Bloomberg

September 16, 2004

<u>Via CESR's website:</u> www.cesr-eu.org

The Committee of European Securities Regulators
17 Place de la Bourse
75082 Paris Cedex 02
France

Re: CESR's Advice on Possible Implementing Measures of the Directive 2004/39/EC on Markets in Financial Instruments <u>Ref: CESR/04-261b (17 June 2004)</u>

Ladies and Gentlemen:

Bloomberg L.P. ("Bloomberg") and Bloomberg Tradebook Europe Limited ("Bloomberg Tradebook Europe") appreciate the opportunity to comment on CESR's Consultation Paper presenting its advice to the EU Commission (the "Commission") on possible implementing measures of the Directive 2004/39/EC on Markets in Financial Instruments (the "MiFID Directive").[1]

<u>INTRODUCTION</u>

We wish to commend CESR on the progress it has made in drafting implementing measures for the MiFID Directive in response to the Commission's provisional mandates of January 2004,[2] as evidenced by the publication of its Consultation Paper. We also wish to commend CESR for its adherence to the Lamfalussy process through which CESR has afforded the many constituencies affected by its work the opportunity to participate in CESR's deliberations.

In the Consultation Paper's Executive Summary, CESR identifies a number of policy considerations. We briefly discuss below Bloomberg's position on these structural issues to assist CESR in evaluating our responses to CESR's specific questions in the Consultation Paper.

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[1] Ref: CESR/04-261b (17 June 2004).

[2] Ref: CESR/04-021 (22 January 2004).

Grandfathering and transitional provisions. We think CESR's solicitation of comment on grandfathering and transitional provisions for Level 2 was appropriate. Grandfathering ought to be considered, in our view, wherever the MiFID Directive differs significantly from the current ISD. That is particularly the case where the differences might disrupt an investment firm's settled business practices and relationships or its customer agreements, or would require significant changes to its business model. In our responses to CESR's specific questions, we discuss the provisions for which we believe CESR and the Commission should consider grandfathering.

The distinction between retail and professional clients. CESR has invited comments on the levels of regulatory intervention appropriate for addressing the needs of retail and professional clients. We agree with CESR that its regulation should be stratified in a way that takes account of the differing sizes of investment firms and different types of financial instruments, as well as the nature and sophistication of an investment firm's clients. We therefore support, for example, CESR's current approach in its draft advice to the Commission, which is to apply a light touch to the requirements in relation to professional clients.

The application of CESR standards. In the Introduction to the Consultation Paper, at paragraph 9, CESR notes that it has included its Standards for Investor Protection (the "Standards") in its draft technical advice to the Commission.[3] We appreciate that the Standards are useful to CESR in providing a baseline for its technical advice for the Commission. As CESR has pointed out, though, the Standards are subordinate to the text and principles of the MiFID Directive. Unlike the MiFID Directive and ultimately the MiFID implementing directives, the Standards are not binding on Member States.[4] CESR may wish to reconsider, therefore, whether to include these standards in the MiFID Directive.

Level 3 under the Lamfalussy process. At several points in the Consultation Paper, CESR proposes Level 3 measures and solicits comment as to whether certain issues would be better addressed at Level 3 than at Level 2. For example, together with draft technical advice for implementing Article 25 on transaction reporting, CESR also proposes Level 3 recommendations. We note that concurrently with its work on the MiFID mandates, CESR also issued for comment its consultation paper on the role of CESR at Level 3 under the

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[3] *A European Regime of Investor Protection — the Harmonization of Conduct of Business Rules* (Ref: CESR/01-014d, April 2002).

