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Committee of European Securities Regulators
11-13 Avenue de Friedland
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31 March 2005

Our Ref Rob Moulton/SM

Dear Sirs

CESR's Advice on Possible Implementing Measures of the Directive 2004/39/EC on Markets in Financial Instruments - Consultation Paper March 2005

This letter is addressed to CESR by Linklaters, an international law firm with EU offices in Amsterdam, Berlin, Bratislava, Brussels, Budapest, Cologne, Frankfurt, Lisbon, London, Luxembourg, Madrid, Munich, Paris, Prague, Rome, Stockholm and Warsaw. We provide regulatory and compliance advice to a variety of market participants. Our clients have actively followed MiFID's progress and, having advised a number of clients on the negotiations over the Directive, we continue to advise clients on the implications of CESR's consultation process.

Our comments are, again, based on our own experience of advising our clients on the implications of changes to regulations, but is our own and not provided on behalf of any particular client.

We are happy to discuss any of these points in more detail and, should you wish to do so, please call Rob Moulton on + 44 207 456 4939.

Yours faithfully

Linklaters

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1 Article 19(1) – Lending to retail clients

Number	Page	Para or Q.	Comment
1	*7*	Box 1	CESR proposes that, in all circumstances where a firm lends money to a retail client to allow that client to carry out a transaction, or arranges for a third party to do so, the firm must obtain information to assess suitability and ensure that the loan and amount are suitable for the type of transaction proposed. In our opinion, making such a proposal in the guise of giving advice on the meaning of the general obligation to "act honestly, fairly and professionally" completely ignores the compromise which was originally reached relating to the carrying on of execution-only business on a non-advice basis which is contained in Articles 19(4) to (6). Had it been intended that a particular type of business would be carved out from that general compromise, this would have been agreed at the time that the directive was finalised, and included within it. In our opinion, CESR should withdraw the provisions on restricting the ability to carry on execution-only business contained in Box 1.

2 Definition of Investment advice

Number	Page	Para or Q.	Comment
2	9	Background	CESR makes it clear that a majority of respondents on the first consultation were against defining investment advice to include generic advice. In our opinion, respondents are likely to have understood all of the issues which CESR has chosen to re-highlight, and we do not see any point in re-consulting on these issues. We refer you to our response on the first consultation, when we said that we do not think that generic advice should be included. It is not possible to act on such advice without either seeking further advice or deciding to enter into a non-advised transaction.
3	10	Implicit specific recommend-ations	CESR states that a recommendation that could appear to be generic could be investment advice because it was an implicit recommendation (for example, because the firm only distributed one product of the type covered by the generic advice). We do not understand this view. We do understand why a generic recommendation could be considered to be a specific recommendation if there was only one product in the world which fell within that generic category (in CESR's example, because there was only one equity *UCITS*). The fact that a firm generically recommends equity UCITS to a client might be perfectly appropriate advice. It would only become "investment advice" for the purposes of MiFID if the firm proceeded to give advice relating to that particular investment product, rather than the generic class of investments.
4	11	Q1	CESR suggests that one consequence of providing generic advice if it is not investment advice is that a client would not get protection where the firm does not go on to provide specific advice. We consider that to be a very good reason why generic advice should not be caught by the definition of "investment advice". If a client chooses to invest on the basis of generic advice, without getting further advice, then they are entering into an execution only transaction and the firm that has provided the advice should not owe the customer an obligation as they have chosen not to seek further advice. The judgement over the investment firm's conduct should not be whether their generic advice was suitable but whether they had complied with the general principle contained in Article 19(1).

