MARKETS IN FINANCIAL INSTRUMENTS DIRECTIVE

CESR's Draft Technical Advice on Possible Implementing Measures
of the Directive 2004/39/EC on Markets in Financial Instruments

• Aspects of the definition of Investment Advice and of the
General Obligation to Act Fairly, Honestly and Professionally
in the Best Interests of Clients
• Best execution
• Market Transparency
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SOCIETE GENERALE COMMENTS

Société Générale is one of the largest financial services groups in the euro-zone. The Group employs 92,000 people worldwide in three key businesses:

- Retail Banking & Financial Services: Société Générale serves more than 16 million retail customers worldwide.
- Global Investment Management & Services: Société Générale is one of the largest banks in the euro-zone in terms of assets under custody (EUR 1,115 billion) and under management (EUR 315 billion, December 2004).
- Corporate & Investment Banking: SG CIB ranks among the leading banks worldwide in euro capital markets, derivatives and structured finance.

Société Générale is included in the four major socially-responsible investment indexes.

Société Générale thanks CESR for this consultation and for the solutions proposed on many issues. Such solutions show a real concern to take into account responses from the industry to previous consultations, and particularly SG agrees with CESR to let investment firms determine on their own the relative importance of each best execution criterion.

However, Société Générale wishes to point out the following issues, on which we'll come back later on in this answer.

- For both practical and legal reasons, SG is of the opinion that the best execution principle should not be applied to entities whose activity is the reception and/or transmission of orders nor to portfolio managers' order transmission activities. Those entities do not indeed execute orders and do not have direct access to the market.
- Best execution should not apply to pure OTC (derivative) contracts (negotiated on a counterparty basis). Best execution is indeed only conceivable for comparable financial instruments/conditions
- SG considers that only one criterion should be used to define the frequency in art. 4.2. of the MIFID. SG agrees with CESR that such a criterion should be calculated on the basis of a ratio number of client orders executed internally/totality of client orders executed by an investment

firm. But, to achieve the goal of the directive, SG considers such volume should be of 10% (and not 20% as proposed by CESR)

- The definition of liquidity should also be unique and defined for all Member states at level 2, to ensure a level playing field and comparability between securities. SG considers that liquid securities are those that fulfil the following double criterion : a free-float of minimum 2 billion euros and a ratio volume traded per day/free-float of 0.25%. This is indeed an objective test which has the advantage to be passed by almost all securities belonging to the different national and European indices.
- SG considers finally that the number of classes of liquid shares proposed by CESR (10) is by far too high. This would *inter alia* lead to a very low number of shares per class.

I. « BEST EXECUTION » (article 21 MIFID)

I.1 – The submission by CESR of orders receivers/transmitters and of portfolio managers' order transmission activities to the « best execution »

CESR intends to extend the best execution obligation to order reception and transmission and portfolio managers' order transmission activities.

Thus, firms receiving and transmitting orders and portfolio managers in respect of their order transmission activities:

- would be obliged to select market members according to objective criteria in clients' interests,
- should inform clients, where applicable, that a group entity has been chosen as market member,
- would have a right and even a duty to examine and conduct a daily check on the order execution policy of the chosen market members.

A. Article 21 applies only to third-party order execution and therefore not to order reception and transmission activities nor to portfolio managers' order transmission activities.

1. For practical reasons, Article 21 should not apply to order reception and transmission activities nor to portfolio managers' order transmission activities

The purpose of firms receiving or transmitting orders is not to trade directly on the markets to execute orders. Their role is to transmit to pre-selected "market member" intermediaries orders to buy or sell financial instruments from their clients so that these market members can execute them on the markets.

Neither is the role of third-party portfolio managers in their order transmission activities to trade directly on the markets by executing orders. Acting pursuant to a client mandate, their role is to transmit to pre-selected "market member" intermediaries orders to buy or sell financial instruments so that these market members can execute them on the markets.

