Bill Eldridge
EU Public Affairs Director
Barclays PLC
54 Lombard Street
London EC3P 3AH

bill.eldridge@barclays.co.uk
Tel. +44 20 7699 2895

BARCLAYS

Fabrice Demarigny
CESR
11-13 avenue de Friedland
F-75008 Paris
France

29th July 2004

Dear Mr Demarigny,

Barclays Response to CESR's Call for Evidence on the second set of mandates from the European Commission on the legislative measures to implement the Markets in Financial Instruments Directive (MiFID)

Barclays PLC is a UK-based financial services group engaged primarily in banking, investment banking and investment management. In terms of assets employed, Barclays is one of the largest financial services groups in the United Kingdom.

The Group also operates in many other countries around the EU and the world. Barclays has been involved in banking for over 300 years and operates in over 60 countries, including Spain, Portugal, France, Italy and Germany.

Barclays welcomes the opportunity to respond to CESR on its call for evidence on its mandate for technical advice on possible implementing measures concerning the Markets in Financial Instruments Directive (MiFID). However, we feel that the one-month response period provided by CESR is not adequate, particularly as it falls in the month of July when people start to leave on holiday. This creates difficulties in obtaining the necessary expert input to provide a thorough response.

We have seen the responses to this consultation by ISDA/LIBA and other trade associations and agree with and endorse their comments in respect of:
- Impact of the short timetable overall for implementation of MiFID
- Level of detail and regulatory prescription at Level 2
- Determination of priorities
- Transitionals and grandfathering

In addition, we have the following comments on some of the areas on which CESR has requested input:

3.1. List of Financial Instruments

In developing their advice on Annex I Section C, CESR faces a difficult task in balancing the interests of a wide range of potential market participants. For a bank such as Barclays, the overriding objective is for the Annex to give an unambiguous guide to Member State regulators on the activities covered by the Directive and, hence, caught within the scope of the passport for investment services.

One of the key benefits offered by the new Directive is the extension of scope to commodity trading. Commodity trading largely falls outside the scope of the current Investment Services Directive and Second Banking Consolidation Directive which creates a "regulatory gap" between the comprehensive regulation of commodity trading by our home regulator (the UK FSA) and the ability to perform these activities elsewhere in the EU. This has required us to investigate the regulatory treatment of commodity trading on a state-by-state basis and, where necessary, to notify or seek authorisation from Member State regulators. This is a costly and inefficient process, which undermines the operation of the Single Market. There is also a remarkable divergence in approach taken by Member States to the regulation of commodity trading. Broadening the passport to commodity trading therefore offers significantly greater regulatory certainty and more efficient, liquid EU commodity markets.

Against this overall background, we respond to the specific issues raised in the CESR mandate in the sections below.

3.1.1. Definition of "Commodity"

In developing the definition of commodity, we would recommend that CESR adopt a dual approach of defining both the characteristics of commodities that would bring them within the scope of the Directive and a (non-exhaustive) list of commodities which CESR believes meet these criteria. This pragmatic approach will combine clear regulatory certainty on a range of commodity asset classes while retaining the flexibility to include new commodities should a future need arise.

Although it is difficult to formulate a clear and unambiguous definition of commodities for the purposes of the Directive, the intention appears to be to include commodities whose trading shares several key characteristics. For example, the definition should include products that are:

- routinely bought and sold to effect a transfer of price and delivery risk between producers, consumers and specialist risk-management intermediaries;
- traded under standardised industry trading agreements with industry standard lot sizes, delivery calendars etc; and
- fungible such that the delivery of one lot of the product can be effected successfully from multiple and diverse sources.

Also we suspect that it would be possible to form a broad consensus around the products that should fall within the intended scope of the Directive. For example, the following products are all traded on standardised terms in fungible lots for risk management purposes:

- Oil and oil products (including some plastics);
- Metals;
- Natural gas;
- Coal;
- Electricity;
- Agricultural products (wheat, soy beans, oats, cocoa etc);
- Timber and related pulp/paper products;
- Carbon allowances.

Having defined the commodities potentially subject to the provisions in Annex I, the Annex includes several "qualifications" which restrict the circumstances in which trades in those commodities would be considered similar to other financial instruments for the purposes of the Directive. These qualifications are crucial in defining whether commodity transactions fall within or outside the scope of the Directive. As a result, it is important that the initial definition of a "commodity" is not drawn too narrowly to exclude transactions, which in some circumstances, resemble trades in other financial instruments. We turn to the detail of these "qualifications" in the following sections.

3.1.2 Section C7: Definition of "Commercial Purpose"

CESR invites evidence on "the conditions under which an option, future, swap forward rate agreement or other derivative contract related to commodities (which can be physically settled and is not otherwise covered by section C.6) should be determined not to be for a commercial purpose". This clause appears designed to exclude market participants who undertake forward physical trades solely as a means of hedging underlying physical production or consumption position in the commodity in question.

