Fédération Bancaire Européenne

European Banking Federation

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RESPONSE TO THE REVISED CP ON THE 1ST SET OF MANDATES FOR THE MARKETS IN FINANCIAL INSTRUMENTS DIRECTIVE (MiFID)

I. INTRODUCTION AND SUMMARY

1. The European Banking Federation[1] (FBE) welcomes the opportunity to comment on the 2nd Consultation Paper issued by CESR for the 1st set of mandates of the implementing measures of the Markets in Financial Instruments Directive (MiFID). We welcome the fact that CESR has decided to issue a second consultation on the issues arising from the 1st CP, to which we responded in detail. We believe that the 1st round of consultation made it very clear that many of the issues covered in the 1st set of mandates require further debate.

2. We note, however, that the revised CP covers only a portion of the subjects included in the 1st set of mandates (excluding, of course, the issues that are subject to a different deadline, such as best execution). It is not immediately clear to us at this stage how CESR plans to proceed with the other issues that are subject to the January 31 deadline for submission to the Commission, but which are not included in this new CP. Assuming that they are not going to be revised in any form, we would like to reiterate our concerns with respect to some of those provisions. To facilitate ease of review, we re-attach our first response to the CESR CP on the first set of mandates (Enclosure). These subjects include, among others:
   - Client Agreements (pages 6, 18-20 of the enclosed FBE response to the 1st CP)
   - Information to Clients (pages 6, 17-18)
   - Fair, Clear and Not Misleading Information (pages 5-6, 16-17)
   - Safeguarding of Clients' Assets (pages 5 12-13)

3. With regard to the subjects that are covered by the 2nd CP, we find it hard to respond in greater detail in those areas where no precise Level 2 text is provided. For example, it is not clear to us what changes, if any, CESR is proposing to its original proposal with regard to the burden of proof or the conflicts of interest.

4. The degree of detail in some areas is still not optimal. We need to ensure sufficient flexibility for market participants. However, the degree of detail intended by CESR is far from clear from the 2nd CP. We do not have a clear indication as to the detail of the technical advice to be submitted to the Commission.

5. Another difficulty is the inter-linkages between some of these subjects and the draft advice for the 2nd set of mandates (for example, relevant market for liquidity, information to clients).

6. We are aware that the problems we highlighted above are almost entirely due to the time constraints faced by CESR. One cannot ignore these problems, however, if one is

[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.

to limit any negative impact on the quality of the consultation and the eventual technical measures.

7. Hence, we would suggest that CESR take the following approach:
    - Submit to the Commission its clear preferences on issues on which no further work is deemed necessary;
    - On issues that are outstanding, submit options from which the Commission could choose, with clear explanations of the costs and benefits of these options;
    - Advise to the Commission that the draft implementing measures on certain, inter-connected, issues be grouped together (all Article 19, for example).

8. Turning to the **substance** of our observations, in addition to our remarks in our first response which still stand, we would like to make the following observations:

    - We welcome the fact that CESR has adopted a functional approach to **compliance**, and the acknowledgement that a separate compliance department may not be practical in some firms. We find both of the two options (outsourcing of compliance and allowing some degree of flexibility to investment firms as regards the means to achieve the objective of independence of compliance) potentially helpful, and recommend that CESR make it possible for firms to choose either option. We also do not believe that specifying criteria to define small firms would be helpful or necessary.

    - While we appreciate CESR's statements that "its proposal does not intend to reverse the **burden of proof** but, rather, to introduce obligations of record keeping" and that there is "no assumption of guilt", we continue to be very concerned about how CESR will achieve this goal. We agree with CESR that "the intensity of these [record keeping] obligations varies according to the nature and complexity of business carried out by investment firms". It is exactly for this reason that we would recommend leaving it to the firms to decide how they will establish their compliance with the rules and vis-à-vis the clients.

    - In response to CESR's question, we have had extensive discussions with our members regarding the costs and benefits of **keeping records of telephone orders on a voice recording system**. We come to the conclusion that the result of a mandatory voice recording system would be a net loss for the client, who would have to pay for the costs of the new system while not benefiting from it proportionately. Whether the storage is for 6 or 12 months would therefore have only a limited impact on the overall costs.