2. For legal reasons, Article 21 should not apply to order reception and transmission activities nor to portfolio managers' order transmission activities

To justify application of Article 21 to both the activities referred to above, CESR invokes the provisions of Article 19.1 of the directive. This article states that intermediaries providing services to their clients must act fairly and professionally in the best interest of their clients.

There is no legal justification for applying the provisions of Article 21 to order reception and transmission activities or to portfolio managers' order transmission activities because to do so would be at odds with the wording of the directive.

Article 21 of the directive covers order execution and not order reception and transmission or order transmission activities. The article does refer to intermediaries executing client orders, that is both order execution for third parties and counterparty activities.

This analysis is predicated both on the title of Article 21 and on its contents (Article 21, paragraph 1, which states that investment firms must take "*all reasonable steps to obtain the best possible result for the execution of client orders (...)"*.)

The extension of the best execution obligation envisaged by CESR runs counter to the provisions of Article 21. The Level 2 implementing measures laid down by CESR cannot take precedence over the wording of the directive.

In this respect, and from a general standpoint, when the directive seeks to impose obligations on all financial intermediaries, it states so explicitly in the text. Article 19 provides a perfect example of this because it obliges all financial intermediaries to follow good conduct of business rules when providing investment services to clients. In this respect, it is logical to consider firms receiving and transmitting orders and portfolio managers in respect of their order transmission activities as covered by Article 19 of the directive.

B. Not all the obligations imposed by CESR on firms receiving and transmitting orders and portfolio managers are justified

1. SG considers that obliging firms receiving and transmitting orders and portfolio managers to examine and control on a daily basis the order execution policy of the market member is unacceptable because it would represent a confusion of the roles and responsibilities between intermediaries.

In SG's opinion, it is legitimate to oblige firms receiving and transmitting orders and portfolio managers to select on the basis of objective criteria the market members that have implemented an efficient "order execution policy".

This said, this obligation cannot justify the following two constraints envisaged by CESR. The roles and thus responsibilities of the market members, on the one hand, and firms receiving and transmitting orders and portfolio managers, on the other hand, should not be confused.

a) Firms receiving and transmitting orders and portfolio managers should not be involved in the daily activities of market members.

In return, they should not have to take responsibility for any potential errors in place of the market member.

b) Firms receiving and transmitting orders and portfolio managers should not influence the membership policy of the market member

It is not the role of a firm receiving and transmitting orders or a portfolio manager to decide, in the place of the market member, on the choice of execution venue for client orders. Neither should it have to take responsibility for the implications of this choice.

Admittedly, within a retail banking network, such as the one of SG, the interests of the entity receiving and transmitting orders (the network) and the market member will usually converge in this respect. But the ultimate responsibility for the choice of execution venues used must rest with the market

member itself. In this respect, the market member should be able to refuse to become a member of a particular market if this refusal is justified on objective grounds (for instance, if market access costs are very high or if the number of orders to be executed on this market is very low).

Conversely, SG recognises that a client may legitimately ask to be informed by the firm receiving and transmitting his orders or his portfolio manager of the order execution policy of the selected market members.

2. SG recognises however that two obligations imposed by CESR on firms receiving and transmitting orders and portfolio managers may be part of their professional obligations.

a) SG considers, the obligation to select market members according to objective criteria serving the client's interests as being part of the professional obligations of firms receiving and transmitting orders and portfolio managers.

To protect the clients' interests, only market members whose professionalism is recognised should be selected. In France, this obligation already exists for portfolio managers and for firms receiving and transmitting orders.

b) SG considers also the obligation to inform the client that a group entity has been selected (possibly with external entities) as a market member as being part of the professional obligations of firms receiving and transmitting orders and portfolio managers.

With respect to this obligations, SG has however the following observations:

- It is legitimate to state the name of the chosen market member or members, these market members belonging or not to the same group as the firm receiving and transmitting orders or portfolio manager.

