Enclosure to FBE Letter 0611

Fédération Bancaire Européenne

European Banking Federation

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RESPONSE TO

CONSULTATION PAPER ON CESR'S ADVICE ON POSSIBLE IMPLEMENTING MEASURES OF THE DIRECTIVE 2004/39/EC ON MARKETS IN FINANCIAL INSTRUMENTS - Ref.: CESR/04-261b

June 2004

INTRODUCTION

The European Banking Federation[1] (FBE) welcomes the opportunity of commenting on the Consultation Paper issued by CESR for the 1st mandate of the implementing measures of the Markets in Financial Instruments Directive (MiFID). The FBE fully supports the goals of the MiFID and is committed to providing the necessary input to ensure that the implementation stage of the MiFID achieves the objectives of the Directive.

We have participated in numerous consultations conducted by CESR to date and fully support its ongoing work on the MiFID. As we recently addressed the various aspects of the process related to the preparation of the implementing measures in a separate letter (August 31, 2004), we will not reiterate those points here, but only wish to underline the importance of the process to the outcome of the work underway.[2]

As the deadline on the Best Execution and Post-trade Transparency parts of the CP has been extended to October 4th, we will respond to those sections then.

Below we provide an Executive Summary ("I. General Remarks" and "II. Summary of Key Points by Section"), followed by a more detailed section (III.) which will respond to CESR's questions.

[1] Set up in 1960, the European Banking Federation (FBE) is the voice of the European banking sector. It represents the interests of over 4,500 European banks, large and small, with total assets of more than EUR 20,000 billion and over 2.3 million employees.

[2] Please see Ref. FBE Letter No 0561, dated August 31, 2004, addressed to CESR and other relevant institutions. In this letter, we focused, among others, on the importance of allocating adequate time to the preparation of CESR's advice and the subsequent implementing measures; the significance of evidence-based proposals; the need for transitional measures for various aspects of the Directive which will require the industry to make organisational and technological changes; and the need to avoid excessive detail and prescription in Level 2 measures, while providing the necessary degree of legal clarity for consistent application.

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EXECUTIVE SUMMARY

I. GENERAL REMARKS ON THE CONSULTATION PAPER (CP)

- We appreciate the alternatives presented by CESR in most cases and CESR's evident efforts to base its proposals on a consideration of the net benefits of its proposals. While we support CESR's efforts to reach a common view on the maximum number of points in its preparation of technical advice, most of our members believe CESR should make a greater use of such alternatives in its consultation, and also in its eventual submission of its technical advice to the Commission, in those cases where alternative routes, with varying expected impact, exist to satisfy the objectives set out by the Level 1 Directive. Such an approach will enable the Commission to make a more informed policy decision based on the consequences of the possible alternatives to achieve its objectives under Level 2.

- We find that, in certain areas, the CP is much too detailed and asks far too many questions. There is a danger of legislative overkill. We see the set of rules proposed by CESR generally as in line with current best practice (which is recognised in most jurisdictions) in Europe, but are concerned that codifying them as rules rather than internal procedures would in certain cases undermine flexibility and efficiency. Hence, the overall body of rules should be reviewed with a view to leaving some of these principles to Level 3 and to best practice. Besides, the diversity of the existing national approaches, and the varying impact of the proposed solutions at Level 2 in these different national contexts, should be kept in mind.

- At the same time, we support the maximum harmonisation principle established by the Directive and its application in the implementing measures. In several parts of the advice, CESR seems to allow for the possibility of Members States imposing additional requirements. While we believe that this in any event contradicts the Level 1 of this Directive, the key purpose of which was establishing a single passport for investment firms, we also believe that allowing Member States to impose additional requirements would undermine the overarching objective of achieving a more standardised approach to investment services regulation across the EU as a whole. We believe that CESR should seek to follow the principle of harmonisation while providing the necessary framework for flexibility and efficiency.

- In many areas, the CP envisages far too many heavy disclosure requirements. These are unnecessary, burdensome and not obviously of any benefit to customers. They do not meet the points raised by the Post-FSAP Securities Expert Group, which underlined that regulation should be justified and shown to be needed and beneficial before it is imposed. Among the disclosure requirements of concern are those relating to best execution policies (which we will come back to in our next submission) and conflicts of interest policies. In addition, we see it as absolutely imperative to ensure that information provided to clients can be standardised. In particular, one needs to consider the need not to impose unnecessary burdens on the regulated entities, especially the smaller institutions in Europe, as their continued presence is a positive factor in the diversity of European markets.

- Indeed, one of the key needs of an efficient capital market is the ability to standardise basic information provided to clients. The Level 1 text very clearly makes that possible. The current proposals by CESR in certain areas do not seem to allow this. This may partially be due the fact that the 1st mandate was prepared at a time when the final shape of Article 19, Paragraphs 4, 5 and 6, was not yet known. These paragraphs are dealt with in the 2nd mandate, and will allow CESR to work on the tailored information to be provided to clients. We believe that it is very important not to confuse the requirements called for by Article 19.4 and 19.5 with the basic information requirements in the rest of the Article. We provide concrete drafting suggestions in Section III to ensure that standardisation remains possible.

