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Confidential response. Not for publication

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Consultation on CESR's Draft Technical Advice on Possible Implementing Measures of the Directive on Markets in Financial Instruments (2004/39/EC), and in particular, those Articles relating to Investment Advice, Best Execution and Transparency.

Morgan Stanley welcomes the opportunity to respond to CESR's 2nd consultation on its draft advice on possible technical measures, relating to Investment Advice, Best Execution and Market Transparency provisions, to implement the Directive on Markets in Financial Instruments ("MIFID"). Morgan Stanley supports the aims of MIFID and the current consultation process in seeking to update and revise the Investment Services Directive to provide increased harmonisation and clarity of implementation of the single market in financial services across Europe.

Morgan Stanley is a global financial services firm, offering a wide range of financial products to governments, corporations, institutions and individuals. We have a significant pan-European business, both on a cross-border basis and through local offices in the United Kingdom, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Spain and Sweden, comprising both passported branches and separate local legal entities.

We welcome the fact that use of the Lamfalussy process for MIFID has resulted in much greater openness in the consultation process and the active engagement of industry bodies and interested firms in the development of the new rules. Given the scale of the proposed changes and the significance of them for the efficiency and cost of European investment (including long term investment for retirement), to the competitiveness of the European financial markets, and ultimately to the cost of capital for European businesses, we believe that this active consultation is essential.

Morgan Stanley has been heavily involved in the detailed analysis and response prepared by the International Securities Market Association and the London Investment Banking

Association amongst others ("Joint Industry Association")[1]. Given this, we have not sought to repeat the detail of the combined industry association response here but have focused on a number of key issues, which are of particular significance to us.

The following sections set out our high level issues as well as some more specific comments.

Chapter 1 - Lending to Retail Clients

Morgan Stanley would refer CESR to the comments submitted by FBE, BBA, and APCIMS with regard to this chapter.

Chapter 2 - Definition of Investment Advice

Morgan Stanley supports the views expressed by the Joint Industry Association in their submission with regard to this chapter.

Chapter 3 - Best Execution

Morgan Stanley believes there have been significant changes to the proposed technical advice in this area and that the regime would be broadly workable.

We are encouraged by CESR's pragmatic approach, in particular in Boxes 2 and 3, that have the effect of setting a broad framework within which firms can operate without introducing unnecessarily prescriptive provisions. In particular, we are encouraged by CESR's decision not to over prescribe the circumstances when changes to a firm's Order Execution Policy may be appropriate, by the recognition that a prescriptive approach to application of factors in Art 21 (1) is not workable and by your decision to rely on Level 1 text in relation to monitoring.

We also believe that CESR has delivered some significant and helpful clarifications, e.g., around the definition of venue, duties of Portfolio Managers and Order Transmitters, and the manner in which responsibility for Best Execution obligations should be viewed, i.e.,

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[1] The Joint Industry Association comprises: International Swaps and Derivatives Association, International Securities and Market Association, International Primary Market Association, Association of Norwegian Stockbroking Companies, Bankers and Securities Dealers Association of Iceland, Bond Market Association, Danish Securities Dealers Association, Finnish Association of Securities Dealers, Futures and Options Association, London Investment Banking Association; and Swedish Securities Dealers Association.

clear adoption of Recital 33 provisions around Best Execution applying to a firm that has a "contractual or agency obligation to the client".

Scope of Level 2 framework

We would nevertheless encourage CESR to continue to focus on ensuring that Level 2 provisions do not prescribe a framework that may not be workable for, or relevant to, certain product areas, for example, OTC derivatives (as these are specific and unique transactions negotiated between two counterparties acting as principal) and listed derivatives (where the products are often non fungible and can only be traded on one venue). With respect to products such as these, provisions that require a comparison between venues, and information to investors regarding the venues accessed, become somewhat redundant. For example, provisions such as that contained in Box 4 para 21(3) 1. (a) (b) ii) setting out a requirement to describe the process for obtaining consent to execute orders away from a RM or MTF will not work in the context of these products.