- CESR justifies this obligation on the possible existence of a conflict of interest. For SG, there is no reason to suspect *a priori* the selection of a market member belonging to the same group, when this market member has been selected on account of its professionalism.

I.2 – CESR's proposals on the relative importance of various best execution criteria

A. SG agrees with CESR on the way to determine the relative importance of the various best execution criteria

SG agrees with CESR that determining the relative importance of the various criteria for best execution involves taking account of client categories, the types of orders undertaken and the execution venues chosen.

SG also agrees with CESR that determining the relative importance of these criteria should be left to the discretion of the market member, when that the latter acts in the client's interest and the information provided to the client is clear and complete.

B. SG accepts the obligation for a market member to justify to a retail client that a criterion is more important than price or cost, provided that this justification does not have to be unduly detailed and may be provided once and for all in the order execution policy given to and accepted by the client.

CESR intends to oblige the market member considering a criterion as more important than the price or the cost, to state so to the retail client and to provide justification.

SG recognises that price and cost are very important criteria and may often predominate for retail clients, and so it is legitimate to ask a market member to state to its client upon the execution of a given order, for instance, that it believed a criterion other than price or cost to be predominant (for instance, the speed of order execution or the high liquidity offered by a particular market).

This said, SG wishes to clarify two points. Firstly, the obligation to inform and justify to clients should not be unduly cumbersome or enter into technical details. Consequently, the justification that the market member has to provide to its client must not lead to too detailed comparisons between markets (e.g. comparing their respective degrees of liquidity).

Secondly, from a practical standpoint, it is practically impossible for a market member to satisfy this obligation on a transaction-by-transaction basis. Moreover, it would be prohibitively costly for the firm and thus for the client. The market member must be able to satisfy this obligation earlier on and once and for all, when it informs its client about its order execution policy, provided that the client approves this policy prior to the beginning of their relationship. The market member must be authorised to state in its order execution policy that it reserves the right, for instance, to execute its clients' orders on a market giving rise to high transaction costs if it considers that the market is more liquid and permits a more rapid execution of orders.

I.3 – <u>Implementation and review of "order execution policy" by the market member</u>

A. SG agrees with CESR on how order execution policy should be established, but has reservations about the issue of market access costs.

SG agrees with CESR on the various factors that the market member may take into account when selecting a particular order execution venue (e.g. rapidity, quality of service, market spreads, trading volume). SG is also satisfied that the CESR recognises that market members should have the option of taking into account other criteria, provided that they are selected objectively.

Conversely, SG does not agree with CESR on the specific issue of access costs for an execution venue. CESR recognises that this represents a legitimate selection criterion, but considers that an intermediary seeking to avoid paying high market membership costs and thus passing them onto the client may overcome this dilemma by using the services of a local market member. SG does not share this point of view. Using a local market member will incur expenses for the French intermediary and thus the aggregate cost of the transaction for the client will include the intermediary's own charge and the cost of the service offered by the local market member, which is passed on by the French intermediary.

B. SG agrees with CESR, subject to certain reservations, on how to review the "order execution policy".

SG is satisfied that CESR leaves it to the market member's discretion the way to review its order execution policy (provided, of course, that the review is conducted objectively).

In addition, SG agrees with CESR that the order execution policy should be revised once a year.

But SG disagrees with CESR on any obligation to conduct unduly frequent checks on their order execution policy because this would give rise to additional costs without any real benefit for the clients. In this respect, having to schedule checks less than every 12 months seems excessive for measuring the respective performance of markets unless of course there is a significant change in the regulatory or market environment during the said period (for instance, if a new execution venue is set up during the period and very rapidly wins a large proportion of liquidity)

C. SG agrees with CESR that market members should be obliged to disclose to clients information about the order execution venues of which they are direct members, provided that this information remains of a general nature.

SG agrees with CESR that market members should be obliged to disclose to clients information about the order execution venues of which they are direct members.