- We are firmly convinced that there should be “grandfathering” arrangements and transition measures on a range of requirements introduced by the Level 2 measures. The requirements introduced by MiFID should only apply to new customers or to existing customers when revised terms and conditions are being sent to them to avoid the need to send a substantial amount of documentation to a large number of existing customers. Furthermore, as we stated in our August 2004 letter, the implementation schedule of the Directive and its implementing measures will have to be carefully revised to take into account the amount of time needed for the regulators and industry to complete the necessary preparations. Not allowing adequate time would not only undermine the effectiveness of the policies introduced, but might also cause unnecessary delays and slippage in subsequent stages.

- One of the most important questions posed by the CP concerns a proposed reversal of the burden of proof for firms. We believe that such a reversal would be either unconstitutional or against the established legal traditions in most jurisdictions within the EU and strongly urge CESR against adopting such an approach. It should be up to the competent authority to demonstrate that the investment firm has breached a conduct of business rule, and not up to the firm to prove the contrary.

- Last but not least, the Level 2 measures must be fully consistent with other existing or upcoming EU legislation and their Level 2 measures, such as the Market Abuse Directive (which also covers the conflicts of interest related to research, for example) and the latest work by CEBS on outsourcing. The MiFID rules must not only be consistent with these other laws, but they must also avoid all overlaps and duplications. On a similar note, CESR's advice on the Level 2 measures must be consistent with existing or upcoming international initiatives and regulation, such as the ongoing work on the compliance function (which involves IOSCO and the Basel Committee as well as CEBS.)

II. SUMMARY OF KEY POINTS BY SECTION

Compliance and Personal Transactions

- The FBE considers that firms should be obliged to have an independent compliance function. However, this should be a functional rather than an organisational requirement. This means there would be no need for smaller firms to have a separate Compliance Department, provided compliance is otherwise managed in a way that includes sufficient independence.

- It is very important for the final work of CESR in this area to be fully consistent with the ongoing work undertaken by other bodies, notably the Basel Committee.

Obligations Relating to Internal Systems, Resources and Procedures

- We believe that CESR's proposal goes farther than International Accounting Standards and, as such, is too prescriptive and should be re-phrased.

Obligation to Avoid Undue Operational Risk in Case of Outsourcing

- We consider that it is not necessary to have as much detail on outsourcing. Furthermore, as CEBS and CESR have both published requirements for outsourcing and IOSCO is 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 offering investment services as they will be subject to both the CEBS and CESR requirements. It should be clarified that it is not necessary to send a pre-notification to the authority if the investment firm intends to outsource.

Record Keeping Obligation

- There should be no separate obligation for the investment firm to demonstrate that it has not acted in breach of its obligations under the Directive. Furthermore, we oppose CESR's proposal to impose a requirement to voice-record telephone orders. Moreover, the text should be reviewed for consistency with the Distance Marketing Directive ("Directive 2002/65/EC concerning the distance marketing of consumer financial services").

Safeguarding of Clients' Assets

- CESR should not go further than requiring a firm to exercise due skill, care and diligence in the selection, appointment and periodic review of the depository including a regular review of the continuing appropriateness of its selections.

Conflicts of Interest

- The proposals are excessively detailed and formalised. Many of the matters for which CESR appears to be proposing rules should only be dealt with in the context of compliance policies and a firm's internal arrangements and not legislative text, e.g. the detail relating to conflicts of interest, information barriers, and information on inducements.

- Furthermore, the section should be fully revised to ensure that there is no overlap with the requirements of the Market Abuse Directive ("Directive 2003/6/EC on insider dealing and market manipulation"). Where an overlap with or a contradiction of the Market Abuse Directive regime exists, or the MiFID mandate is exceeded, the proposals should be deleted.

Fair, Clear and Not Misleading Information

- CESR's advice seems to foresee Member States being able to require additional requirements. We strongly oppose this approach.

- This requirements should be formulated in a high-level manner, since the more detailed information and reporting requirements are based on the types of services received by clients, either Article 19.4, 19.5 or 19.6, and must not be imposed on all clients irrespective of the type of service.

- The FBE recognises that regulators have a legitimate public policy concern to ensure that non-professional clients of a firm are not misled. However, it is important that the protections which are built into the process are built in the right way and at the right point in the sales and distribution process. We believe it is right that the customer should have received the required information about the characteristics of, and risks associated with, the types of financial instruments in question by the time an order is placed. At present, however, CESR's advice fails to make an adequate distinction between the various stages of the relationship with the customer from the time the relationship is initiated to the placing of an order. It would be unreasonable, in our view, to provide the customer with all the information at a stage where a business relationship is merely being initiated.

- Furthermore, it is important to differentiate between information which should be provided when advertising a product and information which should be provided at

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the point of sale or prior to sale at the latest. An advertisement should be fair, clear and not misleading, but this should not require a detailed statement of the risks associated with the product – as seems to be required by Box 7 Paragraph 8 (a).

Information to Clients

- CESR's advice seems to foresee Member States being able to impose additional requirements. We strongly oppose this approach, for the reasons explained above.

- This requirement should be explicitly restricted to non-professional clients.

- The section needs to be revised so that it does not hamper the bank's ability to standardize information, which is explicitly allowed in the Directive.