[4] See, for example, *Correspondence Table on Standards for Investor Protection (Ref. CESR/01-014D and CESR/02-098B) — United Kingdom* (Ref: CESR/03-134), which provides a detailed description of the extent to which current U.K. regulation conforms to and differs from the Standards. In the Introduction to its response to the questionnaire, the U.K. Financial Services Authority (the "FSA") notes that "[t]he various provisions of the FSA Handbook referred to in this questionnaire generally pre-date the April 2002 CESR paper on 'A European Regime of Investor Protection: The Harmonization of Conduct of Business Rules' and therefore have not been drafted with the specific intention of implementing those rules." The FSA did not subsequently implement the Standards.

Lamfalussy process.[5] We support CESR's decision to include in its Consultation Paper discussion and consideration of the scope and application of Level 3 analysis to aspects of the MiFID mandates. To avoid overly detailed and prescriptive Level 2 implementing measures, we think it would be appropriate to consider at this point whether some of the issues at hand would be better dealt with at Level 3. As CESR has recognized, more detailed consideration is properly the work of Level 3. It is at Level 3 that the CESR Review Panel will consider consistent transposition by Member State regulators and CESR will seek to embody common approaches into guidelines, recommendations or standards.

COMMENTS

QUESTION 1.1.

Must the compliance function in every investment firm comply with the requirements for independence set out in paragraph 2(d), or should this degree of independence only be required where this is appropriate and proportionate in view of the complexity of its business and other relevant factors, including the nature and scale of its business?

RESPONSE

Paragraph 2(d)(ii) would uncouple compensation for compliance "from the financial performance of the business lines of the investment firm." That general principle, we believe, should apply to all investment firms regardless of their business mix or business plans since the compliance function needs to be sufficiently independent to avoid both the appearance and the reality of undue influence by individual business units. We would nevertheless suggest a clarifying amendment to the proposed language, so that it would read: "remuneration for the compliance function not be linked to the financial performance of specific business lines or services of the investment firm." The alternative language addresses the primary concern, that the compliance function not be tied to the success or failure of a particular business line or service while avoiding the possible suggestion that, for example, a senior compliance person could not have stock options, profit-sharing plans or other remuneration tied to the overall profitability of the entire enterprise. We think the latter interpretation would be unfortunate for it could well limit the ability of investment firms to attract and retain highly competent and knowledgeable people to oversee and manage compliance.

On the subject of the independence of compliance, we offer two suggestions. First, to be effective, the compliance department must be able to muster enough "clout" to have its voice heard and heeded by senior business leaders within the firm. Second, an investment firm's chief executive officer should be accountable for proper firm-wide

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[5] *See The Role of CESR at "Level 3" Under the Lamfalussy Process*, Consultation Paper (Ref: CESR/04-104b, April 2004).

compliance. That implies the need to refrain from relieving the CEO of responsibility out of a concern for the "independence" of compliance. At the same time, however, the compliance department should not be subject to undue pressure and influence exerted by the heads of individual business units.

Ultimately, the board of directors or other governing body of an investment firm should examine the effectiveness of the compliance effort in judging the CEO's own performance as a manager. To make the board's oversight sufficiently meaningful, the director of compliance should be encouraged to have direct access to the board, as well as to the chief executive officer, when necessary to ensure the integrity of the compliance process.

QUESTION 1.2.

May deferred implementation of requirements for independence be based on the nature and scale of the business of the investment firm?

RESPONSE

In keeping with our response to Question 1.1, deferred implementation of the requirements in paragraph 2(d) may appropriately be based upon the nature and scale of the investment firm, particularly in the case of small firms. CESR could most effectively address the question of deferred implementation through guidelines, recommendations or standards issued at Level 3.

QUESTION 1.3.

Should the current text of CESR Standard 127 be retained or should its scope be extended to the outsourcing of all investment services and activities or should paragraph 9(b) be deleted and reliance be placed on the status and responsibilities of the outsourcing investment firm?