    - We welcome CESR's commitment to ensuring convergence with other work on **outsourcing** and alignment with other Directives on e.g. UCITS. However, without sight of the exact wording of the CESR Level 2 advice we are not in a position to comment in more detail.

    - We find the principles listed by CESR on page 9 on **conflicts of interest** generally helpful, but are unable to provide further views without sight of the exact wording of the CESR Level 2 advice.

    - We welcome CESR's clarification that **transaction reporting obligations** are limited to financial instruments admitted to trading on a regulated market. We welcome that fact that CESR has paid special attention to existing arrangements for transaction reporting and intends to refrain from proposing unnecessary new requirements that would bring about excessive additional

costs for the entities concerned. In the long term, we also welcome alignment, where appropriate, of existing arrangements in order to ensure a more consistent and efficient approach for reporting of financial transactions across Europe.

- We support a **proxy-based approach** rather than computing a liquidity measure for each financial instrument admitted to trading on a regulated market, because it is simple and transparent.

9. Last, but certainly not least, we strongly support the introduction of transitional arrangements, and in particular an extension of the MiFID implementation deadline. Without a significant extension of the current implementation deadline of April 2006, we fear that the Directive will miss its objective of integrating investment services and enhancing competition among execution venues in Europe. The implementation of the Directive, with more than 25 pieces of comitology measures will require substantial alterations to the technology and practices of market participants, requiring extensive design, testing and implementation of new systems as well as new training. The precise nature of these changes will not be clear until Level 2 measures have been adopted, and in fact in many cases until after the national implementation has occurred. To complicate matters further, there is a great degree of inter-dependency between the changes that have to be accomplished by banks and the decisions to be made by the regulated markets, which in turn can only be known after the rules are finalised. We believe that the industry will need about a minimum of eighteen months from the finalisation of the rules until the transposition date.

10. This compares with the three to four months that would be left for the industry at best under the current timetable, counting from the supposed adoption of the Level 2 measures. Hence, the FBE strongly recommends an extension of the current transposition deadline. We would therefore ask for CESR's support in achieving an extension of the implementation deadline **until the end of 2007 as a minimum.**

II. DETAILED REMARKS

Compliance and personal transactions

11. In our first response, we agreed with the principles that firms should be obliged to have an independent compliance function. We argued, however, that 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. We also noted that 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

12. We therefore welcome the fact that CESR has adopted a functional approach to compliance. We also welcome CESR's acknowledgement that a separate compliance department may not be practical in some firms.

13. We have two comments in response to CESR's proposal here:

    - First of all, we are not certain if CESR has proposed the two options on page 6 (outsourcing of compliance and allowing some degree of flexibility to investment firms as regards the means to achieve the objective of independence of compliance) as mutually exclusive options. In principle, we find both of them potentially helpful, and recommend that CESR make it possible for firms to choose either option.
    - Second, we do not believe that specifying criteria to define small firms would be helpful nor do we think this to be necessary. We will therefore not make any proposals on such criteria. Instead, we would encourage CESR to focus on a flexible approach that is "appropriate and proportionate to the nature, scale and complexity of the business."

Record keeping and the burden of proof

14. We welcome CESR's statement that it does not intend to reverse the burden of proof, and that there is "no assumption of guilt". However, we continue to be very concerned about how CESR will achieve this goal.

15. We also agree with CESR that firms should be able to conduct adequate and consistent audit trails to demonstrate compliance and that this should enable the regulator to ascertain the firm's compliance. In our view this is the right starting point for the advice to be given. This would also mean that it would be left to the firms to decide how they will establish their compliance with the rules and vis-à-vis the clients.

Tape recording requirement

16. Already in our first response, we strongly opposed 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." This would be a completely new requirement within the EU since there is no such requirement in the EU so far (with the exception of one jurisdiction) and would be very costly to implement. We do not see any evidence 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.

17. 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 voice-recorded. We consider that the decision as to the means by which telephone orders are 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, we continue to believe that Paragraph 2(b) of Box 4 should be deleted.