- CESR seems to require a firm to provide all information "in writing". We think it is good practice to give the client written information on the risks and characteristics of the type of financial instrument s/he is interested in, e.g. generic information on the possible effects of illiquidity. 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 think that Article 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. Such information might also be available on the web. Additional requirements would pose severe problems for existing service models, such as direct banking.

Client Agreements

- While we welcome the restriction to non-professional clients, we are convinced that many of the requirements are not mandatory under EU law and are additional requirements CESR proposes to impose. Accordingly we suggest reducing the information proposed in order to achieve an adequate content of the retail client agreements. Finally, the question of how to deal with existing clients is not explicitly resolved. It would be unreasonably burdensome if all contracts with an investment firm's existing customers had to be replaced.

Reporting to Clients

- We would want it to be clearer that the statement of clients' assets only needs to be sent once. As a general principle, it should be possible for the firm not to send the information physically but rather to make it available to its clients on the firm's website. This would be in line with Article 19.8 of the Directive. Furthermore, this section should not require any duplication of information already sent to clients, e.g. confirmation notes of executed orders. Such items should be left to the service agreement between the firm and the client.

Client Order Handling

- Generally, and in this section in particular, we believe that CESR should be prepared to deviate from the existing CESR Standards in view of the fact that they have been put in place some time ago and on a transitional basis, and were focused on equities.

- We agree with CESR that the client order handling requirements should apply to dealings with non-professional (retail) clients. Professional clients are able to look after their own interests and many professional orders are larger, more complex, and have more conditions attached.

- We agree with CESR that order aggregation should be permitted if it is likely that aggregation will not work to the disadvantage of a client and if there has been disclosures of the possibility that the effect of aggregation could sometimes work to a client's disadvantage. Aggregation with own orders, while exceptional, should also be allowed to accommodate those situations where a small client order may otherwise be clearly disadvantaged.

Transaction Reporting

- In MiFID, the obligations relating to transaction reporting apply to financial instruments admitted to trading on a regulated market. However, the CP envisages that the obligations will apply with regard to all MiFID financial instruments. This would be exceeding CESR's mandate. We were pleased to hear in the Open Hearing that CESR will look into this question and hope that the matter will be clarified accordingly.

- Secondly, we believe in the need for a harmonisation of the content of the transaction reports so as to generate cost efficiency for firms working on a cross-border basis. This should be provided alongside with flexibility in terms of format so as to allow the existing (in some cases, rather comprehensive) reporting systems to continue so that disruptive transitional costs are avoided.

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III. DETAILED REMARKS & ANSWERS TO QUESTIONS

Section II of the CP – "Intermediaries"

❖ **Compliance and Personal Transactions (Article 13.2 – pages 11-17 of the CP)**

The FBE considers that firms should be obliged to have an independent compliance function. However, this should be a functional rather than an organisational requirement. This means there would be no need for smaller firms to have a separate Compliance Department, provided compliance is otherwise managed in a way that includes sufficient independence.

In particular, while larger firms can be expected to have separate personnel working in a compliance department and working exclusively on compliance matters, it is not practical to require this in small firms. In those firms it should be permissible for a person to act as compliance officer and hold other responsibilities provided that s/he is not responsible for monitoring her/his own compliance with her/his additional responsibilities – that should be monitored by someone else – either within the firm or an external appointee. Independence should be interpreted in such a way as to permit this approach.

In line with these views, our answer to Question 1.1 is as follows:

Question 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 its business?

Answer: The FBE considers that Paragraph 2(d) of Box 1 (page 14) should provide that:

> "An investment firm must be able to demonstrate that the compliance function of the firm is independent. The way in which a firm organises itself to ensure the independence of its compliance function may vary depending upon the nature, scale and complexity of the business, and includes a range of possible organisational arrangements such as a separate compliance department as well as the compliance function being executed on a part-time basis. These different organisational arrangements are allowed as long as the investment firm can ensure that:
>
> (i) the individual/s in the compliance function is/are not allowed to monitor their own activities;
>
> (ii) the budget and remuneration of the compliance function is linked to its own objectives. It may be linked to the overall performance of the firm, but

> not to the individual lines that are directly subject to the compliance function."

With respect to Code of Conduct (page 16), we interpret Paragraph 6(e) as allowing Chinese walls as one possible method of conflicts policy and support the text on this basis.

With respect to Personal Transactions (page 16), first of all, we believe that CESR should re-consider whether Paragraph 7 (a) of Box 1 is duplicating requirements under the Market Abuse Directive. We think this paragraph is duplicative and should be deleted.

Secondly, we interpret CESR's advice as one allowing a range of different arrangements, so that notifications would not have to be made, for example, if not required by the firm (see Paragraph 7.(c) [marked "(d)" in Box 1].

Question 1.3 (in Box 1 on page 17 of the draft advice): Should the current text of CESR Standard 127 be extended to the outsourcing of all investment services?

Answer: As for all other CESR Standards, this standard too should be reviewed to determine whether it remains appropriate to the current context established by the Level 1 Directive. We believe that outsourcing should be allowed for all investment services, as the benefits of this flexibility would apply to all other fields. In this sense we would favour applying the outsourcing possibility provided in the draft advice to all services. On the other hand, any application of the conditions for outsourcing should take due account of the difference between products and services and the respective levels of risk.