RESPONSE

As noted above, CESR Standards today are advisory and not binding. For that reason, we respectfully suggest they should not be imported wholesale into CESR's implementing measures. In the case of Standard 127, relating to outsourcing, we think the Standard, if expanded beyond its current reach, would be too restrictive. Standard 127 permits an investment firm to delegate portfolio management to an authorized firm, but a firm located in a non-EEA country could do so only if an agreement between regulators in the two countries were in place. Instead of importing an expanded version of Standard 127 into CESR's technical advice to the Commission, we recommend that CESR require the outsourcing investment firm to (i) exercise due diligence in appointing an investment service provider and (ii) include in its outsourcing contract a requirement that the service provider fully cooperate with the investment firm's regulators, including granting access to data and records.

With respect to outsourcing operational functions, we note CESR's concern that investment firms not adversely affect either their regulatory responsibilities or their obligations to their clients. We think that concern may best be addressed by requiring the outsourcing firm to (i) exercise due care in making the selection of a service provider and (ii) monitor the service provider's conduct prudently.

We suggest, moreover, that CESR need not and should not promulgate detailed rules of the kind proposed in paragraph 9(a) through (g) at this time. Several organizations currently are addressing issues arising from outsourcing. CESR pointed to the Consultation Paper on High Level Principles on Outsourcing issued by the Committee of European Banking Supervisors on 30 April 2004.[6] In addition to that paper there is a consultation paper by the International Organization of Securities Commissions ("IOSCO") issued in August 2004[7] as well as outsourcing guidance to the financial sector issued on the same date by The Joint Forum.[8]

In view of these recent initiatives, investment firms may ultimately face several highly detailed and duplicative regulatory regimes. We respectfully recommend that CESR defer to Level 3 further consideration of detailed rules after considering and harmonizing duplicative standards and recommendations already in place or soon to be adopted.

If CESR nevertheless advises the Commission to adopt the draft implementing measures in paragraph 9(a) through (g), those measures should be prospective only. This area of regulation is quite complex. A large number of investment firms are conducting business in reliance upon existing outsourcing arrangements. In view of those factors, CESR should grandfather existing outsourcing arrangements so that the firms having such arrangements would not have to reconfigure them in light of any new standards.

QUESTION 4.1.

Should there be a separate obligation for the investment firm to be able to demonstrate that it has not acted in breach of its obligations under the Directive?

RESPONSE

We respectfully suggest that CESR should not take the extraordinary step of reversing the burden of proof by requiring that investment firms demonstrate they have not breached their obligations under the MiFID Directive. Proving a negative always is problematic. The plain language of Article 13(2), moreover, neither requires nor implies such

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6 *See* CEBS CP 02 April 2004.

7 *See Principles on Outsourcing of Financial Services for Market Intermediaries — A Consultation Report of the International Organization of Securities Commissions Standing Committee 3 on Market Intermediaries* (August 2004), available at: http://www.iosco.org.

8 *See The Joint Forum — Outsourcing in Financial Services* (2 August 2004). The Joint Forum includes the Basel Committee on Banking Supervision, the International Organization of Securities Commissions ("IOSCO") and the International Association of Insurance Supervisors. The Joint Forum developed its principles in conjunction with the work of the IOSCO Technical Committee.

a burden. Neither the Level 1 principles of the MiFID Directive nor the Commission's mandates for Article 13(2) provide any authority for such a proposal.

In support of its proposal, CESR suggests the need for harmonizing the MiFID Directive with Article 15 of the Directive 2002/65/EC on distance marketing of financial services (the "Directive on Distance Marketing"). The European Parliament, the Council and the Commission were fully aware of the Directive on Distance Marketing when they deliberated on the MiFID Directive and yet they elected not to include a similar provision in the MiFID Directive. That determination, we believe, should govern and not be disturbed. Nor does the fact that the reversal of the burden of proof is contained in CESR Standard 10 be construed as authority for the proposal.[9] In fact, paragraph 2 of CESR's draft advice under Article 13(2) is fully responsive to the Commission's mandate and sets forth sufficient safeguards.

QUESTION 6.1.

Should other examples of methods for managing conflicts of interest be referred to in the advice?

