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**Comments of the
Zentraler Kreditausschuss¹
on the Formal Request for Technical Advice on Possible Implementing Measures on the
Directive on
Markets in Financial Instruments**

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¹ The ZKA is the joint committee operated by the central associations of the German banking industry. These associations are the *Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR)*, for the cooperative banks, the *Bundesverband deutscher Banken (BdB)*, for the private commercial banks, the *Bundesverband Öffentlicher Banken Deutschlands (VÖB)*, for the public-sector banks, the *Deutscher Sparkassen- und Giroverband (DSGV)*, for the savings banks financial group, and the *Verband deutscher Hypothekenbanken (VdH)*, for the mortgage banks. Collectively, they represent more than 2,500 banks.

I. General

Timeline

The implementation of all Level 1 and Level 2 measures by April 30th, 2006 is an extremely ambitious undertaking. Implementation of these measures will in many cases necessitate a considerable amount of IT adjustments. Hence, we should like to endorse the Commission's comment that "subject to adequate justification, CESR should have the right to ask the Commission to defer the deadline set in the mandate" for its deliberations. Yet, this should not lead to any inappropriate shortening of the time available for market participant consultation concerning final legal texts and implementation thereof in Member States. Rather, all legal possibilities should be reviewed in order to ascertain whether at least IT intensive implementation tasks may be implemented at a later date than April 30th, 2006.

One approach, however, that can by no means be regarded as a suitable policy, is the consistent use of a Regulation as legal tool for an allegedly faster road to implementation. In each individual case, the question whether a Directive or a Regulation is the right Level 2 tool hinges on the specific nature of the national legal regimes. What is more, the choice of the right regulatory tool also depends on whether the respective measures are restricted to a purely technical area or whether the provisions have wider implications.

Use of the mandate

CESR should – in line with the Commission's comment under section 2.3 – seek to carefully identify those provisions that are necessary for harmonisation whilst singling out those provisions which would encumber investment firms with a needless bureaucratic burden. This aspect also makes the present mandate liable for a critical review. Not all issues that have been raised therein are in need of further implementing provisions. Article 19.1 of the Directive, for instance, highlights that "when providing investment services and/or, where appropriate, ancillary services to clients, [investment firms are held] to act honestly, fairly and professionally in accordance with the best interest of its clients"; contrary to the suggestion implied in section 3.3.1 of the mandate, this principle is not in need of any further specification. The mere existence of a formal Level 2 mandate does not warrant any requirements that have already been specified in detail under the Framework Directive. CESR should rather hold a careful review of the need for any further Level 2 implementation in order to ascertain whether those provisions that have already been created at Level 1 may indeed be sufficient.

Need for a cost-benefit analysis

Since the first Consultation Paper on Possible Implementing Provisions on the Markets in Financial Instruments Directive (MiFID) presented by CESR under the first mandate on June 17th, 2004 features an extremely high degree of detail, we would strongly recommend CESR to reassess this approach. Under section 2.3, the Commission calls for an equilibrium between the envisaged regulatory goals (harmonisation, investor protection) and the requisite flexibility needed by investment firms. From the point of view of a **cost-benefit analysis**, this call is more necessary than ever.

II. Detailed review of the individual provisions

3.1. List of financial instruments (Article 4 – Annex I, Section C)

Pursuant to section C.10, also those financial instruments should be taken into consideration where the price or return is contingent upon circumstances that may or may not occur in the future. The market does feature a demand for trading in such instruments. Having said this, the present legal situation – at least in Germany – is still unclear. As a result, investment firms are still shying away from transactions of this kind².

The market does feature demand for such transactions. In order to create the requisite legal certainty in this regard and in order to subject such transactions to the regulatory scope, one further category of rights should be created which, for instance, might be defined as follows: "The term 'financial instruments' shall also include those derivative contracts that have the same features as other financial instruments, which, however, are additionally contingent upon conditions the manifestation of which is uncertain."