- **Obligations Relating to Internal Systems, Resources and Procedures (Article 13.4 and 13.5, 2nd subparagraph – pages 18-21 of the CP)**

Paragraph 4 of Box 2 (page 19) goes farther than International Accounting Standards and, as such, is too prescriptive and should be re-phrased. 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 file 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 position. A firm's accounting procedures should include: a) documentation…[Text to continue as CESR text]..rules set out by the relevant authorities."

❖ **Obligation to avoid undue Additional Operational Risk in Case of Outsourcing (Article 13.5, first subparagraph – pages 22-24 of the CP)**

CEBS and CESR have both published requirements for outsourcing. IOSCO is 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 offering investment services as they will be subject to both the CEBS and CESR requirements.

We consider that it is not necessary to have as much detail on outsourcing. For example, it is not appropriate that the content of a service level agreement between a firm and its outsourcer should be included in Level 2 law.

Only "material" outsourcing arrangements should have to be notified to a competent authority, and they should be notified after they have been made, not before. Even though it does not seem to be CESR's intention to require a pre-approval of such arrangements (and doing so would in any event probably be beyond the mandate), a reference to pre-notification would create confusion as to the respective rights of the authority and the firm signing the contract. In fact, the wording of Paragraph 7 of Box 3 (page 23) is quite vague, referring to the intention of an outsourcing arrangement. Hence, we would suggest revising the paragraphs as follows:

> "An investment firm must provide the competent authority with notification of the material outsourcing arrangements it has entered into falling within Paragraph 2 and make available all relevant information, enabling the competent authority to effectively exercise its supervision in respect of the provisions referred to in this advice."

❖ **Record Keeping Obligation (Article 13.6 – pages 30 of the CP)**

Question 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?

Answer: No. There is no need for a separate obligation, and we believe that to impose one would contradict the Level 1 text (Art 13.6). The content of Art 13.6 coupled with the proposed text of Box 1 Paragraphs 2 (a), (b) and (c) are sufficient.

Moreover, the proposed draft text is objectionable because:

(1) It puts the burden of proof on firms – something which is either unconstitutional or against the legal tradition in most jurisdictions;

(2) It would force firms to prove that they did <u>not</u> do something on many occasions – which is usually impossible to prove. The problem is to demonstrate to the authority that in a particular event the firm has acted in accordance with the client's instructions and in compliance with the regulatory requirements;

(3) The Distance Marketing Directive foresees the possibility of a shift of the burden of proof for a specific type of service provision. This specific regulation cannot be extended to other services.

The FBE has the following general comments on Box 4 (pages 27-30):

We oppose the requirement of Paragraph 2 (b) to "keep records of telephone orders on a voice recording system for a period of at least one year." CESR intends to impose a requirement to voice-record telephone orders which would be a completely new requirement within the EU as it is not required almost anywhere in the EU so far (with the exception of one jurisdiction) and would be very costly to implement. It is not obvious to us that it would be helpful as a general requirement. Furthermore, complying with such a comprehensive requirement would raise significant problems with privacy rules in many jurisdictions.

It goes without saying that the FBE members currently capture the required data relating to all orders received from customers, as the current ISD requires. However, they do not voice-record all telephone orders. By way of example, telephone orders from non-professional customers given to local bank branches are typically not recorded.

We consider that the decision as to the scope of telephone orders to be recorded should be left to the bank, which will be best placed to determine its need, depending on the type of its business and clientele. Hence, Paragraph 2(b) of Box 4 should be deleted.

Similarly, in order to allow for different needs of firms, Paragraph (c) in Box 4 should be revised as follows:

> "keep records in such a way, …that they may be readily reproduced on paper ***or readily accessible on another durable medium***, and that…"

In the Annex of Box 4, we would suggest the following changes:

- "Aggregation of one or more client orders and an own account order" – seems inconsistent with the section on Conflicts of Interest, which forbids this (please see our remarks there).

- "Financial instruments held for clients used for stock lending activities" – should only include those instruments that have been lent, and not available to be lent since, in many cases, this will mean a very large range of securities which may never, in fact, be lent. It is only securities which are actually lent which are relevant.

- "Marketing Communications" should be changed to "Direct offer retail marketing communication". This should also allow for the special case of websites, which would be very cumbersome to record as they are subject to change on a very frequent basis.

Finally, we would like answer Question 4.2 in Box 4 as follows:

Question 4.2: What should the nature of the record keeping requirement be in relation to different types of services (capital markets business, investment banking, general financial advice)?

Answer: We believe that there should be no additional requirements for any of these services.

- **Safeguarding of Clients' Assets (Article 13.7 and 13.8 – pages 31-38 of the CP)**

In Box 5 (page 34), Paragraph 8(a), CESR should not go further than requiring a firm to exercise due skill, care and diligence in the selection, appointment and periodic review of the depository including a regular review of the continuing appropriateness of its selections. The matters in (i) to (v) could be part of guidance about what could be included in a review, but should not be part of Level 2 measures.

Paragraph 8(a)(i) should permit firms to use unauthorised depositaries in jurisdictions where there is no regulatory requirement for a depositary to be regulated.[3]

Paragraph 12(b): It would be hardly possible to deliver risk disclaimers (legal opinions) on the implications of pooling under foreign laws.