It is difficult to draw an absolute line between hedging an underlying physical position and becoming an active and regular trader of the associated commodity in its own right, particularly since many significant physical players will also be offering risk management services to other companies. However, it is somewhat easier to define when trading in a commodity may <u>not</u> be considered as being for a commercial purpose, i.e. the transactions would not be for commercial purposes if:

- *the person trading the commodity expects to have no net physical delivery requirement over time*. This definition would have to be drawn sufficiently wide to include storage of the commodity (e.g. gas storage or metals warehousing). However, the key driver would be that the market participant did not routinely deliver or take delivery of the commodity under the contracts to manage directly the risks associated with underlying production and consumption requirements.

This definition has the benefit of including physical commodity trading activities within the scope of the Directive – and hence the passport – for a class of intermediaries (e.g. financial institutions) while at the same time continuing to exclude a large class of "pure hedgers".

3.1.3. Conditions for Other Derivative Financial Instruments (Section C7)

One of the key uncertainties in the current regime is the treatment of physical forward commodity contracts. In some jurisdictions, these are treated as financial instruments or derivatives and are subject to regulation. However, there is no common approach to whether or not these subsequently qualify for mutual recognition of home state regulation of these services. The Directive offers a major opportunity to resolve this uncertainty by explicitly including forward physical agreements when they are relevantly similar to other derivative financial instruments. In this regard, some ambiguity remains on the respective coverage of sections C6 and C7 of Annex 1 to the Directive. In particular, while C7 explicitly mentions "forwards", C6 does not and instead refers to "any other derivative" contracts. Given that in many member states, forward physical contracts are currently considered as derivative contracts, CESR should provide guidance on the definition of "other derivative" contracts covered by section C6 (particularly given the cross reference in C7).

Improved clarity on the treatment of physical forward contracts would be particularly valuable in the electricity and gas markets. Forward physical gas and electricity contracts may fall within the scope of section C6 to the extent that they are considered "other derivative contracts" and are traded on a regulated market and/or MTF. However, many electricity and gas markets are still relatively immature and will not necessarily be traded on regulated markets or MTFs in all jurisdictions. Hence, even if physical electricity and gas contracts qualified as "other derivative instruments", there is no guarantee that they would fall within the scope of section C6, which could lead to patchy coverage of these instruments across the EU.

CESR should resolve the uncertainty over the application of section C6 by stating that forward physical electricity and gas contracts fall squarely within the scope of section C7. In electricity and gas markets, there is little practical difference between physical and financial forward contracts. Moreover, while physical electricity and gas contracts may not necessarily be cleared and settled through "recognised clearing houses" or subject to "regular margin calls", very similar arrangements surround the "balancing and settlement" agreements which are a mandatory feature of all physical electricity and gas markets. As a result, forward physical electricity and gas contracts would appear to have the "characteristics of other derivative financial instruments". We would therefore recommend CESR determine that physical forward trades in electricity and gas fall within the scope of section C7 (subject to the "commercial purposes" caveat). Appendix 1 to this note provides some further background on why physical electricity and gas contracts are fundamentally similar to financial electricity and gas contracts and, hence, qualify as having the characteristics of "other derivative financial instruments".

3.1.5. The Treatment of Carbon Allowances under Section C.10 and Annex 1

CESR should determine that forward trades in carbon allowances fall within the scope of the Directive. There appear to be two main options for achieving this:

- Including carbon allowances within the definition of a commodity for the purposes of the Directive. This is an attractive option in that, under section C.7,

transactions by market participants trading purely to comply with the Emissions Trading Scheme would qualify as trading for "commercial purposes"; or
- Clarifying that "forward rate agreements" in C.10 would include an agreement to deliver a carbon allowance at a fixed price at some future date.

Forward trades in carbon allowances should fall within the scope of the Directive for a number of reasons. The nascent EU carbon allowance market is pan-European and participants include a range of financial institutions in addition to the companies with installations covered by the EU Emissions Trading Scheme. In advance of the release of the first allowances in 2005, the market is currently based on "physical" forward trades, i.e. an agreement to deliver an allowance at fixed dates in 2005, 2006 and 2007. Delivery is effected through the transfer of account entries in Member State allowance registries (i.e. the exchange of title to an allowance that can ultimately be surrendered against actual carbon emissions in each year). This differentiates carbon allowances somewhat from the other variables (e.g. freight rates, inflation indices etc.) covered in section C.10 in that market participants take title to carbon allowances rather than solely writing derivatives against an index.