RESPONSE

With particular reference to the draft implementing measures for inducements in Box 6, we think CESR's approach is the correct one. Some conflicts of interest may involve inducements to investment firms that do not benefit an investment firms' clients, or in the case of fiduciaries the clients' beneficiaries. Those inducements should be prohibited. Notorious examples of impropriety have occurred in all countries — for example, most recently in the case of mutual funds, the scandals involving late trading and market timing have come to light and have led to prosecutions in the United States. Some direct prohibitions against conduct such as late trading and market timing, when accompanied by improper inducements, are appropriate and are being implemented.

In other contexts, potential conflicts of interest often involve more complex considerations. Particularly where the customers are eligible counterparties and other sophisticated investors, we believe the best approach to the latter group of potential conflicts of interest is full and fair disclosure. The investment services business is sufficiently rife with potential conflicts that outright prohibition would be unrealistic and unworkable. For example, investment firms that allocate investment opportunities between and among their several clients routinely have to resolve questions of fairness, avoiding undue favoritism, etc. Also, investment firms that deal with fiduciaries as their clients routinely face questions as to whether the provision of research to fiduciaries and other commonly accepted business practices are consistent with the duty to avoid improper inducements.

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9 *See A European Regime of Investor Protection — The Harmonization of Conduct of Business Rules* (Ref: CESR/01-014d, April 2002), Section 1.3 Compliance and Code of Conduct, Standard 10.

In the case of allocation of brokerage to firms that provide investment research, efforts at stamping out the conduct are not likely to succeed and may have anticompetitive results, such as disadvantaging the small and medium-sized investment manager who cannot readily replicate the in-house research capacity of a large investment manager. Also, a small to medium-sized brokerage firm may well be at a disadvantage in competing for institutional brokerage against a large, integrated house that can afford to establish and maintain a significant in-house research department. As in many other contexts, disclosure of the conduct to the clients or beneficiaries may be the best approach to resolving such conflicts.

Part of the problem is that it would be inadvisable to distinguish between in-house and third-party research and inadvisable to exclude tools aimed at leveling the informational advantages between the sell side and the buy side, including the BLOOMBERG PROFESSIONAL service, which assists investment managers in evaluating the research and other information they receive from the sell side.

All investment firms reward their clients for giving them business by giving the clients preferential treatment in the receipt of favorable investment opportunities. Where a buy-side firm that is the customer of a brokerage firm is acting for multiple accounts, for example, the possibility will always be present that managed account A's brokerage directed to a particular brokerage firm will result in the brokerage firm's giving the adviser a trading opportunity that will benefit managed account B. Stamping out through regulation such incidental benefits would be impractical and unwise. It is better to require disclosure of the existence of such conflicts and periodic inspection of investment firms to discover how they are managing them.

QUESTIONS WITH REGARD TO CLIENT ORDER HANDLING

We will respond to the questions regarding client order handling in connection with our October 4, 2004 response to issues of Best Execution raised in connection with Article 21.

QUESTIONS REGARDING TRANSACTION REPORTING

Q 15.1.

Should competent authorities be able to waive the requirement for investment firms to report transactions in electronic format? Should such an exemption be limited to exceptional cases, and what cases would those be in your view?

RESPONSE

The general public interest in having transactions reported electronically via agreed-upon reporting protocols and formats is too important to risk its being compromised routinely through exemptions. Nevertheless, there may be some need for specific exemptive relief in the case of, *e.g.*, power outages and the like.

Q 15.2.

In respect of bond markets and commodity derivatives markets, new systems for reporting financial transactions will probably have to be put in place in many Member States, in order for investment firms to be able to meet the requirements of the Directive and Level 2 advice. (Note that Article 20(1)(b) of ISD1 already requires investment firms to report all the transactions covering bonds and other forms of securitized debt to competent authorities, though Member States have the right to provide that this obligation only applies to aggregated transactions in these instruments.) To what extent should the implementing measures allow market participants more time to implement these proposals ("transitional regime")? What could be legitimate reasons for such a possibility?