Paragraph 12(d): The extension to other jurisdictions is not feasible, given the complexity of obtaining legal opinions for all the countries where one has sub-custodians, constant updating, etc.

In addition, we would like to answer the questions as follows:

Question 5.2 (in the draft technical advice): Should a requirement be imposed that the records of the investment firm must indicate for each client the depository with which the relevant client's assets are held?

Answer: No, it should be possible to keep these together as is the practice today – which raises no concerns. Securities in most central depository systems are held on a fungible basis. In this case, there is no possibility of (or added value in) knowing exactly where the respective client's assets are. The client entitlements to securities deposited under the fungibility regime are protected in case of bankruptcy of the intermediary. The client will have a proportionate claim on securities of the same category held with the central depository.

[3] Our Italian member considers that firms should only use authorised depositories.

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Question 5.4 (in the draft technical advice) 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) required to accept the same responsibility for a depository that is a member of its group as it accepts for itself; or

(b) must the contract between the investment firm and the client state that 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 in the selection and periodic review of the depository?]

Answer: Some of our members prefer the approach under option (a), provided that the investment firm would not be held to the same degree of responsibility for a depository of its group when such a depository is not acting as a local custodian, but as a global custodian (re-depositing securities held with 3rd parties). Other members prefer the option under (b).

- **Conflicts of Interest (Article 13.3 and 18 – pages 39-48 of the CP)**

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

Answer: No.

Question 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? (c) If the answer to question (b) is yes, which of these measures should be subject to the requirement referred to in that question?

Answer: Most of our members want the arrangements described at (a) to (f) to be described as examples. Only some would prefer them to be included in Level 2 measures.

Question 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?

Q 6.3(a)

Answer: Yes, we support this separation.

Q 6.3(b)

Answer:

Most of our members consider that information barriers should exist between analysts and (i) corporate finance business, (ii) portfolio management and (iii) proprietary trading.

Others 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. They believe that 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's Rules relating to analysts.

Question 6.4.: Should the derogation from the requirements in paragraph 16(f)(i) to (v) be available if: (a) the investment firm complies with the requirements in paragraphs 17, 18 and 19 of the first option set out below, or (b) the investment firm complies with the requirements in paragraph 17 of the second option set out below?

Answer: Both options (a) and (b) should be available. If we had to choose between them, most members would think that the option (a) is preferable.

We note that the provision relating to inducements (Paragraphs 9 to 11 in Box 6, page 45) are from the original CESR Investor Protection Standards and have remained unchanged. However, 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 give anything other than a general description of the sorts of "inducements" it receives (e.g. soft commission). In particular, a firm may provide a range of different services to one client only some of which may be affected by inducements, while others may not. A different client may use different services affected in a different way. To oblige firms to establish the resulting variable geometry 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 no tangible benefit to clients or regulators. Moreover, it is often disproportionately costly and burdensome to quantify those inducements (e.g. soft commissions).

It would make more sense to ensure that the investor receives general information about the inducements utilized by the firm, but not in relation to each transaction or service. We would therefore propose that Paragraph 11(b) be deleted, or, in the alternative, be re-drafted as follows:

> "(b) at least once a year, in general terms, of the nature of any inducements which it gives or receives."

Furthermore, it is necessary to clarify that inducements do not comprise commissions paid back to some investment firms by others as a professional fee of an investment service. This payback of commissions (e.g. rebate) is a technical way of payment of investment services, necessary to pay the investment firm carrying out an investment service.

Otherwise, the monies and utilities received or offered, not directly connected to an investment service, should certainly be considered as inducements. In this view typical inducements are utilities or services given to collective or individual asset managers.

We would propose that SECTION I – DEFINITIONS p. 11 "Inducements" be revised as follows:

> "(……); commissions paid back to investments firms by others as a professional fee of an investment service provision are excluded."

Finally, the disclosure requirements in Box 6 should be such that the general types of conflicts which exist have to be disclosed. We believe that this is the intention of this section, but we are concerned that some of the paragraphs in Box 6 might be interpreted as requiring disclosure on a client-by-client basis. These paragraphs should be re-drafted so as to make it clear that the disclosure needs to be made in general terms, not client by client. In particular, we would recommend the following changes:

- Paragraph 12 of Box 6 goes beyond Level 1, which does not require disclosure of the conflicts policy to the client. Furthermore, a general disclosure of such policies is mandated in the Market Abuse Directive (Article 5.2 of the Level 2 Commission Directive 2003/125/EC as regards the fair presentation of investment recommendations and the disclosure of conflicts of interest), which requires "disclosure, in general terms, of the effective organisational and administrative arrangements set up within the investment firm or the credit institution for the prevention and avoidance of conflicts of interest with respect to recommendations, including information barriers." Furthermore, Paragraphs 5 and 6 of the same article of the implementing measure explicitly allow for the necessary flexibility with respect to the disclosure to ensure proportionality. In light of this provision in the context of the Market Abuse Directive, we feel that CESR's proposal in Box 6 would be of no additional use to clients but instead would add to costs and may constrain the flexibility set out by the Market Abuse Directive.

❖ **Fair, Clear and Not Misleading Information (Article 19.2 - pages 49-53 of the CP)**

On page 50, CESR states that: "Member States may impose additional requirements in relation to the subject matter of this advice".