Carbon allowances are in many senses the perfect commodity because they will be fungible across the EU and across years within the separate Phases of the Emissions Trading Scheme. However, the development of a reliable index in carbon allowances is likely to take some time to develop. Consequently, it will also take some time for a market to develop in carbon allowance derivatives that must be or may be settled in cash against that index. Pending the development of a derivatives market in carbon allowances, the market is likely to remain "physical" and relate to forward agreements to transfer allowances coupled with spot transfers of allowances. As a result, there is a danger that trading in carbon allowances falls outside the scope of section C.10.

The regulatory treatment of these forward agreements is currently unclear and inconsistent in many member states. Specifically, in some countries, they are treated as unregulated and in others, they are classed as regulated securities or derivatives. In other countries, it has proved impossible to clarify whether or not this would be a regulated activity. This uncertainty and inconsistency of regulatory treatment for carbon allowances seriously threatens the development of liquidity in this market, which in turn is essential to allowing EU carbon emissions to be reduced in line with our Kyoto targets at least cost. Including carbon allowances within the definition of commodities and/or the scope of section C.10 would therefore ensure that forward trades in carbon allowances fall within the scope of the Directive and ensure consistent regulatory treatment across the EU commensurate with the EU-wide nature of the market.

3.2 Definition of Investment advice (Art. 4(4))

The measures for defining "investment advice" must include:
- advice provided to an investor or potential investor;
- advice to buy, sell, subscribe or underwrite a particular investment;
- advice to exercise any right conferred by a particular investment.

Investment advice will therefore be specific to a particular investor, or potential investor, and a particular investment and will be determined by the information provided by the investor on his financial situation, knowledge and experience and investment objectives.

This is in contrast to a "general recommendation". It would be beneficial for CESR to refer to the definition of "research recommendation" in the Market Abuse Directive. Such a recommendation may recommend an investment strategy or a particular investment recommendation, but it is intended for distribution to the public or to a large number of persons. A "general recommendation" would therefore not be tailored to an individual investor.

A tailored recommendation is also in contrast to "marketing" which is an invitation or inducement to engage in investment activity but not a recommendation to do so. Indeed most marketing and general recommendations will be accompanied by a warning that investors should seek financial advice before proceeding if they are unsure whether the particular investment or investment strategy is suitable for them.

3.3.2.1. Suitability test (Article 19.4) &
3.3.2.2. Information about the client knowledge and experience in the investment field (Article 19.5)

We agree that CESR needs to take account of the nature of the service, the nature of the financial instrument offered and the retail or professional nature of the client or potential client.

For professional clients, no additional information should be required over and above that already collected to determine that the client is categorised as a professional. Professional clients are deemed to possess the knowledge and expertise to assess for themselves the suitability of the investment service or financial instrument in question.

For retail clients, the Level 2 requirements should be drafted to distinguish between the <u>types</u> of service that can be offered:

- Discretionary or advisory investment management – i.e. where the firm is obliged to consider suitability on an on-going basis for the client. This should require a comprehensive "fact find" process;
- Advisory non-management services – i.e. where advice is in relation to a "one-off" transaction or investment and where there is no obligation for on going suitability. This should require only limited information from the client, in direct relation to the proposed investment/transaction.

It is also important to recognise that in determining whether an investment service or product is suitable for the client, an assessment should take account of a <u>balance</u> of factors, rather than looking at the factors in isolation. For example, it may be inappropriate for an individual with a low level of knowledge to invest in non-complex securities. But if that individual has a significant proportion of their assets in "free assets" i.e. cash, bonds, equities, property not subject to mortgage etc, it may be suitable to complement their portfolio by introducing a degree of complexity. Equally, whilst a potential investor with a high degree of knowledge may fully understand the complexity of derivative products, they may not be in a financial position that makes this type of investment suitable.

3.3.3.3. Execution only (Article 19.6)

Non-complex instruments must include equities, gilts and UCITS in both domestic and foreign markets and regardless of whether they are inside or outside of tax shelters. This is already provided for in the Directive text.

We recommend that any definition should be sufficiently broad and principal-based to cover a variety of instruments; in particular, it should be wide enough to allow for any new types of instruments that may be created in the future.

For example, one method of distinguishing complex and non-complex instruments would be according to whether the initial investment represents the full amount of the investor's risk. Using this definition, instruments such as equities and gilts would be deemed non-complex, whereas instruments such as derivatives, where the client risks losing an amount in excess of his initial investment, would be deemed complex.

With regard to the criteria for determining whether a service is provided at the initiative of the client, we support the BBA's position; namely, this is sufficiently set out in Recital 30 of the Directive and no further definition(s) at Level 2 are required.

With regard to the content of related warnings, we again support the BBA's position; namely, it is inappropriate to set out the text of warnings in Level 2 legislation and that any warnings should be developed at Level 3 by discussions between CESR and the industry.