This said, SG considers that only information of a general nature should be covered by this obligation. For instance, it may comprise the name of the markets (service agreements usually provide for this already in many cases), their characteristics (liquidity, the level of security that they provide to investors in terms of execution and settlement-delivery of transactions, etc.). Conversely, the disclosure of more specific information (e.g. access costs for markets, operating rules on these markets) is not pertinent for logistical and/or commercial reasons.

D. SG asks CESR to confirm the right of an intermediary not to accept a specific client instruction that conflicts with its own order execution policy

An investment firm should not be obliged to accept a specific client instruction that contradicts the order execution policy that it has implemented.

SG believes the terms used by CESR (e.g. in box 4 on page 35) lead in this direction. CESR should confirm this point.

If, however, the firm agrees to execute a specific client instruction that is at odds with its order execution policy, SG agrees with CESR in envisaging that the intermediary should warn its client about the specific risks that would be incurred by the client and about the possibility that the intermediary may not be able to fulfil its best execution obligation. In this scenario, SG thinks the client instruction should be executed at the sole risk of the client.

I.4 – <u>The best execution obligation is neither applicable nor appropriate for OTC (derivative) contracts</u>

A. The Best execution obligations are not applicable to OTC (derivative) contracts

1. <u>Execution of an order implies that a client order is being executed on the basis of a pre-existing mandate</u>

a) Under the directive, for best execution to apply, an order must be executed

This derives from both the title of Article 21 ("Obligation to <u>execute</u> orders on terms most favourable to the client") and its contents : investment firms "*must take all reasonable steps to obtain, <u>when executing orders</u>, the best possible result for their clients* (…)".

Where the directive seeks to extend obligations to cover all investment services, it states so explicitly. This notably applies in Article 19, which lays down "Conduct of business obligations when providing investment services to clients". It is therefore not by chance that the best execution applies to the sole execution of orders.

b) The execution of an order implies that the client has given a mandate to the investment services provider

From a legal standpoint, an order is a <u>mandate</u> given by a client to an investment services provider to buy or sell a financial instrument (security or contract). From the outset, the client contacts the

investment services provider in its capacity as a market intermediary (since the client is unable to trade directly on the markets upon which these financial instruments are traded).

c) Accordingly, orders may be executed in one of two situations

- The investment services provider executes the order acting as an intermediary, i.e. it buys (or sells) the financial instrument on a Regulated Market or an MTF or by finding an order matching the client order in reverse;
- The investment services provider adopts the opposite position to execute the order, i.e. it buys (or sells) the financial instrument that the client holds in his portfolio. This is known as a counterparty trade. In this scenario, the initial mandate is converted into a sales contract.
    - In both instances, there is a mandate at the outset, followed ultimately by execution of the order;
    - The service provider has been called upon to act as an intermediary and not as a counterparty for the transaction (in the usual meaning of the term on over-the-counter markets).

d) This concept of order execution is thus broader than third-party order execution investment service

Order execution may thus actually comprise two investment services, depending on how the order is executed.

It covers the execution of orders on behalf of clients when the investment services provider executes the order as an intermediary ("Execution of orders on behalf of clients means acting to **conclude agreements to buy or sell** one or more financial instruments **on behalf of clients**"), as well as the proprietary trading service when it executes the order by acting as the counterparty ("Dealing on own account means trading against proprietary capital resulting in the conclusion of transactions in one or more financial instruments").

2. Where a client wishes to trade OTC contracts, there is no execution of an order based on a mandate granted at the outset

Where a client wishes to enter into a transaction for an OTC derivative product with an investment services provider, he knows from the outset that he will deal with the investment services provider as counterparty owing to the pre-eminence of individual characteristics (*intuitu personae*) with such transactions (counterparty risk, etc.). Put in another way, no order is given, but a desire is expressed to enter into an agreement with the investment services provider. Where no order is given, no order can be executed, and thus there can be no best execution within the meaning of Article 21 of the directive.

