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Dear Sirs

SECOND CONSULTATION PAPER ON THE FIRST SET OF MANDATES REGARDING POSSIBLE IMPLEMENTING MEASURES FOR THE MARKETS IN FINANCIAL INSTRUMENTS DIRECTIVE

The City of London Law Society Regulatory Committee is pleased to have the opportunity to respond to CESR's Second Consultation Paper on the first set of mandates. The representatives on the Committee are all lawyers whose practice covers the law and compliance matters for clients who operate in the financial markets, both in Member States and third countries (see our submission of 17 September 2004 for further details).

Degree of Detail and Calibration of Rules

We welcome CESR's recognition that its final advice must strike a balance between different interests and, importantly, that it must address various differentiations in the market. We encourage CESR to maintain this line. In our previous comments we highlighted that CESR should consider using the following tools to achieve proportionality and flexibility.

- (1) High level principles of universal application.
- (2) Rules of clear application to particular categories of firm. In our substantive comments, we pointed out a number of instances where CESR's advice is well considered and has a good basis in policy, but where that policy justification does not extend to the same regulation for every type of firm.
- (3) Authoritative guidance which elaborates upon the application to different types of firm of a particular rule.

We continue to think that this would be a helpful, practicable and balanced approach. Unless there is such an approach there will need to be a significant number of exceptions from

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detailed rules, which in our experience produces a legal framework which is difficult to follow, even for those with experience. Flexibility and proportionality are not weaknesses, they are a necessary reflection of the depth and breadth of the activities carried on in the financial services and markets field.

Lack of responses from retail investors

We acknowledge and understand CESR's concern about the low level of input that it will have had from consumers and retail investors. We do, however, urge CESR to consider the important point we made in paragraph 3.7 of submission of 17 September 2004, set out below for ease of reference:

“3.7 As a related point, it is important to bear in mind that the criteria in the Directive for classifying a professional client by reference to its size (set out in Annex II) will in many cases exclude relatively large corporations and sophisticated individual investors; thus many clients currently classified as “intermediate” customers may be retail customers within the Directive. Many investment firms, used to dealing only with professional clients under current rules, will find that their clients do not satisfy the size or other test in the Directive: those firms will therefore be subject to more onerous and potentially inappropriate regulatory obligations than they are today.

We welcome the fact that CESR has not included in its draft advice detailed rules applicable to investment firms when they deal with professional clients. However, CESR has approached provisions relating to retail clients as though all retail clients were private individual investors. Although the Directive only draws a distinction between professional clients on the one hand, and retail clients on the other, we believe that there is room within CESR's advice and level 2, further to distinguish between categories of retail client. Certain rules, for example those relating to the provision by an investment firm of detailed information during telephone calls, may be appropriate only where a client is a private individual investor who requires the greatest degree of investor protection. It would be proportionate, and would facilitate an appropriate use of regulators' time and resources, to tailor exceptions to those rules to other types of retail clients (for example some corporates).”

The definition of retail customer in the Directive is extremely broad and will cover many experienced individuals as well as corporations of some size. In striking the balance and addressing differentiations in the market, it is important that CESR, within its advice, recognises that there are different types of retail client.

Independence of Compliance

We welcome CESR's recognition that the size of an investment firm is a factor that deserves particular attention in addressing the calibration of regulatory intervention. It is indeed relevant to CESR's proposals for the independence of the compliance function, however, in our view, it is not the only factor. We encourage CESR to recognise that there may be more than one way of achieving an effective compliance function and that it is not just very small firms for which CESR's two options may be appropriate.

In particular, we do not believe that mandatory outsourcing of compliance will produce an effective compliance function. An outsourced compliance function is, by definition, not operating within the business. It is not there to see and anticipate problems, deal speedily with issues that arise and, critically, be familiar with the business, the culture and the personalities. It is at best a post-event monitoring function. In our direct experience there is not sufficient breadth and depth in the external market for this to be a satisfactory solution.

We have all had experience of the direct regulation of persons responsible for the compliance function and have noticed, in our own relations with clients, that this has had a marked and positive effect on the attitude within firms to compliance issues. A person whose reputation, job prospects and financial resources are under threat if there is a material compliance breach, is far more likely to deal properly with compliance issues within a firm, whatever his position. If he is employed there, as stated above, he is also more likely to notice and deal with issues that are arising. The threat of personal discipline is, and can be, a real one that produces a material effect. We would suggest that this should be seen as an alternative to the pure independent compliance officer - which in our experience is not necessarily suitable for all firms.

We urge CESR to avoid tying its options to the limited definition of a small firm - the CESR standard currently recognises that independence is required "when this is appropriate and proportionate in view of the complexity of the business and its nature and scale". The CESR standard, therefore, already recognises that size is not the only issue, and we urge CESR to continue to reflect the current standard in any advice that it produces.

Outsourcing of Investment Services

We welcome the recognition that, in the light of work on outsourcing being carried out by other bodies, there needs to be a degree of convergence between all of the proposals. We are concerned, however, by proposals to bring parity with the UCITS Directive for other forms of individual portfolio management. The UCITS Directive concerns collective funds marketed to the general public - the rules adopted in respect of such matters are not necessarily appropriate to all other forms of portfolio management, particularly individual portfolio management for professional clients. We do not therefore think that the advice on delegation of individual portfolio management should be consistent with the UCITS Directive - as this involves adopting principles developed for one purpose and applying them to services of an entirely different nature. In many cases, for example private equity, this will simply produce an unworkable result - private equity managers in many countries are not regulated, but are the most experienced.

We firmly believe that the key to outsourcing is that the firm which does the outsourcing remains responsible to the client. It is then the firm that bears the risk of the outsourcing, which seems to us to be appropriate.

Please do not hesitate to contact us if you would like further elaboration or information.

Yours faithfully

p.p. Phil Galt

MARGARET CHAMBERLAIN

Chairman

City of London Law Society Regulatory Committee