, other activities that a firm may consider permitting, again provided that it is satisfied that they do not create a reasonable perception of a lack of impartiality, include

(a) meeting potential investment banking clients prior to award of a mandate for the purposes of assisting both the clients' decision to involve the firm and the firm's decision to be involved in the transaction;

(b) advising investment banking colleagues on pricing and structuring of a securities offering, or on market sentiment and the likely reception of an offering;

(c) participating in due diligence with companies and their advisers alongside investment banking colleagues or otherwise; and

(d) participating in investor education meetings with investor clients not involving the presence of company management.

5.4 Similarly, the guidance does not preclude analysts from maintaining an active dialogue with sales and trading personnel, just as they do with investor clients, provided that they do not disclose the timing or content of forthcoming research reports or disclose or receive other material non-public information.

6. Inducements and inappropriate influences

6.1 The guidance states that a firm's policy should prohibit analysts and other employees from offering or accepting inducements for the provision of favourable research, and that the firm should not give effective editorial control to someone whose role or commercial interests might reasonably be considered to conflict with the interests of the clients to whom the investment research is to be published or distributed. The latter point is stated to preclude the firm from allowing anyone other than an analyst (in particular an issuer) to approve the content of research or allowing anyone outside the firm, or any employee of the firm other than an analyst[4], from viewing research before publication except for verification of factual accuracy. Firms should consider whether it is appropriate to implement procedures controlling the transmission of comments to ensure that these are limited to factual corrections.

---

[4] This is clearly not intended to preclude review by legal or compliance personnel as part of the firm's policies and procedures designed to ensure compliance with applicable legal and regulatory requirements (including the firm's conflict management policies).

6.2 The matters which a firm will need to consider in structuring its arrangements will include the physical location of analysts. The FSA's guidance does not state that physical separation of analysts from the trading floor is a prerequisite for the preparation of impartial research and the prevention of inappropriate influence, or for appropriate procedures to combat dealing ahead of publication of research; firms will need to consider what is appropriate in their circumstances. A firm may consider that physical separation of analysts is an effective way to reinforce its dealing ahead policies. Alternatively a firm could provide desks away from the trading floor at which research would be prepared. Absent either of these measures, firms should consider whether they need more robust policies and surveillance to prevent the inappropriate receipt and use of knowledge of the timing or content of forthcoming research by sales and trading personnel. The guidance does not preclude an analyst from having free access to a firm's trading floor in order to maintain an active dialogue with salespersons and traders.

6.3 Firms should consider whether an analyst's knowledge of firm trading positions in designated investments which are the subject of the analyst's research (other than positions that are broadly publicized to investor clients) could represent an inappropriate influence or otherwise prejudice the analyst's impartiality.

7. Method and timing of publication

7.1 The guidance states that the firm's policy should provide for research to be published or distributed in an appropriate manner. It indicates that this will entail the firm's taking reasonable steps to ensure that its research is published and distributed only through its usual channels, these being set out in the firm's policy, and that the FSA regards it as inappropriate for an employee (including an analyst) to communicate the substance of a piece of research by means other than those set out in the policy. The guidance does not lay down any more specific requirements regarding the means or procedure for publication; in particular, it is clear from the joint LIBA/BBA/ISMA/IPMA guidance on COB 7.3, to which the FSA refers in its policy statement, that a firm may make its research available simultaneously to clients and to other parts of the firm who had no prior knowledge of publication (including proprietary traders) without imposing a waiting period before trading desks and proprietary traders can act upon the research.

7.2 Firms should consider whether, in addition to observing any legal, regulatory or contractual requirements for "black-out" periods, their policies should include provision for restricting the publication of research, generally by or in consultation with the legal or compliance department, at times when activities elsewhere in the firm might be thought to give rise to a reasonable perception of lack of impartiality of research. For example, a firm's policy may restrict publication of research, or limit its content (for example by removing a recommendation and/or price target) for certain periods before, during or after marketing of a securities offering or during other significant transactions in relation to which investment banking services are being provided.

Firms' policies may need to provide that the nature and extent of such restrictions will vary depending on the type of transaction and even upon the individual circumstances of the transaction.

8. Disclosure of interests and personal account dealing

8.1 The rule and the associated guidance deal with disclosure of interests in very general terms, stating merely that the policy must address the issue. Many member firms will be subject to more specific requirements (including requirements imposed by the measures listed in the Annex) and a firm's practice will need to take account of these. Matters disclosed may include interests of the firm and its affiliates in securities of companies referred to in research, directorships and other material relationships of individual officers of the firm or its affiliates, market making or trading by the firm, investment banking mandates or relationships and personal interests of an analyst or close relatives of an analyst.

8.2 Firms should also take into account the requirements of the FSA rules[5] relating to analysts' personal account dealings. These require that, with very limited exceptions, an analyst be prohibited from dealing in a manner contrary to his published recommendation and refer to the possibility of stricter prohibitions being imposed.

[5] COB 7.13.4, 7.13.7.