3 Best Execution

Number	Page	Para or Q.	Comment
5	14	Paragraphs 2, 8, 12	CESR repeatedly states that the Article 19(1) mandate permits CESR to extend the best execution obligation to firms that provide portfolio management and reception and transmission services. We disagree with this analysis. In our opinion, the directive has decided which firms owe a duty of best execution. That is contained in Article 21. It is not open to CESR to extend this provision by the backdoor through its use of an article intended to set out general conduct standards. We discourage CESR from re-opening matters which have been settled at level 1 in this way. We do not consider it to be within CESR's powers to do so where the directive is clear as to its scope, as is the case in Article 21.
6	18	Para 24	CESR emphasises that, if an investment firm reserves trading decisions to itself, it needs to comply with Article 21, even if it does not actually "execute" orders on behalf of its clients. In our opinion, this will create an unnecessary duplication. The firm that does execute the client order ought to owe the duty of best execution. It should be the responsibility of that firm either to contractually ensure that other investment firms to whom it passes orders agree to provide it with best execution, or to monitor to ensure that they do so.
7	18	Para 28	CESR repeatedly refers to the receipt of inducements by portfolio managers. We do not consider this phrase to be appropriate. The receipt of inducements is covered by Article 18. Portfolio managers should not act because they receive an inducement. This should not prevent them from using competitive pricing models to ensure that the overall service that they provide to their clients benefits from the relationship which the portfolio manager has with other firms.
8	21	40	CESR states that "it is too much to say that best execution means whatever an investment firm says it means". However, this does not mean that best execution does not mean whatever a client says it means. Analysing the MiFID best execution criteria will produce different results for different clients, there is no universal, optimal outcome. We hope that this will be reflected in box 3, paragraph b, where "client preference" only appears in the list that relates to the maintenance of execution venues. It should also be added to the lists that relate to the selection of execution intermediaries and taking account of costs.
9	23	Para 56	CESR asks for suggestions on circumstances in which a firm might satisfy the requirements of Article 21 while using only one execution venue. In our opinion, such a situation might be to comply with a client's request (see point 9 above).

Number	Page	Para or Q.	Comment
10	30	Para 103	CESR continues to suggest that investment firms should disclose a list of the venues to which they have direct access. CESR's definition of "execution venue" is very broad and includes other investment firms where they are a key component in the execution chain. In our opinion, if any disclosure on this point at all is required, it should be sufficient to ask firms to disclose the exchanges which they are members of. Requiring them to disclose all execution venues will lead to a constantly changing list of other investment firms which might be used in a particular market, and this could be substantial (for example, in the government bond market).
11	32	Para 115	CESR asks for comments on where the firms need to disclose information about their error correction and order handling policies. In our opinion, the disclosure of information on error correction policies is unnecessary. It may also be in breach of the insurance policy as maintained by some firms which would restrict them from providing information on the handling of errors which could compromise any insurance claim.
12	34	Para 126	CESR asks how an investment firm might gain the necessary consents to the best execution policy of that firm by telephone. In our opinion, this is quite straight forward. Firms are required to keep records of orders and, in practice, could record the consent in the same way. Firms are likely to follow up this consent in writing, as no firm would want to rely solely upon a voice-based disclosure.
13	35	Para 130	CESR states that it cautions firms against soliciting, including "client instructions", either as part of the general terms of business or otherwise in order to evade their obligations under Article 21. In our view, Article 21 makes it quite clear that firms must handle orders in accordance with their client's instructions. Some clients will have instructions which will vary from order to order. However, some clients will have general instructions as to how to handle their orders, which might be varied on a transaction by transaction basis. Therefore, it should be open to the client to agree with the firm in advance, if necessary in the terms of business, how it wishes orders to be handled generally.

4 Market Transparency

Number	Page	Para or Q.	Comment
14	40	Q 1.1	CESR asks whether its revised criteria for assessing "organised systematic and frequent" are an improvement, and what further modifications might be proposed. In its commentary, CESR suggests that its qualitative factors, which positively describe the attributes of a systematic internaliser, can (by logical deduction) be turned around to demonstrate negative factors. However, this would only make sense if the qualitative factors were both absolute (in other words, only if you complied with those factors could you be a systematic internaliser) and cumulative (in that all of them would need to apply). This would then delineate the attributes of a systematic internaliser and allow firms to use a negative reading of the factors to satisfy themselves that they were not a systematic internaliser. CESR should either follow this approach or propose negative criteria to balance the open-ended positive criteria.
15	40	Box 1, 12(b)	CESR proposes to catch firms that either execute more than 20% of their client orders on an internalised basis, or who internalise more than 0.5% of the value of the shares traded on the most liquid market. CESR's commentary states that "a small firm may internalise a significant part of its activity in a given share but it might still represent a very small amount of the total turnover in that share such that it could reasonably be excluded". CESR's proposals in paragraph 12 do not achieve this. Such a firm would be caught if it internalised five orders out of ten – this would amount to "frequent" for the purposes of paragraph 12(a). Further, the definition in 12(b) discriminates against firms who currently operate in non-concentrated markets, as the relative size of the most liquid market forms a smaller proportion of the overall trading. Therefore it is more likely that such firms will be caught by this requirement. To use an example, if a concentrated market model saw 90% of trading executed on that market, then a firm would need to be internalising 0.45% of the remaining 10% of the shares, in other words, it would need to account for almost 5% of the off-exchange market. In a non-concentrated market model, where (say) 30% of the trading is conducted on the regulated market, a firm would need to internalise 0.15% of the remaining 70% of the market, or to amount to 0.25% approximately of the off-exchange market, to be caught. This is a significant disparity. In our opinion, the quantitative approach should be cumulative. The "or" should be replaced with an "and". Further, 0.5% seems to us to be a very low threshold (see our numbers above, and we would consider 5% to be a more sensible figure).