For us, the text of MiFID does not provide for this possibility. However, even if this were an accurate statement of EU law, we would strongly discourage the Members States from imposing additional requirements in view of the very detailed nature of the requirements in Box 7 and the overarching objective of achieving a more standardised approach across the EU as a whole.

If individual Member States imposed additional divergent information requirements, this would be harmful in the development of a Single Market.

In addition, we have the following general points about Box 7 (pages 50-53):

The FBE recognises that regulators have a legitimate public policy concern to ensure that non-professional clients of a firm are not misled. However, it is important that the protections which are built into the process are built in the right way and at the right point in the sales and distribution process.

The FBE agrees with the "value chain" approach advocated by the Commission's Banking Expert Group. This points out that the EU authorities and regulators, when developing regulation, should take into account the way in which products are developed and sold. In particular, in the context of Box 7, it is important to differentiate between information which should be provided when advertising a product and information which should be provided at the point of sale or just prior to sale.

An advertisement should be fair, clear and not misleading, but this should not require a detailed statement of the risks associated with the type of product – as seems to be required by Box 7 Paragraph 8 (a). This sort of detailed information should only be required prior to the sale – either in the form of advice (in the case of an advised sale) or in the form of information about the risks associated with the type of product a client is proposing to trade in (which could be given to an execution only client, either when signing up for an execution only service, or prior to trading).

In view of this, we consider that Box 7 Paragraph 8(a) and (b) should be deleted.

If such a deletion were not accepted, we would strongly advise that Paragraph 8, with the exception of the information on liquidity (which is impracticable), be limited to direct offer marketing communications (as defined under Item 15 of page 9 of the draft technical advice).

We believe it is right that the customer should have received the required information about the characteristics of, and risks associated with, the types of financial instruments in question by the time an order is placed. At present, however, CESR's advice fails to make an adequate distinction between the various stages of the relationship with the customer from the time the relationship is initiated to the placing of an order. It would be unreasonable, in our view, to provide the customer with all the information at a stage where a business relationship is merely being initiated. We therefore suggest adding a second sentence to Paragraph 2 on page 50:

> "Where the requirements laid down in the following provisions would be disproportionate in relation to the media and the kind of client contact, it shall suffice that the client may obtain further information from the investment firm before entering into a contract."

Such an approach is also in line with the implementing measures of the Market Abuse Directive.

Furthermore, the requirements in this section should not be confused with what should be required of the investment firm when providing services under Article 19.4 or 19.5, which are subjects of the 2nd mandate for technical advice. It is appropriate for the firm to provide certain types of information under 19.4 and under 19.5, but it is not correct to extend this information to all clients and potential clients, including those receiving services under 19.6. The obligations required general for all clients should therefore be only high-level in this section. (These comments also apply to Information to Client – please see below).

❖ **Information to Clients (Article 19.3 – pages 54-59 of the CP)**

On page 55, CESR states that: "Member States may impose additional requirements in relation to the subject matter of this advice".

For us, the text of MiFID does not provide for this possibility. However, even if this were an accurate statement of EU law, we would strongly discourage the Members 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 imposed additional divergent information requirements this would be harmful in the development of a Single Market.

Similarly, we would like to reiterate our comments above regarding the need to ensure an appropriate distinction between the information to be provided to all clients or potential clients versus information only to be provided to clients receiving the services under Article 19.4 and information to be provided to clients receiving services under Article 19.5. In fact, we find that it would be useful for CESR to revise its proposal in this section in its entirety in the context of the upcoming work on Articles 19.4 and 19.5, which are part of the 2nd mandate for technical advice.

Furthermore, in all cases, it is important to keep in mind that the Directive explicitly allows the firm to provide information in a standardised form. To achieve a consistent approach on this point, throughout the section, "financial instrument" should be replaced by "type of financial instrument" and "transaction" should be replaced by "type of transaction". For example, Paragraph 7 (second indent) in Box 8 should be revised to refer to **"*type of financial instruments*.**"

Another important point is that this section should not apply to professional clients. This is again in line with the Directive, which requires CESR to consider the different needs of the client types. Accordingly, this section should only apply to retail clients.

With respect to Box 8, the proposal requires a firm to provide all information "in writing". We think it is good practice to give the client written information on the risks and characteristics of the type of financial instrument s/he is interested in, i.e. generic information on the possible effects of illiquidity. It is not practicable to require written information concerning the specific instrument, i.e. details about its liquidity (Paragraph 8 (a) (ii) (1), whether it is traded on regulated markets (Paragraph 8 (a) (ii) (2), or its duration (Paragraph 9). We think that Article 19.3 envisages giving this type of generic information ("standardized format"). More specific information would be provided by firms as a matter of service and competitive advantage, but should not be required as a basic level of information.

❖ **Client Agreements (Article 19.7 – pages 60-64 of the CP)**

First of all, we expressly welcome the restriction of Box 9 to retail clients. Nonetheless, the content of the Box will still have to be streamlined to achieve a proper balance in the interest of retail clients.

In view of the substantial and complex requirements that CESR requires a firm to include in its client agreement, it may be difficult to ensure that the agreement will be "clear and easily understandable by the client". In any event the test for whether the agreement is "clear and understandable" should be an objective one, not the subjective view of the client.