3.5 Limit orders display (Article 22.2)

Clearer CESR guidance in this respect would be useful as we are having difficulty in establishing how to comply with this requirement. Our stockbroking company currently has in the region of 3,000 unfilled limit orders. Each order is linked to an electronic price system and when the order reaches a defined tolerance level the order is placed with the market (usually it is automatically dealt through our electronic links with market makers).

It would be highly impractical either to display such orders on SETS or to ask a market maker to display them due to the volume of orders and the fact that many are substantially outside of the current market price and will not be filled. Displaying such orders would only serve to distort the market. In addition, 20-30% of retail limit orders are for non-standard settlement and therefore cannot be displayed on the SETS order book. Clear guidance on how we can practically display such orders is necessary.

3.6 Eligible counterparties

We have no particular comments on this issue but do support ISDA's response on it.

3.7 Transparency

Definition of "systematic internaliser"

We agree with and endorse ISDA's comments; namely that given the shortness of the time available and the contentious nature of the debate on the Level 1 measure, we consider that CESR should advise the Commission not to propose Level 2 measures on Article 4.1.7.

3.7.2.2 The determination of the Standard Market Size/Classes of shares (Article 27.1 &2)

We agree with ISDA's comments on this point. Determining Standard Market Size (SMS) by class of share may not be appropriate; e.g. the average size trade for FTSE securities varies considerably. The LSE's Normal Market Size (NMS) would not be appropriate to use as the SMS – SETS average.

3.7.2.7 Retail size orders (27.3)

The retail size order should be the mean or median retail order taken across the whole of Europe.

Please do not hesitate to contact me or my colleague, Laura Mowbray (laura.mowbray@barclays.co.uk), if you have any questions relating to the issues raised in this response.

Yours sincerely,

Bill Eldridge
EU Public Affairs Director

Appendix 1

Why Physical Power and Gas Contracts Have the Characteristics of "Other Derivative Financial Instruments"

In electricity and gas markets, physical delivery takes place "automatically" through an integrated network of wires or pipes. This means that there may be discrepancies between a participant's actual deliveries and their contracted "physical" deliveries. For example, a retailer's customers may take more than they have contracted for (e.g. if it is unexpectedly cold) or an equipment failure may mean that a generator is not able to produce enough to meet its contracted sales.

Electricity and gas markets therefore incorporate a system of "imbalance settlement" to calculate and settle differences between actual physical deliveries (measured through meters) and contracted deliveries (which are notified by participants to the operator of the imbalance settlement system). Imbalance settlement is mandatory for all market participants trading physical power and gas. The successful physical "delivery" of power and gas contracts takes place with the completion of a successful notification to the imbalance system operator of contracted quantities and associated counterparties. These arrangements prevent free-riding on the system by preventing participants from selling electricity or gas that they have not purchased or produced and by ensuring that any un-contracted offtakes are paid for ultimately.

For any market participant without metered deliveries (i.e. a trader without physical production or consumption), there is no scope for any outstanding physical delivery to take place in the absence of physical meters and delivery points registered to that participant. They will therefore close any open positions before delivery (typically in a day-ahead spot market) or be forced to cash-out any remaining imbalance through the balancing and settlement arrangements. There is little practical difference between this economic result and a trade in a financially settled derivative for power and gas written against a spot price index based on day-ahead or balancing prices.
For example:

- A physical seller of 100 MWh for delivery in one hour would <u>receive</u> a fixed price for the 100 MWh and <u>pay</u> the spot price for the 100 MWh to buy that quantity in the spot market (or via the balancing arrangements); or
- A financial seller of 100 MWh would receive the difference between the fixed contract price and the spot price for the 100 MWh in that hour.

The economic effect of physical and financial electricity and gas contracts is therefore identical which means that physical power trades have the characteristics "of other derivative financial instruments".[1] In addition, the mandatory balancing arrangements

---

[1] This example can be generalised to a producer or consumer buying or selling to hedge physical deliveries. For example, a generator who sold 100 MWh physically and generated against that contract would receive the fixed contract price for the 100 MWh (and would have zero imbalances). Similarly had the generator sold 100 MWh financially they would receive the spot price on 100 MWh delivered in the spot market coupled with the difference between the spot price and the contract price. The net effect of these two cash flows would again be to receive the contract price for the contracted delivery of 100 MWh.

themselves exhibit similar characteristics to "recognised clearing houses" and are "subject to regular margin calls" in that:

- Any outstanding imbalances between net contracted and actual deliveries are cleared via cash-settlement of imbalances at imbalance prices; and
- Imbalance settlement operators impose conditions relating to the credit standing of market participants and require security against potential imbalances in the form of collateral, letters of credit etc.

As a result, forward physical power and gas contracts exhibit the characteristics of "other derivative financial instruments" for the purposes of Annex 1 Section C.7 of the Directive.

Barclays PLC
54 Lombard Street
London EC3P 3AH

29th July 2004