18. We note in the 2nd CP that our views on this point were supported by the great majority of respondents. If CESR wishes to adopt this requirement, we believe that there needs to be clear evidence of substantial investor protection benefits. Clearly, we would be happy to accept a new requirement that has costs if there were net benefits to the market and investors. We therefore welcome, in principle, CESR's request for input on the costs of the proposed obligation, for instance regarding the marginal cost of the period of record keeping. We believe that the information we provide below will demonstrate that the costs of the proposal far outweigh the benefits in this case, irrespective of the duration of the storage required.

19. After extensive discussions with our members, we have the following input:

20. The costs of the system proposed by CESR can be roughly broken down to the **fixed costs** (including: cost of **installation of the recording system**, **testing** of the system, effort required to address the clash with the **data protection/privacy rules and obtaining of administrative permits**, **staff training**) and **ongoing costs** (including: **maintenance** of the system, **storage** of the data, **retrieval** of the data when requested). In each case, the costs would be composed of a combination of: salaries of the staff, cost of technology used, and opportunity costs. The overall costs would accrue to the firm, but would eventually be passed on to the clients. The installation effort would be complicated by the fact that the systems needed for such recording are considerably more complex than ordinary recording devices (and require, for example, multiple channels). They would therefore need to be built specifically for this purpose.

21. What would be the **magnitude** of these costs for the EU? In the EU financial sector industry, so far only one such system exists, namely in Italy. If CESR's proposal were adopted, the costs would be borne by all the sectors outside Italy which would have to install such systems. The data from Italy is a good indicator for the costs one can expect for the rest of the EU. **In Italy, the aggregate cost of this change as estimated in 1998 was about 250 billion lira**[2], which corresponded to **1 percent of the aggregate costs of the sector that year.**

22. The potential magnitude of the cost for the EU, both on a fixed and ongoing basis, can be easily estimated when considering the fact that a major European bank would receive about 3,000-5,000 calls per day. To take the example of a recent case of a bank in Germany, the recording system will involve 2,700 employees. The telecommunications provider would charge an annual fee of 500,000 Euro (for rent).

23. As the above breakdown demonstrates, the duration of the storage would affect only one of the four major categories of costs. The taping and record-keeping of all retail orders could be achieved technically only if every single retail phone conversation could be taped; in practice, this would mean that all phone connections and extensions

[2] Analysis of the costs of the system was carried out from late 1997 to spring 1998 by the Italian Banking Association. The number of banks was 921. The number of branches was 26,258. Aggregate costs of the sector (not including staff costs) were 25,500 billion lira (Bank of Italy, 1998).

would have to be equipped with a tape recorder, or tape recording would have to be organised through a central phone system (excluding mobile phone conversations). In fact, it would be practically impossible to make a distinction between retail phone conversations that relate to a client order and those conversations that do not. So every phone conversation would have to be taped and stored in a way that allows retrieval. Costs would be enormous irrespective of whether the storage is for 6 or 12 months.

24. By comparison, the benefits of the proposal would be the legal clarity provided in those rare cases where a client disagrees with the firm. The effective potential value-added which may result from such a measure is that it may allow for an easier investigation in those very rare exceptions where there has not been correct recording, and/or where the forwarding of a client order has not been completed. In principle, the benefits would accrue to the firm and the client. In fact, since the bank usually has to prove that the client's telephone order was executed properly, the potential benefit mostly accrues to the bank in the form of additional evidence that can be used in the investigation.

25. What is the magnitude of these benefits? In our view, these benefits are limited, because the cases in which the firm would need to call up recorded conversations would be very rare. This assumption is supported by the practical experience of our members. This benefit is not comparable with the financial and organisational logistics which would be triggered through a technical change in the infrastructure of thousands of bank branches.

26. As a result of the overwhelming costs and limited benefits, we expect that the impact of the proposed rule on retail branches might well be the termination of telephone order service in these branches. Retail clients would be forced to order through execution-only service providers (discount broker, online banking) when asking to put in an order by phone. The end result would be that they would not get any advice before ordering.