RESPONSE

The extent to which market participants may be allowed more time to implement the transaction reporting proposals should depend upon the cost and complexity of the necessary technology and supporting infrastructure. Where these functions may be outsourced to third-party service providers with minimal adjustments to systems already in place, less time will be needed. Businesses that will require significant and costly modifications or additions to their established infrastructures will require more time. The amount of time needed to comply may also vary depending upon the costs of conversion to compliant systems.

We do not have specific timing suggestions for CESR on these issues on the moment. We do think the implementing measures at Level 2 should give broad latitude for Level 3 adjustment of the effective dates.

Q 15.3.

To what extent should CESR investigate the possibility for future convergence between national reporting systems? What are the advantages and disadvantages of harmonizing at EU level the conditions (including format and standards) with which all the reporting methods and arrangements have to comply in order to be approved, instead of, as proposed by CESR, harmonizing the conditions at a national level? What impact might harmonization have on existing national reporting channels, national monitoring systems and on the industry?

RESPONSE

We recommend that CESR appoint an expert group to study the possibility for future convergence at the EU level among the reporting systems of all the Member States. There a number of protocols supported in the marketplace inside and outside the European Union and it would be useful to settle on a single protocol for all E.U. markets. The disadvantages of convergence would be the expense and the logistics of the project, but would be far outweighed by the advantages. Convergence would not only enhance the regulatory function, but also would further unify the securities markets by increasing transparency, access and, ultimately, liquidity and market efficiency.

Q 15.4.

Do you agree with the set of the general minimum conditions suggested? If you do not agree, what other general conditions would be more appropriate in your view? In particular, taking into consideration the responsibilities of investment firms on the one hand and third parties and other reporting channels, on the other, do you think that CESR should include the requirement of a standard-level agreement between an investment firm and a reporting channel in the list of general minimum conditions, or would this be better addressed at Level 3? What is your view on the border line as to the responsibilities for reporting if done by a third party acting on behalf of an investment firm or by a reporting channel?

RESPONSE

We think the implementing measures will have done enough if they articulate the objectives investment firms and reporting channels must achieve in their relationships with reporting channels. In our view, it would not be necessary or advisable for CESR to dictate contractual terms by which an investment firm and a reporting channel allocate responsibility for meeting those obligations. The investment firm presumably would bear the ultimate regulatory burden of reporting. We suggest, nonetheless, these issues are contractual in nature and a reporting entity can address them in its contract with a reporting channel.

Q 15.5.

What other issues, if any, should CESR take into account when responding to the Mandate concerning the "methods and arrangements for reporting financial transactions"?

RESPONSE

CESR should anticipate some amount of resistance on the part of market participants that fear the advent of transparency. Some may seek to forestall effective reporting mechanisms. Others may seek to intervene at Level 3 to frustrate the purposes of Article 27, among others. The best approach may be to build in, in addition to specific requirements at Levels 2 and 3, a general prohibition against conduct that would be inconsistent with the provision of market-wide transparency.

QUESTIONS REGARDING CRITERIA FOR ASSESSING LIQUIDITY TO DETERMINE THE MOST RELEVANT MARKET IN TERMS OF LIQUIDITY FOR FINANCIAL INSTRUMENTS

Q 16.1.

Do you agree with the approach to use proxies suggested above? If you do not agree, what other approach would be more appropriate in your view?

RESPONSE

We note that CESR's liquidity proxies, or measures, are (i) aggregate trading volume in numbers of shares or other units, (ii) aggregate value of (i), measured in euros, and (iii) number of transactions in a defined time period. Those measures, we believe, typify liquidity measures used in other contexts. They are backward-looking of course, but they have in most cases significant predictive value as to future liquidity.