Retail/Professional Distinction

We would also encourage CESR to focus on making, wherever possible, appropriate distinctions between retail and professional clients so that the protection the Best Execution regime is designed to afford is appropriately targeted to the investors most in need of that protection. For example, CESR appears to have been cognisant of this in relation to Box 4 para 21(3) 1. (a) ii) regarding factors other than price or cost, but has made Box 4 para 21(3) 1. (a) iii) regarding specific instructions apply to both retail and professional clients. We would encourage CESR to clarify that this provision should apply to retail clients only. We are also disappointed that CESR has not taken this opportunity to make a distinction between retail and professional clients in respect to the nature of consent, i.e., to the Order Execution Policy and to executions outside RM/MTFs. As pointed out in the previous consultation, we would encourage CESR to define consent between investment firms and professional clients as being achieved through one-way notification, whilst consent between investment firms and retail clients as requiring a two-way agreement. This would avoid (at least between investment firms and professional clients) an overly burdensome, and potentially annual, market-wide administrative exercise that achieves little in terms of investor protection.

Information to Investors

As a general point, Morgan Stanley would encourage CESR to clarify that the requirement to provide information to clients in "durable medium" and "in good time" does not prevent a firm communicating the information envisaged in Box 4 para 1.(a) within the Order Execution Policy (reviewed/issued at least annually) rather than on an

order by order basis. This has become particularly important given that the new provisions around information on process for determining the relative importance of factors under Art 21 (1), explanations of why other factors are deemed more important than cost and price, and warnings relating to specific instructions, are very order specific.

Morgan Stanley remains concerned that the provisions are not sufficiently mindful of the need to ensure that information provided to clients is both targeted (i.e., to retail investors) and useful (i.e., meaningful and succinct). There is a very real danger that the requirements to provide lists of venues will amount to information overload that at best adds little value and at worse confuses investors. We are encouraged by CESR's clarification that an investment firm will not be required to disclose venues to which it has indirect access (Box 4 para 21(3) (a) v)). This will certainly aid the situation of firms that operate on a global basis and who could be said to access every market in the world either directly or indirectly. However, given that CESR has rightly clarified the definition of venue to include brokers (Box 2 para 2.), the list of venues may not be any shorter. The provisions as currently drafted would require a global firm such as Morgan Stanley to list every market counterparty and affiliated entity with which we have a relationship that may execute client orders. Again, we fail to see the value added to investors of including these in such a list. As an alternative to providing a list of venues, we would encourage CESR to give more serious consideration to firms being free to provide a more generic description of their order execution capabilities.

Morgan Stanley would caution CESR against requiring further information on execution volume splits, as discussed in the explanatory text paras 105 – 109, on the basis of SEC rule 11Ac 1-6 requirements. We believe this will be costly for firms to produce and will amount to an information overload for investors, especially given that they will not be able to assign meaning or value to this information without execution quality data from the venues themselves.

We would encourage CESR to delete Box 4 para 21(3) 1 (a)(c) relating to inducements. It is our opinion that matters relating to inducements should not be addressed as part of the Best Execution regime. We would also, as mentioned above, encourage CESR to delete Box 4 para 21(1) 1. (b) ii) given that, in our opinion, this provision will not be workable in a Level 2 framework that will need to encompass all products.

Chapter 4 – Market Transparency

We appreciate the considerable difficulties CESR is facing in formulating its advice in this area. Failure to create the correct levels of transparency, and in respect to Art 27, the correct definition of liquid share and SMS, could have serious consequences for liquidity provision and the ability of firms to execute client orders with minimum market impact. For this reason we support the Joint Industry Association comments regarding the need to

exercise caution and perhaps introduce measures in a gradual, staged manner, e.g., test the Systematic Internaliser regime with a small universe of liquid shares before extending that universe at a later stage.

As an additional general observation, we would not advocate provisions that allow firms and/or Competent Authorities to arbitrage between "options", as we believe that this will not create harmonisation across Europe and that this would therefore run contrary to the objectives of the Directive. For example, the non-cumulative drafting of Box 1 para 12 a) and b), the options provided in Box 2 para 22. c) and d).

We would also not advocate provisions that are at odds with the Directive's objective of encouraging equal competition between venues. For example, we would support the Joint Industry Association comments regarding the anti-competitive effect of the proposed drafting in Box 3 para 84 (regarding negotiated trades), and Box 3 para 99 compared to the provisions of Box 3 para 79 (regarding Systematic Internalisers rights to withdraw/update quotes in comparison to market markers on RM/MTFs), as these would discriminate against the interests of Systematic Internalisers and their clients.