We would propose adopting the wording already used in Box 7 Paragraph 3(a) and amending Box 9 (pages 60-64) Paragraph 3 to read as follows:

> "The retail client agreement must be clear and likely to be understood by the average member of the group of clients (retail/professional) receiving the agreement".

Many of the requirements in Box 9 are not mandatory under EU law but are additional requirements CESR proposes to impose. In the cases where some of the requirements are already in EU law, they are duplicative since similar provisions are already imposed by the Distance Marketing Directive. Where the same requirements are targeted, this should be done in a way that is streamlined for firms complying with both Directives. For example, Paragraph 4, subparagraph (e) and subparagraph (l) should be replaced by wording used in the Distance Marketing Directive.

It is stated that client agreements must be clear and easily understandable. It would be impossible to fulfil this requirement if we took into consideration the number and nature of the items of information required: client agreements would be made of several pages and would be technically complex.

Accordingly we suggest reducing the information proposed in order to achieve an adequate content of the retail client agreements. In this respect the following provisions could be deleted:

i. the types of orders and instructions that the client may place with the firm. This type of information may differ by regulated market or other trading venue. Investment firms can be linked with several trading venues with different types of orders. In case of 5 to 6 trading venues, it could mean nearly 40 to 50 types of orders, which may be often modified and would have to be described;

ii. the actions that the firm shall or may take to dispose of, or appropriate, any assets of the client in the event of the client not honouring her/his obligations [(e.g. payment of money due to the firm)], including the timeframe for doing so and the information to be given to the client in such circumstances. It is a very complex matter which doesn't seem to be considered adequately as it relates to breaches of agreement;

iii. where a custody service is provided to a retail client, either directly by the investment firm party to the contract with the client, or indirectly by another investment firm or other entity, the contract must contain an adequate indication of the rights and obligations of the parties, including the provisions relating to the exercise of corporate actions (such as takeover bids and other tender offers, capital reorganisations and conversion or subscription rights) and the exercise of voting rights relating to the securities held. This type of information does not relate to investment services, but to the custody/safekeeping agreement.

We also suggest considering as optional the following indications relating to useful but inessential elements:

i. the geographical address and telephone number or other appropriate contact details of the investment firm;

ii. the identity and geographical address of any relevant representative of the firm established in the client's Member State of residence.

The obligation to revise client agreements in accordance with an implementing measure based upon Box 9 is an example of a requirement where it is imperative that transitional arrangements are put in place. In many countries, firms will not be in a position to revise client agreements and send them to all existing customers immediately on the coming into force of MiFID at the start of May 2006.

According to the consultation document, Article 19.7 requires retail client agreements to be concluded in written form, i.e. signed by the customer. Under Paragraph 5, it will be possible to refer the customer to other documents, so it will continue to be possible to use general terms of business, for example. The question of how to deal with existing clients is not explicitly resolved. It would be unreasonably burdensome if all contracts with an investment firm's existing customers had to be replaced. This would necessitate sending out the new contracts, having them signed and returned by the customer and sending at least one follow-up package to those customers who fail to respond. In Germany, for example, with over 30 million securities accounts, postage costs alone would pose a heavy cost burden on the firms and ultimately its clients. In the interests of proportionality, the new form of contract should only be mandatory for new customers. It should at least be sufficient, simply, to advise existing customers about the new rules and, if necessary, send them any information which is not covered in their existing contracts without the need to obtain their signature. As we believe it is doubtful whether this would be permissible under the civil code of some Member States with the envisaged wording of the current draft, this point needs to be clarified.

Alternatively, one could require a new contract to be introduced at the time when the client requests an additional service or a change to the services offered.

- **Reporting to Clients (Article 19.8 – pages 65-69 of the CP)**

In Paragraph 3 in Box 10 (page 67), we believe that it would not be appropriate to require confirmation of unexecuted orders. By requiring a confirmation of orders that are executed, one already ensures that the client will be duly aware of the fact that an order has not been executed yet. This is especially important since it is the practice in most of the European markets to have orders with long validity periods. If the firm had to continuously send notes to the effect that the order is not executed, in those cases where the market conditions do not allow an order to be executed, it would be excessive in terms of cost and also confusing for the client. If this requirement is not deleted, it should at least be made clear that it is not CESR's intention to require a continuous notification regarding the status of the unexecuted orders.

As a general principle applicable for the whole of Box 10, for the information to be reported, it should be possible for the firm not to send the information but rather to make it available to its clients on its website. This would be in line with Article 19.8 of the Directive.

In terms of drafting, we find it difficult to understand precisely what is required by Paragraphs 8 and 9 of Box 10 (pages 66-69).

In Paragraph 8, we would want it to be clearer that the statement of clients' assets only needs to be sent once. For example, if a monthly statement is sent, it is not appropriate for there to be a further annual statement aggregating the information already given in the monthly statement. This would be an unnecessary duplication. Furthermore, we find that the subparagraph (c) of Paragraph 8 would be a clear duplication of confirmation notes which the client will have received throughout the year. This kind of additional reporting should be left to the service agreement between the firm and the client. Hence, Paragraph 8(c) should be deleted.