As we commented in our letter of August 5, 2004 to CESR, we think a somewhat more accurate measure of liquidity, and one not more difficult to calculate could be used. To determine what is to be considered a liquid market in an individual share for purposes of Article 27, we would recommend that CESR include in its analysis the following criteria:

a) the number of shares issued and outstanding;

b) the frequency of trades in a share in a defined period of time;

c) the value in euros of turnover, that is, the number of shares being traded in a defined period of time multiplied by the price of the share;

d) the number of investment firms willing to purchase or sell the share; and

e) the willingness of dealers to make a market in the security.

While we continue to question the usefulness of the concept of "standard market size", which has no known use in any other context of which we are aware, it would seem appropriate, as CESR has concluded, to look at the primary market as the basis for making this determination.

We note with interest CESR's determination that the primary markets in equity securities traded with the EEA account for the vast preponderance of trading in those securities, and that therefore the much-feared market fragmentation has not yet materialized. We continue to think CESR should view fragmentation not as the division of trading volume between or among markets, but as the division of volume among markets that do not provide transparency and accessibility. Compliance with Article 27 will be important here.

Q 16.2.

Do you agree with the suggested proxies? If you do not agree, what other proxies would be more appropriate in your view?

RESPONSE

Ideally, upon the advent of consolidated trading information, consolidated data would be the best source of information on liquidity. Until that becomes available, reliance on data from the principal market would be the best source, particularly given the apparent absence of significant division of trading volume between and among markets at the moment.

QUESTIONS REGARDING MINIMUM CONTENT AND STANDARD/FORMAT OF TRANSACTION REPORTS

Q.17.5.

What are the advantages/disadvantages of requiring the field "client identification code" in transaction reports, bearing in mind the objectives of transaction reporting? What are your views on making the client/customer identification field mandatory in transaction reports? What are your views on the idea to promote a pan-European code for client/customer identification? Do you see any legal impediment to the introduction of such a code in your Member State?

RESPONSE

We recommend that the field "client identification code" not be routinely included in transaction reports, particularly if under Article 48 governmental bodies can delegate their authority in this respect to non-governmental bodies, such as securities exchanges. Serious questions of client confidentiality are involved here. In many instances, particularly involving institutional investors, the fact that a given investor is buying or selling a security may by itself convey highly important information the disclosure of which can damage the investor's interests. We note also that there may well be substantial issues under the bank secrecy and other laws of some countries.

If the disclosure were being made solely to a governmental body with jurisdiction over the markets and/or market participants, as opposed to a securities exchange or other non-governmental body, the disclosure presumably would not involve a risk of damage to the client, but a governmental agency would not need — and likely could not digest and process — such information on a routine basis. For clearance and settlement purposes, presumably the identity of the investment firm itself would suffice since it would settle with the counterparty as agent for an undisclosed principal, its client.

QUESTIONS REGARDING COOPERATION AND EXCHANGE OF INFORMATION

Q 3.

CESR considers undertaking more detailed work on the issue of a mediation mechanism in case of disagreements between competent authorities. Such a mechanism would not only cover the situations envisaged by Article 16(2) and (4) of the Market Abuse Directive, but might be a more general approach by CESR at Level 3. Do you have any views whether such a mechanism would be appropriate for areas of the Directive (e.g. concerning the identification of the most liquid market or exchange of information)? Are there other areas of the Directive where such a mechanism should apply?

RESPONSE

As stated in our opening comments, Bloomberg believes it is important for CESR to articulate and keep in view its role at Level 3 in the Lamfalussy process while it works on Level 2. To ensure an appropriate degree of uniformity at Level 3, CESR should remain actively involved, as a mediator as well as an adviser.

CONCLUDING REMARKS

In closing, we wish to reiterate our support for the Lamfalussy process and the CESR's procedures for facilitating participation by interested parties in the Level 2 process. We hope our responses to CESR's Consultation Paper prove useful in its deliberations. If you should have any questions or would like additional information, please let me know.

Respectfully submitted,

Stephen G. Baker by R.D.B.

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