

HVB Group's response

to

CESR's Call for Evidence

on the second set of mandates from the European Commission on legislative measures to implement the Markets in Financial Instruments Directive (Directive 2004/39/EEC)

3.1. List of financial instruments

- a. Commodity: A ~~primary~~ semi-finished or finished product which has a market value, is tradeable on national or international markets and can be classified.
- b. According to HVB Group, commercial objectives can be pursued with derivative contracts relating to a commodity only if the contracting party of the investment firm classifies the derivative contract as an exclusively private domain contract. It is irrelevant here whether the contracting party concludes the transaction or form of transaction for the first time or not. Instead, the intention forming the basis of the transaction is decisive. For the definition of the term "private domain" we also refer to Art. 13 of the Rome Convention (Official Journal C 27/02 of 26 January 1998) which refers to it as *"not connected with a person's (consumer's) professional or commercial activity."*
- c. The terms "climatic variables", "rates of inflation" etc. may only be defined by means of their common feature which is the fact that the variables are deducted from accepted amounts of data, thus offering market participants a reliable, neutral basis of calculation.

- d. HVB Group does not consider it advisable to finally include the list contained in Section C, notably in C.10, under Level 2 of the Lamfalussy Process. If this happens, developments on financial markets may be taken into account with a time lag only.

Irrespective of that, HVB Group does not believe that the variables for earthquakes have sufficiently been taken into account in Section C. Annex 1 of the Directive.

3.2. Definition – Investment advice – Art. 4 (1) of the Directive

When defining the term "investment advice" it must be considered that under the new directive "investment advice" is a core business which cannot be regarded as an ancillary service provided by the investment firm. The term "investment advice" may therefore only be deemed to denote that the investment firm gives advice which serves the investor's needs and is in conformity with the envisaged investment (see explanation of "investor-compliant advice" and "investment-compliant" below). In addition, special account must be taken of the regulations set forth in Art. 19 (4) to (6) of the Directive serving as interpretation criteria. The terms below are defined as follows in accordance with these regulations:

- a. "General recommendations" are statements made by the investment firm to more than one client and referring to products, product groups, firms, branches or markets. Accordingly, information provided by the investment firm (sales bulletins, country reports, stock valuations etc.) must be regarded as "general recommendations" and not as investment advice, as these statements do not include any "personal advice". It is irrelevant here whether the client himself requested the information, or whether it was submitted to him on the investment firm's own initiative.

To determine whether a service constitutes investment advice or a general recommendation, it must be established whether the client received any personal advice tailored to his individual needs. If recommendations are addressed to more than one client, the service cannot be regarded as investment advice.

- b. We do not think that a clear distinction can be made between the terms "marketing communications" and "general recommendations", since "marketing communications" do not include any advice tailored to a client's individual needs either and thus may not be regarded as investor-compliant advice.

The objective pursued by the investment firm may be regarded as the only distinction criterion for distinguishing between "general recommendations" and "marketing communications." The main objective of "marketing communications" is to cause a product which is advertised by mailings, radio and television advertising or posters to become known to a potential group of clients. It is also irrelevant here whether or not the investment firm made a rough selection within the target group for its "marketing communications."

- c. The term "simple offer" means that the investment firm, when making such an offer (as in the case of "general recommendations" or "market communications") does not take an individual client's needs into account. Instead, the investment firm will offer a product regardless of the clients' personal profile. The primary distinctive feature of a personal recommendation is that the investment firm checks whether or not a product is suited for a particular investor.
- d. A "tied" agent" is a person who acts in the name and on behalf of one or, provided the financial products are not competitive, several investment firms, but does not receive the payable fees or any amounts due to the client, and acts under the full and unconditional responsibility of the investment firm in respect of the products. This definition that has already been used in the Directive on insurance mediation (see Official Journal No. L 009 of 15 January 2003) should also be used in the present Directive.

3.3. Conduct of business obligations

Before going into the regulations relating to the conduct of business obligations in detail, we wish to outline our understanding of subsections 4 to 6 of Art. 19 of the Directive. As we see it, all services other than investment advice or portfolio management (see Art. 19 (4) of the Directive) or "execution only" services (see Art.

19 (6) of the Directive) are covered by Art.19 (5) of the Directive. We appreciate this classification of possible services with a three-stage system, which by the way is unknown in German law, provided, however, that the application of the provision set forth in Art.19 (5) of the Directive will not result in a permanent examination obligation for the investment firm. The intention of Art. 19 (5) of the Directive must be to oblige investment firms to examine which products or group of products are not suitable for the client when they establish a business relationship with the client or after important client information has changed. The investment firm will inform the client of the results of this examination in the form of a warning before establishing a business relationship with him.

It cannot be intended by the Directive, however, that an examination in accordance with Art. 19 (5) of the Directive has to be carried out prior to each transaction. Instead, the investment firm will not send any further warnings as long as the information provided by the client has not changed.

3.3.1. Act fairly, honestly and professionally

The Commission should not regulate the general obligations addressed in Art. 19 (1) of the Directive in detail, namely that investment firms shall act fairly, honestly and professionally toward their clients. Instead, the terms should be defined more precisely under Level 3 of the Lamfalussy Process.

3.3.2.1. Suitability test

Pursuant to Art. 19 (4) of the Directive, investment firms providing investment advice or portfolio management are obliged to obtain the necessary information regarding the client's or potential client's knowledge and experience in the investment field, his financial situation and his investment objectives.