Definition of Systematic Internaliser

Morgan Stanley is encouraged by CESR's clarification of the Art 27 regime in light of Recital 53 and by the introduction of the language "separate business model" that is "marketed" to clients as such (Box 1 para 11) as a step towards a regime that allows firms to define a distinct area of its business as the Systematic Internaliser as opposed to applying the regime to the whole firm. However, we believe that this concept needs to be reinforced further still so that the regime does not unintentionally restrict the provision of dynamic and discretionary order execution services typically provided to professional clients. It is our view that negative indicators, as well as the positive indicators currently proposed are still required if the provisions are to accurately define Systematic Internalisers and ensure the correct scope for the regime's application. We endorse the Joint Industry Association comments in which they suggest negative indicators that would achieve this.

In the interests of further defining Systematic Internaliser more accurately, we also endorse the Joint Industry Association comments regarding application of Box 1 provisions and in particular, would encourage a move to a cumulative approach to Box 1 para 11 and move away from the use of positive quantative provisions to define "frequency" in Box 1 para 12 a) and b).

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Pre-Trade Transparency

Morgan Stanley welcomes CESR's suggestion that a single definition for "large in scale" should be used in the context of pre-trade transparency, i.e., Arts 22, 27, 29 and 44, whilst a separate definition should be developed for the purposes of post-trade transparency, i.e., Arts 28, 30, and 45.

Morgan Stanley has worked extensively with the Joint Industry Association on formulating their views on CESR's suggested pre-trade waiver thresholds as expressed in Box 6 Table 1. We strongly support the view expressed in their response that the preferred option is set out in Option 2 of Annex 1, i.e., determining "large in scale" by reference to a percentage of number of trades and that the percentage should be less than 95%.

In addition, Morgan Stanley is encouraged by CESR's introduction of a concept of "negotiated trades" as a further exemption to the pre-trade transparency requirements (Box 3 paras 83, 84 and 85) which recognises the ability of firms to execute "natural" business in a manner that achieves a better overall result for clients than would have been possible by executing on an RM/MTF. However, we are concerned that the current drafting of the provisions could be interpreted as amounting to a concentration rule which cannot have been the intention. We would endorse the Joint Industry Association comments regarding the way in which a combination of references to "made on an RM/MTF", the inclusion of the final sentence of para 84 regarding Systematic Internalisers, other elements of paras 83 and 84, and an inappropriately broad application of the definition of Systematic Internalisers, would effectively re-introduce a concentration rule by favouring on-exchange execution and preventing off-exchange execution of negotiated trades.

We welcome CESR's commitment to the concept (as accommodated by Level 1 and Recital 34) that a firm's website is a sufficient proprietary publication method for the publication of pre-trade transparency information.

Post-Trade Transparency

Morgan Stanley has worked extensively with the Joint Industry Association on formulating their views on CESR's suggested delayed publication thresholds (Box 6 Table 2) and we fully endorse the model and thresholds suggested in their response.

In addition, with regard to the content requirements for post-trade information, we strongly support the Joint Industry Association comments regarding the need to delete requirements to include the RM/MTF of execution as we do not believe this adds value.

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In addition, CESR should delete the requirement to include the name of the investment firm executing the trade (Box 5, para 139 a). Most markets in Europe have already moved, or are in the process of moving, to a model where order book executions and other trades are anonymous in order to protect the position of firms and clients. This is an important market development that delivers better prices to investors that should be preserved in the new regime. We also believe that the requirement in Box 5 para 141 to provide a "reason" for deviation from market prices is unworkable from a practical perspective. We support the Joint Industry Association suggestions that an "out of sequence" marker should be employed as opposed to providing date and time (Box 5 para 139 c)).

We continue to believe that if post-trade information in particular is to be useful to investors, CESR should have a long term goal of achieving consolidation of that information. We welcome CESR's commitment to the concept (as accommodated by Level 1 and Recital 34) that a firm's website is a sufficient proprietary publication method and no further prescription with regard to consolidation is required beyond Box 7 para 201 i.e., published in a "manner that does not impede its consolidation". We look forward to further work in this area, as suggested by CESR in introductory text para 186.

We hope that our response to this consultation has been of assistance and, if CESR considers it to be helpful, would welcome the opportunity to participate in any further dialogue with CESR on these issues. We would be grateful if you would treat this as a non-public response.

Should you have any questions please do not hesitate to contact either Neil Burnard on +44 (0) 207 677 2465, or myself on +44 (0) 207 677 2436.

Yours sincerely

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