² The instruments addressed here might, for instance, serve the purposes of financing large-scale sports events. Such a financing tool might be conceived of in a way that several bonds are issued with a lower coupon than is generally the case in the market for bonds with regular features. Here, repayment of the bond is made contingent upon events that lie in the future, i.e. a victory or defeat of a certain athlete or of a team in the sports event that is being financed. This would mean that such a financial instrument would indeed feature elements of a bet or of gambling; yet, contrary to a regular lottery it would have an underlying economic background: For the organisers of the sports event, the fact that the repurchase is being made subject to the manifestation of an uncertain event in the future results in more economical financing costs. One further difference is that such a financing instrument allows an efficient, transparent secondary trade which is borne by banks in their capacity as market makers. Issuing, distribution and secondary market trade could take place in a supervised environment.

3.2. Definition of “Investment Advice” (Art. 4 (4))

In our view, the definition of '*investment advice*' given under Art. 4 (4) MiFID is already fairly concrete. Yet, in order to ensure legal certainty in the nomenclature, Level 2 might see a more detailed specification of the feature '*personal recommendation*'. Pointers for differentiating investment advice from a general recommendation a marketing communication and a simple offer can be found under Art. 19 (4). This provision hinges on the premise that investment advice needs to be based on some sort of specific knowledge about the client. The definition of '*personal recommendation*' should be modelled on this. This would mean that advice will always qualify as a **personal** recommendation if and when it is based both on the specifics of the instrument involved and takes account of the client's knowledge and experience, his financial situation and his investment objectives. The differentiating criterion of such a personal recommendation would thus be the fact that – unlike 'general recommendation', 'marketing communication', 'information given to the client', 'simple offer' – such a recommendation shall be based on the client's individual situation. One further condition precedent for this specific, situation based recommended course of action is that the investment firm either explicitly or at least tacitly accepts the advisory role. Pursuant to the definition contained in Article 4 Paragraph 4, the question whether the personal recommendations are provided upon the request of the client or at the initiative of the bank, is - quite rightly - not regarded as mission critical. Whenever the client contacts an investment firm, such investment firm shall have to accept the advisory task it is thus entrusted with. This makes it, in turn, a 'trustee for and on behalf of third party interests'. Such role will be regularly fulfilled by initiating an advisory activity.

- A 'general recommendation', on the other hand, does not take account of client and situation specific aspects. 'General recommendations' will only provide guidance of a general nature which is exactly divorced from the individual situation. Any 'market communication' features a similar lack of any individual and specific relation to the client.
- 'Information given to the client' is the mere forwarding of information without any evaluation thereof and/or without filtering or gearing such information to the client's specific situation. The same applies to a 'simple offer'; such 'simple offers' do not seek to address the client's specific situation either.
- Concerning the activity of 'tied agents', the Commission's question is not very helpful: In practice, it will not prove feasible to find any essential difference between the activity of 'tied agents' and the provision of 'personal recommendation'. 'Tied agents' may absolutely take on the function of an advisor, too. Hence, asking for the content of the job of a 'tied agent' would be a

more meaningful distinguishing criterion for singling out this profession; in other words: does such 'tied agent' exclusively work in the field of distribution or does he, in addition to distribution, perform any advisory function? In the latter case such 'tied agent' would also issue 'personal recommendations'.

3.3. Conduct of business rules (Art. 19)

3.3.1. General obligation to act fairly, honestly and professionally in accordance with the best interests of client (Art. 19, (1))

Article 19, Paragraph 1 of the MiFID contains a blanket clause that does not require any further, more detailed specification at Level 2. A more detailed specification is provided by the last part of Paragraph 1. This paragraph highlights the fact that the provision of investment services and ancillary services needs to be in line with the principles set forth in Paragraph 2 to 8. Furthermore, Articles 21 and 22, Paragraph 1 constitute more specific expressions of Article 19 Paragraph 1. This fact is explicitly emphasized by CESR in its Consultation Paper on the first mandate. What is more, any more detailed specification beyond this, would water down the rules of conduct to an extent where those rules might fail to reflect specific scenarios.