B. The best execution obligation is not appropriate for OTC (derivative) contracts

1. *Best execution* implies comparability of prices and costs incurred by the client, which seems very hard to apply to over-the-counter transactions

The best execution obligation implies that the best possible result must be sought for the client—a criterion assessed based on the criteria of price and cost, as well as on qualitative criteria (speed and likelihood of execution and settlement, see Article 21.1 of the directive).

To this end, investment services providers must have an order execution policy (Article 21.2), which must include information about the various systems on which the firm executes its clients' orders and the factors influencing the choice of execution venue and encompass the systems delivering the best possible result (Art. 21.3).

The best execution obligation thus relies notably on a comparison of prices and costs incurred by the client, which implies that these may be compared, and thus, secondly, on knowledge of the items for comparison.

For prices and costs to be comparable, the services provided must be identical. In practice, this applies only to standard transactions in standardised products between parties (the service provider and its client) whose nature and circumstances have no bearing. The best execution obligation cannot thus reasonably apply to tailored services and/or services performed on an *intuitu personae* basis and/or services for which the firm's credit quality enters into the equation. On the other hand, two services or products that do not exist on the market and are assembled on an *ad hoc* basis are not comparable. Put another way, comparability is not feasible for customised or personalised services.

In other words, assuming comparability of prices and knowledge of the items for comparison, the obligation to deliver the best possible execution may without any difficulty apply to negotiable securities because they are fungible. Conversely, this obligation may apply to contracts (option contracts, futures contracts, swap contracts) only insofar as these contracts are sufficiently standardised to be comparable.

2. Clients are still protected

Even when best execution, as provided for in Article 21 of the directive, does not apply, clients are still protected by the rules laid down in Article 19 of the directive, which are applicable in any case, and according to which investment firms must act fairly, honestly and professionally in the best interests of clients.

II. SYSTEMATIC INTERNALISATION (Article 27 of the directive)

II.1 – The definition of the systematic internaliser

A. SG agrees with CESR on the concept of "systematic"

SG agrees with CESR that this term covers both automated (i.e. computer) and non automated systems, such as telephone-based systems, provided that they are used structurally by intermediaries to accept client orders.

B. To define the concept of "frequency", SG proposes using a single criterion, i.e. a maximum percentage of 10% of the volume of client orders executed internally.

1. CESR's proposal (Box 1 page 40)

According to CESR, an intermediary would be considered to be a systematic internaliser:
- if it executes internally over 20% of its volume of client orders, or
- if the client orders executed internally represent, for a given share, over 0.5% of the annual volume traded in its reference market.

2. SG's proposal

SG considers that the second alternative selected by CESR to extend the scope of the systematic internaliser concept could not have the desired effect. Very few, if any intermediaries seem to be in a position to reach the required threshold of 0.5%. For instance, a financial intermediary with market

share of 7.5% in a given share (already a high threshold) would have to internalise at least 7% of its orders for this share for it to be regarded as a systematic internaliser.

SG thus proposes:

- to simplify CESR's proposal and to definr the concept of frequency based solely on the criterion of the percentage of the volume of client orders executed internally, which represents a highly objective criterion,

- to lower the threshold proposed by CESR, to ensure that the concept of systematic internaliser does not remain a "hollow shell", which is not the purpose of the directive. Very few intermediaries seem to envisage internalising 20% of their client orders, and then would be captured by the definition of systematic internaliser. SG thus proposes using a maximum percentage of 10%.

II.2 – To define "liquid" shares, SG proposes using two cumulative criteria, i.e. a free float of at least €2 billion and daily turnover of at least 0.25% of this free float.

1. CESR's proposal (Box 2 page 43)

According to CESR, a share should be considered as "liquid" when it satisfies all three of the following criteria:
- it is traded on a daily basis,
- it has a free float of at least €1 billion,
- it meets one of the following two criteria, to be chosen freely by each Member State:
  *the daily average number of trades is at least 500, or
  *daily turnover in the share is over €2 million.

