FEFSI COMMENTS ON

CESR's Advice on
Possible Implementing Measures on the ISD2/FIM/MiFi Directive

SECTION II.11 ON BEST EXECUTION

The European investment management industry, represented by FEFSI[1] welcomes the opportunity to comment on CESR's Advice on Possible Implementing Measures of the Directive 2004/39/EC on Markets in Financial Instruments[2] and is grateful for the slight reprieve that CESR has allowed market participants for the submission of their reactions to the best execution "concept paper" that forms part of the first CESR consultation on draft Level 2 Advice.

For more general comments on the overall first consultation paper we kindly refer you to the FEFSI submission of 17 September 2004. The comments in this response will refer exclusively to the issues of best execution that form part of the first CESR consultation paper on MiFiD of June 2004.

On a general note we observe that the sub-section on best execution of the first MiFiD consultation paper constitutes a "concept paper" and that industry has thus been given an early opportunity to engage in the debate on whether more detailed rules and technical advice is desirable. CESR concedes that its advice will "*require significant attention, discussion and debate*". FEFSI welcomes this and looks forward to the debate, which we believe should take a more 'holistic' approach and not lose itself in detailed requirements. Achieving best execution does not constitute an exact science, and a generally requires a delicate balance to be struck between "time sensitive" and "knowledge sensitive" factors. We believe that the current wording of Article 21 of the MiFiD already provides sufficient detail and we question the need for further Level 2 provisions.

We welcome the fact that CESR acknowledges that best execution applies *a priori* only to the execution of orders on behalf of clients, as an investment service and activity distinct from

1 FEFSI, the European Fund and Asset Management Association, represents the interests of the European investment management industry (collective and individual portfolio management). Through its member associations from 19 EU Member States, Liechtenstein, Norway, Switzerland and Turkey, FEFSI represents the European asset and fund management industry, which counts some 41,100 investment funds with EUR 4.7 trillion in net assets under management. For more information, please visit www.fefsi.org.

2 CESR/04-261b of June 2004.

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portfolio management (cf. in Annex I section A of the Directive). The best execution obligations of Article 21 MiFiD would therefore not apply to the portfolio management activity as such. However, Article 21 in combination with Article 19 are seen to construe a wider obligation – on the basis of the fiduciary duty - that portfolio managers too have to abide by the best execution obligation of Article 21. We accept that the delivery of best execution means seeking the best possible result on behalf of your clients and advocate that investment managers – individual as well as collective portfolio management - have a defined broker selection policy and an order execution policy, which are geared to achieving best execution. In this regard we refer to the FEFSI/EAMA Discussion paper of July 2003 entitled "Trade Quality Best Practice", which sets out the investment management's considerations on best execution.

We would nonetheless call on CESR to take into account that in portfolio management the execution of a transaction order is the culmination of a lengthy investment decision process and must be seen as the ultimate part of the value chain, and not as a stand-alone investment act. We believe it important to establish clearly a differentiation according to the nature of the activity and, in most cases, portfolio managers do not deal directly on the markets. A portfolio manager will instruct a broker/dealer, who has to take all the necessary steps and appraisals to achieve best execution. The portfolio manager should have a defined broker selection policy and an order execution policy, which are geared to achieving best execution and permit the monitoring of the attainment of the 'best possible result'.

We would welcome a clearer differentiation in terms of which obligations concretely apply to brokers and which to investment (portfolio) managers.

Best execution obligation [Art. 21]

In terms of the factors (such as price, costs, size, etc…) as well as the criteria (client, order and venue characteristics) that CESR has put forward FEFSI feels that they represent appropriate parameters with which to assess whether the best possible result can be achieved when executing orders on behalf of investors or clients. Varying market conditions could also constitute a factor of relevance, just as settlement risk and risk management criteria may also have a bearing on the decision as to which broker or venue is used.

When it comes to determining the relevant importance of these factors, we agree with CESR that this should not be done in a standardised ranking format. The evaluation of the aforementioned factors and criteria should in all cases be left to the discretion of investment management companies as frequently the appraisal depends on a delicate balance of intricately interrelated elements.

Moreover, the evaluation process is often determined to varying degrees by client preferences and instructions. Client instructions as regards selection of brokers, or constraints on broker selection arising from the client's choice of custodian, mitigate the duty of best execution to the extent of the constraints imposed. But investment managers will always keep a strong incentive to obtain best execution as this will enhance the performance of assets under management and this is the key factor over which investment managers are held accountable to their investors – be they retail or institutional.

Although as an industry federation FEFSI is ill-placed to provide specific examples of how individual investment firms apply the factors in Article 21(1), we can say that investment management companies will normally use various criteria, including execution capability, quality of research, efficiency of settlement, settlement risks and financial strength in developing an approved broker list and determining how much business they will do with each firm and on which venue.

The order execution policy

Again, although as an industry federation FEFSI cannot provide answers to the very firm-oriented requests for information, we would nonetheless like to offer some more general considerations. We are concerned by the nature of CESR's requests for information, which seem to indicate a desire to provide very detailed draft technical advice. FEFSI maintains its reservations over this.

Effecting high volumes of transactions is a complex task. An order management system will generally be required to maintain control and is also a prerequisite to perform transaction cost analysis.

An investment management company should have a process for the execution of orders in place with specified individuals responsible for each stage of the process.

The order execution process should generate an audit trail, which should in particular specify:

a) When the portfolio manager originated the order;
b) When the portfolio manager gave it to a dealer;
c) When the dealer passed it to a broker;
d) When the broker informed the dealer of the execution price.

The times of all amendments to orders should also be noted.

The order execution process should be able to explain all costs incurred in executing an order.

In addition, an investment management company should have procedures in place to monitor broker selection, order routing, quality of execution and correction of errors.

Order execution policy monitoring requirements

Once more, although as an industry federation FEFSI cannot provide answers to the very firm-oriented requests for information, we would like to offer some more general considerations. FEFSI believes that the quality of execution by brokers used by investment management companies to effect transactions should be monitored on a continuous basis and the allocations reviewed regularly in the light of such monitoring. This requirement includes brokers that are affiliated to the investment management company and who should be treated on an at arm's length basis.

In addition, a transparent process for dealing with errors that is regularly monitored by senior management should be an integral part of the order management system.

Soft and bundled commission and commission recapture arrangements should be monitored closely to ensure that best execution is being achieved.

Should you wish to discuss any particular aspect of our comments in greater detail, we remain entirely at your disposal for further information.

Brussels, 4 October 2004