3.3.2. Suitability test/Appropriateness test/Execution only businesses (Art. 19 (4) to(6))

Any mandatory, compulsory provisions by CESR would be strictly objectionable in the entire area contemplated under 3.3.2.. When asking information from their clients, investment firms should be granted sufficient breathing space. Some investment houses, for instance, may adopt an approach where the risk profile of individual products is at the forefront. Other service providers may, with the same legitimacy, pursue a portfolio based approach which keeps an eye on the overall risk of the investment or which combines both. Both modi operandi have their own legitimacy. CESR should by no means limit competition between the various information and service models. Hence, the subsequent presentations may only serve as non-exhaustive examples; by no means should they be regarded as an invitation to impose upon investment houses certain models as the one and only correct solution.

3.3.2.1 Suitability test (article 19 (4))

When determining the criteria for the information that investment firms shall ask from clients, the focus should always be on the initial purpose for obtaining such information. Criteria for mandatory information should always be measured against whether they serve this overall purpose. Furthermore, in this field, striking the right balance between meaningful information and excessive requirements that only turn out to be cost drivers, is of particular importance.

The reason for asking the information contemplated by Art. 19 (4) is that it should help investment firms find the right basis for advice. Concerning the information which would have to be obtained pursuant to this, one possible solution would be the breakdown into three categories.

- **Financial situation**

Investment firms should be given the necessary discretion when obtaining information from the client regarding his financial situation, since many clients show a great deal of reservation even towards the bank when it comes to disclosing their entire financial position. The only thing that matters in the final analysis shall be the amount of assets and income that the client is prepared to set aside for an investment. Although, as general rule, there should be a question covering his overall income and his overall assets, it needs to be equally sufficient if the client only volunteers information on the amount of his assets and on the monthly income which he would like to make available for the investment *per se*.

- **Knowledge and experience**

In order to avoid an excessive amount of logistics when asking for information on knowledge and experience concerning the types of financial instruments, here, too, CESR should try to avoid adoption of excessively narrow provisions on criteria for the differentiation of the types of financial instruments. On principle, one possible breakdown concerning transaction types would be the categories bonds, shares, structured products, warrants and derivatives. As far as their risk structure is concerned, investment funds and many certificates are largely in line with the corresponding underlying instruments. This means that, whilst this is not absolutely necessary, they may indeed be listed separately. One further meaningful question that ought to be asked in this regard is whether the client has already had experience in the field of foreign currency investments. Provided that a credit or a loan is granted to an investor to allow him to carry out a transaction in one or more financial instruments (Annex I, Section B (2), MiFID) then this should give rise to the question whether, in the past, there have already been transactions in financial instruments based on a credit and what this credit line was.

- **Investment objectives**

As far as the information on the envisaged investment goals are concerned, in practice, very different approaches are being adopted on the ground. The overarching goal is to identify the client's risk appetite and the investment horizon he is aiming for. CESR should leave institutions the necessary freedom to find criteria that match their respective client structure. Yet, it may be possible to provide examples for possible investment goals. The following is a non exhaustive list of possible examples:

- Provision for old age;
- Home building schemes;
- Saving schemes;
- Asset investment;
- Specific purchase plan;
- Funding of education for children.

Hereby, clients should be enabled to independently articulate their investment goals. In this regard it may also prove helpful to ask the client, in an abstract way, for his expectations concerning the investment horizon. Yet, institutions should be free to decide on the shape and content of aspects that need to be considered in relation to investment goals.