27. As a result of the above reasoning, we come to the conclusion that the result of a mandatory voice recording system would be a net loss for the client, who would have to pay for the costs of the new system while not benefiting from it proportionately. In fact, there would be ways of avoiding this situation, since the benefits expected from the proposed obligation are not unique to voice recording. Alternative methods are used by banks to generate precisely the benefits targeted. Retail branches which are not currently subject to such requirements capture orders adequately in other ways, such as manual data input. Experience with using evidence collected in this manner is fully satisfactory and does not support the view that voice recording generates a unique benefit. We therefore strongly urge CESR to revisit its approach on the basis of cost-benefit analysis, and discuss alternative models. In this regard we would like to suggest once more the alternative solution of allowing the firm to make a record of the order (a note) instead of a voice recording, as is the way some jurisdictions implement the CESR Standards for Investor Protection.

28. Finally, as we also argued in our previous response, it is quite debatable as to whether the current proposal of CESR would have the legal basis under Article 13.6 of the Directive, which does not differentiate between the various forms of communication. Requiring voice recording would create a bias against telephone orders.

Outsourcing of investment services

29. In our first response, we noted that it was not necessary to have much detail in Level 2 on outsourcing. Furthermore, we argued, 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.

30. We welcome CESR's commitment to ensuring convergence with other work on outsourcing and alignment with other Directives on e.g. UCITS. However, without sight of the exact wording of the CESR Level 2 advice we are not in a position to comment in more detail.

Conflicts of interest and the segregation of areas of business

31. We find the principles listed by CESR on page 9 helpful. We welcome CESR's acknowledgement that there should be discretion as regards the means to manage conflicts. We also welcome CESR's statement that information barriers such as Chinese Walls are not the only effective means of preventing or managing conflicts of interest, and therefore should not be mandatory.

32. However, without the exact wording of the CESR Level 2 advice, we are not in the position to comment in more detail.

Methods and arrangements for reporting financial transactions

33. We welcome CESR's clarification that transaction reporting obligations are limited to financial instruments admitted to trading on a regulated market.

34. Our members welcome the fact that CESR has paid special attention to existing arrangements for transaction reporting and intends to refrain from proposing unnecessary new requirements that would bring about excessive additional costs for the entities concerned. However, the "minimum content" still contains details (Annex A, field descriptions "price" and "counterparty") that would impose fundamental, and therefore cost-intensive, changes to national reporting systems, without additional quality for the oversight. In the long term we also welcome alignment, where appropriate, of existing arrangements in order to ensure a more consistent and efficient approach for reporting of financial transactions across Europe. We also welcome CESR's objective of not providing detailed and inflexible advice but to propose "a good and workable framework of general minimum conditions" regarding the conditions with which all reporting channels have to comply in order to be approved.

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

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

36. We support a 'proxy-based' approach rather than computing a liquidity measure for each financial instrument admitted to trading on a regulated market because we see it as simple and transparent. We also welcome that CESR intends to state that for the computation of liquidity to determine the most relevant markets in terms of liquidity, the competent authorities need to consider trading on all markets, and not just regulated markets.

37. We welcome the removal of the requirement to make available to the public (rather than just competent authorities) an updated list of competent authorities designated for the purpose of the most liquid markets for a specific financial instrument. We agree that the publication of such a list could have had anti-competitive effects.

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

III. CONCLUSION

39. The revised consultation on the 1st set of mandates is an important part of the process of preparing the implementing measures of the MiFID. As we have highlighted above, there are several subjects that are not covered by the current paper, on which we continue to have concerns. On these subjects, we would strongly recommend CESR to consult again before finalising its advice. We also have concerns with the current proposals made by CESR on some of the subjects covered in this CP. We believe that CESR would need considerable time to go through the consultees' views on many subjects. While mindful of the limited time available to CESR, given the importance of getting the technical advice right on all of these issue, we would urge CESR to:

    - Submit to the Commission its clear preferences on issues on which no further work is deemed necessary,
    - On issues that are outstanding, submit options from which the Commission could choose, with clear explanations of the costs and benefits of these options;
    - Advise to the Commission that the draft implementing measures on certain, inter-connected, issues be grouped together (all Article 19, for example).

40. The FBE is ready to provide any further information necessary, and once again expresses its appreciation for the work of CESR on this important paper.