- a. As far as a client's personal data is concerned, the investment firm should at least obtain information about his family status, his obligations to provide maintenance, if any, and his job position. The client's previous investment behavior should be determined both on the basis of products and the client's experience (for example experience in years, transaction size and

number of transactions). The client should be able to choose between given individual groups to indicate his investment objective (for example regular income, tax advantages). Comprehension of the transaction is also essential. According to HVB Group, a distinction should be made here regarding the client's readiness to take risks. In addition to a client's regular income, information about his financial situation should also include the assets available for investment. The information should indicate clearly in which form the assets exist or the income (from self-employment or employment) is earned. Furthermore, the investment firm must inquire about the client's liabilities. The information should be recorded on an "information sheet" which the investment firm will give the client and which the client will fill out and return to the investment firm.

- b. When evaluating the information, the investment firm will correlate the data obtained with the products it offers. The evaluation should be analyzed in a counseling interview with the client so that the client realizes and can rely on now receiving advisory service from the investment firm.

The information should be evaluated with a view to the objective pursue with the investment advice, namely to find a product which is appropriate to a specific client. In this context, the term investment advice denotes "investor- and investment-compliant advice."

- The term "investor-compliant advice" denotes the requirement of providing advisory service tailored to the partner's individual needs. To be able to provide such advice, the investment firm must process the evaluation material in consideration of the information provided to it. The subsequent advisory service should be based on the result of that analysis. The advice will be tailored to the client's interests. The criteria for investor-compliant advice should not be determined across the board but only in consideration of the special features of the respective case.
- The term "investment-compliant" advice covers the requirements for contents and scope of advisory services regarding the actually envisaged investment and derivative transaction. First of all, the

investment firm must provide correct, full and comprehensible information to the client about the nature and risks of the financial instrument it recommends which may be critical for the client when deciding whether or not to conclude the transaction under consideration. The information must be unambiguous, conceptually clear and presented in a suitable form. On the one hand, the scope of information depends on the client's knowledge and on the other on the type of the envisaged transaction. Accordingly, information must only be provided to the extent necessary to fill the gaps in the client's knowledge. In addition, the investment firm must provide a comparison evaluating the features, risks and rewards of the financial instrument and its classification within the total range of comparable products available.

Regarding the quality of this analysis, however, the cost-benefit ratio must also be taken into account to ensure that in the final analysis the advisory service provided to the client by the investment firm is financially justifiable. This, however, will only be the case if the requirements for the analysis are reasonable.

Finally, it must be taken into account when evaluating the information that the information the investment firm must obtain from the client in accordance with Art. 19(4) of the Directive is usually not subject to permanent change. To take adequate account of the protective element inherent in the Directive, however, we consider it advisable to oblige the client to notify the investment firm if the information he has submitted has changed. This will help make the provision of investment advice which constitutes a core service of investment firms profitable and cost-effective for the client.

3.3.2.2. Information about the client's knowledge and experience in the investment field

- a. HVB Group believes it would be expedient if the information which the client has to obtain pursuant to Art. 19 (4) of the Directive at the same time also fulfils the requirements of Art. 19 (5) of the Directive.

It should however be duly noted that unlike Art. 19 (4) of the Directive, Art. 19 (5) does not require investment firms to provide investment advice. To meet the requirements of Art. 19 (5) the investment firm therefore only has to identify and evaluate the relevant items in the "questionnaire". This will in turn reduce the processing time and consequently also the costs of the investment firms. This means that the costs would therefore not be passed on to the client. This also has the advantage that subsequent investment advice can take place within a shorter space of time.

- b. In regard to the evaluation of information we would like to refer to our comments under 3.3. In this connection we would like to point out that the assurances obtained by the investment firms pursuant to Art. 19 (5) of the Directive must relate only to the information provided by the client on his knowledge and experience in the investment field.

3.3.3.3. Execution only

The warning required under Art. 19 (6) of the Directive should clearly emphasise that the investment firm does not assess the suitability of the instrument or service provided or offered. The information should be brief and concise for the reader.

3.5. Limit orders display

An alternative possibility would be for the investment firm to publish on its website the limit orders which have not been executed. The client should however be able to easily access the relevant page.

3.7.1. Systematic Internaliser

The Directive itself does not stipulate that the existence of a specific technical system for internalisation may not be a condition for classification as a systematic internaliser. The text of the Directive does not however provide any indication of such an intention and this was never the object of the previous discussions. A systematic internaliser should therefore be defined as follows:

An investment firm which, on an organised and systematic basis, deals on own account in a frequent and regular manner by executing client orders outside a regulated market or an MTF (Article 4 (7) of the Directive) and

- the internalised orders are below or equal to standard market size,
- the internalisation is supported by a technical system specially designed for this purpose and
- the system will be promoted as the business model for the settlement of securities.

3.7.2.2. The determination of standard market size / classes of shares

- a. A price for the offered volume which moves within a range of +/- 3% of the current reference market rate would reflect the prevailing market conditions. In the case of illiquid shares the price would move within a range of +/- 10%.
- b. Large scale: if the average value of a transaction exceeds fifty times (definition of the LSE for block trades) the average size of a transaction (turnover volume of the relevant market / number of transactions).
- c. Standard market size: this is clear from the Directive.

3.7.2.4. The publication of quotes

Quotes may be published on the investment firm's website as well as via the regulated market and MTF.

3.7.2.5. Withdrawal, updating and protection against multiple hits

Article 27 (3) stipulates that quotes may be updated at any time. This should not be subject to any specific conditions. In view of the possibility to update quotes on a continuous basis, there is no need to stipulate under what circumstances quotes can be withdrawn.

The Directive should however define the exceptional market conditions under which systematic internalisers are not obliged to submit quotes, e.g. suspension of trading on the reference market.