2. SG's proposal

Generally speaking, SG considers that giving Member States the option of choosing one of the criteria should be avoided because this represents a barrier to EU-wide harmonisation.

More specifically, SG considers that within the criteria proposed by CESR, free float and average daily turnover are the 2 highly objective criteria for calculating the liquidity of a share.

SG proposes to define as "liquid" shares only those stocks that fulfil both the following two criteria:
- a free float of at least €2 billion (above the threshold proposed by CESR),
- an average daily turnover of at least 0.25% of their free float.

In SG's opinion, the advantage of using these twin criteria and the proposed amount and percentage (i.e. €2 billion and 0.25%) is that they restrict the concept of liquid shares to those listed for trading in the leading national and European indices (e.g. the CAC 40, DAX 30 and FTSE 100). These are the only shares whose liquidity cannot be questioned. In addition, only these shares are, in practice, likely to be handled "internally" because they may generate high volumes for internalisers.

II.3 - For simplicity's sake SG proposes defining just three classes of shares

1. CESR's proposal

CESR proposes defining a large number of "share classes":
- up to €100,000, one class of shares per €10,000 band,
- one class of shares per €20,000 band above €100,000.

2. SG's proposal

In SG's opinion, the creation of such a large number of share classes has a major disadvantage, i.e. the potentially very limited number of shares belonging to each class.

For instance, based on calculations for the 228 shares with the largest market capitalisation in the euro zone, Switzerland and the UK, fewer than 15% of these shares would belong to classes with a standard market size of over €50,000. .

In addition, the creation of a large number of share classes would result in an additional administrative burden for Member States and intermediaries owing to the periodic revisions desired by CESR.

SG proposes defining three classes of share:
- one share class for shares with a standard market size of less than €10,000
- one share class for shares with a standard market size of between €10,000 and €50,000
- one share class for shares with a standard market size of over €50,000.

II.4 – To define the standard market size for each class of shares, either very large or very small transactions should be excluded as they do not reflect the reality of the market

For each share class, the directive states that the "standard market size" comprises a size representative of the arithmetic average value of orders executed in the market for shares belonging to this class. Certain transactions regarded as not reflecting the daily reality of the markets are excluded from the calculations.

1. CESR's proposal

Based on the provisions contained in the directive, CESR proposes excluding from calculations of the standard market size for each share transactions exceeding certain limits:
- €500,000 for highly liquid shares,
- €400,000 for shares with slightly above-average liquidity,
- €250,000 for stocks with slightly below-average liquidity,
- €100,000 for shares with limited liquidity.

In CESR's opinion, these represent minimum thresholds that Member States are entitled to increase.

2. SG's proposal

SG aggrees with CESR approach to exclude from calculations of standard market size transactions exceeding certain limits.

SG has proposed defining three classes of shares. SG thus proposes a limit for each of these three share classes. For each class of shares, transactions with a value exceeding this threshold will not be taken into account for the purpose of calculating standard market size. These thresholds are as follows:

- transactions with a value in excess of €500,000 for highly liquid shares,
- transactions with a value in excess of €300,000 for shares with average liquidity,
- transactions with a value in excess of €100,000 for shares with limited liquidity.

SG also proposes excluding transactions for a single share from calculations of standard market size, which, like those referred to above, do not reflect the daily reality of the market.

Lastly, SG considers that Member States should not be granted the right to upgrade these limits.

II.5 - Determination the size of orders "of a size bigger than the size customarily undertaken by a retail investor"

Systematic internalisers have the possibility to improve the prices offered to their professional clients provided notably that the orders undertaken by these professional clients are "of a size large in scale compared to the orders customarily undertaken by a retail investor".

According to CESR, the size of orders "customarily undertaken by a retail investor" is €7,500.

SG proposes to lower this level at €5,000.