- Determining criteria concerning the suitability of an investment for the client

Such criteria cannot be laid down in an abstract manner but only under due consideration of the peculiarities of the respective individual case at hand. Any forthcoming provisions with regard to the 'suitability test' in the context of investment advice should therefore seek to reflect the criteria of an 'advice that is suitable for the investment and investor alike'. In order to customise the advice given so as to adequately address the individual information needs of the client, the investment advice regime must also allow oral explanations.

- The term 'suitable for the investor' refers to the need for an advice that is geared towards the business partner's specific situation. First of all, this requires a knowledgeable analysis of the situation that needs to be assessed; such an analysis needs to take adequate account of the client's goals, his experience and his financial situation. The subsequent advice shall be based on the outcome of such an analysis. The benchmark for the advice is the client's best interest. Such criteria for an advice that is suitable for the investor cannot be laid down in abstract terms; instead they may only be defined on a case-by-case basis after due consideration of the peculiarities of the individual situation at hand.
- The term 'advice that is suitable for the investment' summarises those requirements that have to be met with regard to the content and scope of the advice in relation to the specific securities and derivative transaction in question. Firstly, the investment firm owes the client correct, full and intelligible information on all features and risks of the financial instruments which it recommends. Such advice shall contain any information that shall have or may potentially have material importance for the investment decision in favour or against the transaction. The information needs to be unambiguous, logically structured and must be provided in a suitable

format. Here, the scope of the information firstly depends on the client's prior knowledge and, secondly, on the nature of the envisaged transaction. Hence, information is only owed for the purposes of filling in gaps in the client's existing knowledge base. Further requirements are a comparative assessment of features, opportunities and risks as well as locating the financial instrument within the overall range of comparable products offered by the investment firm.

3.3.2.2 Information about the client knowledge and experience in the investment field / (Art. 19 (5))

Here, concerning the first item of the Commission's mandate, reference shall be made to the presentations regarding Article 19 Paragraph 4 (cf. above 3.3.2.1).

Concerning the second item of the Commission's mandate we need to point out that, suitability of the service or of the product may only be assessed on the basis of the client's knowledge and experience; this is because - outside of the scope of investment advice and portfolio management - the interview with the client is limited to these two aspects. As a consequence, a product or service would meet the suitability criterion in those cases where the client, based on his knowledge or his experience, is capable of making an informed choice in terms of the product or service, for which he is personally responsible.

Investment firms should be entitled to use their own criteria in order to assess whether, on the basis of his underlying knowledge or experience, a service or a product is suitable for the client. This area should not fall under the scope of Level 2 provisions. Here, firms should be given a sufficient degree of leeway for the organisation of their business operations. In practice, firms can already draw upon numerous criteria that are appropriate and fit for purpose in this respect.

Since the Directive stipulates that standardised information shall be provided only on an optional and not on a mandatory basis, the warning may also be given orally. The minimum content of this warning should only extend to the information that the investment firm considers the business transaction envisaged by the client not to be suitable.

Only such a condensed warning will be fit for purpose and meet the practical requirements on the ground. It is worth highlighting that, Art. 19 Paragraph 5 does not contain any further preconditions on order execution. This means that – in an event where a client issues an order despite a warning, an investment firm may subsequently execute such order without any further qualifications. Obviously, this shall not prejudice any potential information obligation pursuant to Art. 19 Paragraph 3.

4 Execution only (Art. 19 (6))

- Non-complex instruments

For us, an essential part of the Commission's mandate in the field of execution only transactions is the invitation to issue recommendations concerning criteria for the definition of the term *other non complex financial instruments*. Since Level 1 mentions a whole range of non-complex financial instruments, only those instruments may qualify as **other** non-complex instruments that allow a client to compare their underlying mechanisms. In our view, this criterion is met in the case of index certificates and discount certificates. These certificates merely emulate shares, i.e. financial instruments that have been categorised as *non-complex* at Level 1.