Number	Page	Para or Q.	Comment
16	44	Q 2.1	CESR proposes allowing member states to choose from criteria (c) and (d). This is inconsistent with the overall approach of MiFID, which is to create harmonised European regimes. This is one area where a political compromise does not make sense. CESR should require all member states to adopt criteria (c) and we understand that the logic expressed by Jari Virta at the open hearing relating to 500 meaning approximately one trade every minute.
17	48	Para 35	CESR has maintained its position, with Commission backing, that the words “current market price” means both market and limit orders. In our opinion, this is clearly wrong. A limit order is the opposite of a market order. Second, this meaning was not discussed either in the ESC or during the negotiations over this wording in the European Parliament. The wording “current market price” is intended to reflect the service offered by market makers. They only offer one service, which is immediate execution, up to a stated size, at a stated market price. If clients want to ask for a different service, for example, execution at a limit price, then it is wrong to restrict the market maker from meeting that requirement and providing that service. In our opinion, CESR should revert to the plain wording of the directive and treat the words “current market price” as describing a market order.
18	57	Q 3.4	As described, the “negotiated trade” regime discriminates against systematic internalisers. It operates as a type of concentration rule. In our opinion, systematic internalisers should be allowed to negotiate trades in the same way as other market participants.
19	57	Para 103	CESR has imposed a value criteria on the definition of a basket trade. This is odd as a basket is described in the directive as a transaction requiring execution in several securities. It makes no sense to impose any financial limits. Further, a limit which could involve an average trade size of €300,000 per security is completely out of line with CESR’s proposals on defining SMS and retail order size.
20	57	Q 3.7	In our opinion, the definition of SMS should be a monetary value.
21	Pgs 66 - 74	Generally	Dealing with Articles 27, 44 and 45 together causes much confusion. For example, Article 44 and 45 give competent authorities waiver rights, where as Article 27 does not. Therefore, when using words (see paragraph 164) such as “refusing to grant a pre-trade waiver” CESR should make it clear that this only applies to Article 44 and not also Article 27. CESR needs to make it clear that pre-trading transparency for systematic internalisers has no national discretion and will be applied on an EU-wide basis.

Number	Page	Para or Q.	Comment
22	73	Table 1	In our opinion, the numbers used by CESR as the threshold for defining transactions which are “large” for the purposes of Article 27 do not seem to be aligned. For example, a share with an average daily transaction value of €50million would have a cut off of €400,000 applied (or 0.8% of the average daily volume). A share with a liquidity of €1million would have a cut-off of €100,000 applied, or 10%. The second is 12.5x larger than the first. In our opinion, the numbers would make more sense as follows. High liquidity shares - €500,000. Upper/mid-liquidity shares - €300,000 Lower mid-liquidity shares - €200,000 Low-liquidity shares - €50,000
23	73	Table 2	In our opinion, there are a number of flaws with CESR’s current methodology for calculating the applicability of delayed reporting arrangements. First, where a 60 minute delay is permitted for transactions of more than 10% of the ADV, a delay of 180 minutes should be applicable for transactions of more than 20% of the ADV, as it becomes increasingly hard to lay-off risk as transactions get larger. Second, when a firm is trading more than 100% of the ADV it will need longer than the end of the next trading day in order to manage its risk. That is because the firm might, conceivably, only have 11 hours to lay off trading risk represented by eight and a half hours of trading. It would need to be such a significant part of the market in order to fully lay off its risk that it would risk unduly prejudicing the price due to the extent of its trading. In our opinion, the delays applicable to trading of above 100% of ADV should be reassessed on this basis.