In Paragraph 9 we were particularly unclear about what subparagraph (b) meant. 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. We support this, but it would be helpful to give firms a better idea of what sorts of additional material might be acceptable, perhaps by way of CESR guidance.

Paragraphs 16(d) and 18 in Box 10 should be deleted in line with arguments we presented above in relation to inducements.

Question 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?

Answer: No further reporting requirements are needed.

❖ **Client Order Handling (Article 22.1 – pages 80-84 of the CP)**

First of all, we agree with CESR (Box 11, Paragraph 2) that the client order handling requirements should only apply to dealings with non-professional (retail) clients. Professional clients are able to look after their own interests and many professional orders are larger, more complex, and have more conditions attached.

We also agree with CESR (Box 11, Paragraph 8) that order aggregation should be permitted if it is likely that aggregation will not work to the disadvantage of a client and if there has been disclosures of the possibility that the effect of aggregation could sometimes work to a client's disadvantage.

Aggregation of orders is carried out throughout the EU. It is generally only carried out for non-professional clients. The rationale is that 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 execution and settlement costs.

As the price of a security may move before an order is placed, at the date at which the order is executed, the revised price might sometimes be lower than it would have been at the time when the order was given (but it could equally be higher). Usually any lower price is offset by the lower settlement costs. Aggregation thus 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 a smaller order – so this is also an advantage of aggregation.

Overall, therefore, aggregation generally works to the advantage of clients and should continue to be allowed as proposed here.

Q.11.1:*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?*

Answer: We assume that by this question CESR asks whether we agree with the text of Paragraphs 2 to 7 of Box 11. We do, subject to the following comment in relation to Paragraph 7:

We agree that the primary rule in Paragraph 6 should be to execute non-professional orders sequentially. There is a variety of situations when this may not be appropriate and deviation from it 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 think that it would be preferable to make the text of Paragraph 7 a little less prescriptive. We would propose that the last part of Paragraph 7 should be amended to read:

> "Or for other reasons that do not disadvantage the client."

This wording mirrors the text and the approach of Paragraph 8 on aggregation and gives an appropriate balance between the interests of the client and the need for operational flexibility.

On the other hand, the wording of Paragraph 7 is also open to misunderstanding in that the timing of the order is not at the discretion of the firm, but the investor, and it may be useful to provide further legal clarity on what would be covered by "prevailing market conditions", for example.

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Q.11.2: *Do you think that the details of the orders included under paragraph 2 of the draft technical advice should apply also to professional clients?*

Answer: No, we believe that they should not apply to professional clients at all, and the information needs should be left to the firm and the professional investor to determine. The needs of the retail and professional investors in this situation are entirely different; the professional investors will know what information they need – and they will not need all the information set out in Paragraph 2.

Q.11.3: Which arrangements should be in place to ensure the sequential execution of clients' orders?

Answer: There is no need to set out any further requirements other than those set out in Box 11, Paragraphs 2 to 7.

Q.11.4: 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?

Answer: Yes – and see our comments on Paragraph 7 above.

Q11.5: 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?

Answer: No, the fact that such a possibility exists is not in contradiction with the obligation of the firm to act in the best interest of its clients since it does not prevent the firm from fulfilling this obligation – see our comments on aggregation above.

Q.11.6: Do you think that the advice should include the conditions with which the intended basis of allocation of executed client orders in case of aggregation should comply or should this be left to the decision of each investment firm?

Answer: This should be left to the decision of each firm, subject to an adequate disclosure to the client (see the sentence written in page 9, "Client orders handling", second Paragraph).

Q.11.7 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?

Answer: We believe that, in principle, it is reasonable to expect that the aggregation of client orders would only be possible with other client orders, but not with own accounts. However, in exceptional situations, if it clearly works to the advantage of a client (for example, a small order that would otherwise be subject to adverse prices), the firm should have that possibility. This should be subject to rules that ensure that the client is not disadvantaged.

Q.11.8: Do you think that paragraphs 15 and 16 of the draft technical advice should only apply to retail clients?

Answer: Yes.

❖ **Transaction Reporting (Article 25 - pages 101-114 of the CP)**

In MiFID, the obligations relating to transaction reporting apply to financial instruments admitted to trading on a regulated market. However, the CP envisages that the obligations will apply with regard to all MiFID financial instruments. This would be exceeding CESR's mandate. We were pleased to hear in the Open Hearing that CESR will look into this question and hope that the matter will be clarified accordingly.

CESR's current proposal does not attempt harmonisation of the content of the transaction reports. We found CESR's explanation in the Open Hearing as to the reasons for this approach helpful, but believe that CESR should indeed consider harmonisation of the content of the transaction reports as a way of facilitating cross-border provision of services. This will bring about cost efficiency for firms working on a cross-border basis. However, this should be balanced with retaining some flexibility and limiting the burden on those firms which operate in jurisdictions with very elaborate reporting systems. Existing reporting mechanisms should be allowed to continue to the greatest extent possible. Every change to existing systems – especially those which are highly elaborated – will lead to significant costs which might exceed the expected benefits. Hence, harmonisation of content should be coupled with retaining flexibility in the format used in transaction reporting.

Finally, implementation of new or modified systems will need to be done with sufficient time allowed.