- Admissibility of advertising

The only derogation from the information duty pursuant to § 19, Paragraph 5 MiFID for execution-only transactions pursuant to § 19 Paragraph 6, 2nd indent exists in those cases where the service is provided at the initiative of the client or potential client. The Directive's Recital 30 points out that, by default, an investment service shall generally be regarded as having been provided at the initiative of the client. Said Recital furthermore stipulates that this shall remain unprejudiced by any prior advertisement that was geared towards a larger group of clients. An explicit reference in the implementing provisions on Article 19 Paragraph 6 MiFID that such advertisement does not automatically cancel the execution only privilege would seem judicious.

- Content of the warning

Similar to Art. 19 Paragraph 5, in order to live up to its function and the needs imposed by practical realities on the ground, the warning contemplated by Art. 19 Paragraph 6 should remain exclusively limited to a reflection of the text contained in the Directive. Kindly confer the corresponding earlier comments on Art. 19 Paragraph 5 for a more detailed discussion of the absence of requirements as to the form of the warning as well as the need to waive any requirements concerning order execution that go beyond those already contained under Art. 19 Paragraph.

3.5. Limit Orders Display (Art. 22.2)

With regard to the information that is being made public, the text of the Directive does not impose any consolidation criteria. In lieu of this, it limits itself to the qualification that information that is being made public shall be 'easily accessible'. On principle, this criterion is sufficiently met by way

of a publication on the investment firm's internet site. For the purposes of Art. 22 Paragraph 2, this shall be sufficient.

Article 22 Paragraph 2, first sentence furthermore stipulates that in those cases where the client has explicitly instructed otherwise, there will be no such obligation to make this information public. Generally, in wholesale banking, orders are always given with a limit. In effect, this means that any orders by institutional clients would fall under the publication obligation laid down by Article 22 Paragraph 2. Yet, as a rule, these clients will frequently be against public disclosures of their orders. Hence, a Level 2 clarification would appear helpful, pursuant to which it becomes clear that potential instructions prohibiting public disclosure may also be deemed to apply to any subsequent orders that will be executed in the course of a business relationship. Any contrary policy where such an instruction would have to be made for each individual order would generate a disproportionate administrative burden which would not be offset by any tangible benefit.

3.6. Eligible Counterparties (Art. 24)

Generally, we see no need for the Commission to adopt technical implementing provisions on Art. 24. It should be taken into account that the Committology provision under Art. 24 Paragraph 5 constitutes an optional provision only and not a mandatory provision. Especially the procedures concerning the criteria when a client may qualify for treatment pursuant to Paragraph 2 and/or the filing for the explicit approval of potential counterparties pursuant to Paragraph 3 should be left to the investment firms' own discretion. Prudential supervision rules in this field would not be expedient.

3.7.1. Systematic Internaliser

Any answer to the question concerning a closer definition of the criteria for a systematic internaliser laid down in Article 4 Paragraph 1. 7. needs to contain a reference to Recital 53 of the MiFID. This clearly shows that the European legislator wants to refrain from rolling out the pre-trade transparency rules to transactions carried out between wholesale counterparties on an OTC basis. Market participants frequently also refer to such transactions as wholesale market and/or off-floor trading. Recital 53 clarifies that it is precisely not the intention of the European legislator to roll out the cumbersome pre-trade transparency rules also to this highly specialised market. Furthermore, it is a standard market practice that an investment firm which, e.g., carries out a portfolio transaction for one of its clients, shall acquire specific parts of this portfolio directly from another bank for and on behalf of said client (as an agent). Whenever this takes place only in appropriate individual cases and without a systematic basis, this practice should not give rise to the

application of the pre-trade transparency regime. It would be helpful if CESR were to propose a corresponding clarification at Level 2.

For
ZENTRALER KREDITAUSSCHUSS
Deutscher Sparkassen- und Giroverband

For and on behalf

A handwritten signature in black ink, appearing to read 'Schürmann', with a long horizontal flourish extending to the right.

Dr. Thomas Schürmann