ZENTRALER KREDITAUSSCHUSS

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Comments of the Zentraler Kreditausschuss[1] on CESR's Advice on Possible Implementing Measures of the Directive 2004/39/EC on Markets in Financial Instruments Part 2 (Best Execution)

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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. Introduction

On September 17, the Zentrale Kreditausschuss (ZKA) submitted the first part of its comments on the CESR Consultation Paper dated 17 June 2004. We would like to thank you for the two week extension of the deadline for comments on certain sections of said Consultation Paper. The following paragraphs contain our comments on the sections "Best Execution" and "Post-Trade Transparency". Furthermore, we would strongly welcome it if CESR found a possibility of decoupling at least the field "Best Execution" - which still contains a large number of unresolved issues - from the forthcoming Consultation Procedure on the remaining topics under the First Mandate. We feel the compelling need to subject this issue to a further, more in-depth review. Potentially, this might not be feasible within the window of time allowed for the preparation of a second Consultation Paper on the First Mandate.

II. General Comments

In part one of our response (dated 17 September 2004), we pointed out that we are under the impression that CESR believes that the quality of investment services can only be improved through tight supervisory provisions which feature a maximum degree of detail. We do not subscribe to this point of view. What is needed first and foremost in order to enhance the quality of investment services is effective competition. Yet, a regulatory "straightjacket" of supervisory rules rather aborts this very competition. Particularly for smaller investment firms, the proposed regulatory amendments are likely to drive up the costs for their services so that they will no longer be capable of providing these services at competitive rates.

In this context, let us again briefly recall item 2.3 under the European Commission mandate given to CESR on 20 January 2004 (c.f. below). Here, the Commission calls upon CESR to merely set out "*ground-rules*" i.e. *"the right balance between the objective of establishing a set of harmonised conditions... and the need to avoid excessive intervention in respect of the management and organisation of the investment firms"*. Furthermore, the Commission points out that the *"amount of detail … should be very carefully calibrated case by case"*. Last but not least, the Commission feels that the recommendations should *"avoid formulations which would lead to overprescriptive, excessively detailed legislation, adding undue burdens and unnecessary costs to the firms and hampering innovation in the field of financial services"*.

When stipulating its recommendations, we strongly call upon CESR to take into account the provisions under the MiFID and the Commission's mandate.

The deliberations presented in the Consultation Paper on technical implementing provisions for Art. 21 feature a maximum degree of complexity. We fear that this might result in requirements

which, in practice, would be unrealistic. Against this backdrop, special attention should be paid to the following facts:

MiFID lays down that the prime criterion for choosing the execution venue consists in an instruction by the client. Apparently, the Consultation Paper is inconsistent with this Level 1 precedent in that it fails to adequately reflect the fact that a client instruction shall make any further deliberations concerning the execution venue redundant. This means that the requirements with regard to a best execution should only apply on an auxiliary basis. The Level 1 precedent would already rule out excessive requirements with regard to a best execution policy.

What is more, overly stringent requirements with regard to a 'best execution' would involve excessive costs that are financially not viable. This would *de facto* lead to a situation where certain transactions would henceforth no longer be offered to retail clients.

III. Summary of the status quo in Germany

In order to provide a better understanding, the following paragraphs shall highlight the present order execution situation in Germany. In Germany, there are seven trading floor systems, one electronical trading platform (XETRA) and one futures and options exchange (Eurex). Trading covers a host of different financial instruments, i.e. shares, bonds, warrants, certificates, derivatives, to name but the most important ones. There is both exchange trading and OTC-trading.

The current market practices need to be broken down into transactions on the domestic market and on markets abroad. German investment firms are frequently direct members, i.e. they themselves are members of German stock markets. German markets are *inter alia* characterised by their Verbund-organisations, i.e. the financial network of the cooperative banks or the financial network of the savings banks. These Verbundorganisations feature liaison via central banks or transaction banks. Non-domestic transactions generally feature involvement of brokers. Yet, not in every country there will be a direct contact with a broker. Instead, the choice will frequently be a broker who has access to trading venues in several countries. In line with the nomenclature of a *global custodian* or a *general clearer*, these brokers could be referred to as *global brokers* or *general brokers.* If the investment firm is integrated into an international group, then frequently also the group structures will be used in order to gain access to trading venues abroad.

Furthermore, it needs to be noted that an investment firm will only carry out orders in those venues where it can also draw upon the services of a depositary. This will generally be the case in European countries. Outside of Europe, however, sometimes it will not be possible to grant such access. This particularly applies in the case of access to exotic venues.

Under the current market practices, in the event of client orders without an instruction as to the execution venue, the order routing decision shall be incumbent upon the investment firm; here, investment firms shall be dutybound to make a decision in the best client interest and on the basis of due diligence and care. In the absence of a specific client instruction for routing purposes, the investment firm partly looks to whether this order comes from a small-scale investor or from an institutional investor. Basically, when selecting the venue the following criteria play a role:

- Product (shares, bonds, warrants, structured securities, funds)
- Liquidity/order penetration
- Order volume
- Price
- Service at the execution venue

When choosing the broker for the order execution abroad – which, instead of being made individually, will be made a general decision – possible selection criteria are:

- Reputation
- Presence
- Care and due diligence
- Punctuality
- Technical infrastructure, integration possibilities
- Service quality
- Reporting
- Contractual terms (e.g. costs, provision of collateral)
- Structure of the client orders.

To date, already on the grounds of financial viability and due to a lack of information, for the purposes of this choice, there is no comprehensive screening of each and any existing broker across the globe. Adjustments are carried out whenever the broker fails to meet the investment firms' requirements (any longer) and/or whenever it turns out that other brokers can offer better access. If and when an investment firm decides to switch brokers, this obviously shall be subject to the contractually agreed terms and conditions.

IV. Individual questions:

Section II: Intermediaries

Best Execution (Article 21); pages 70 - 79

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Q1: *Are the criteria described above relevant in determining the relative importance of the factors in Article 21(1)? How do you think the advice should determine the relative importance of the factors included under Article 21(1)?*

Answer: Yes, the criteria described are generally relevant in this context. In practice, however, it will be virtually impossible to translate them into an abstract, coherent decision making matrix covering most cases, let alone a 'one-size-fits-all' decision making matrix that would cover each and any case. Hence, derogations on a case-by-case basis shall and must be maintained in future. This is the only way for protecting the necessary degree of flexibility. The principles can thus not define the specific execution procedure for each individual case. Instead, these forthcoming principles must take on the character of a guideline which shall generally inform the firm's policy. Any abstract determination of the relative importance of the factors would furthermore quickly become highly susceptible to obsolete and outdated decisions that would virtually outrule the necessary flexibility. CESR should therefore refrain from preparing proposals on such a prioritisation of factors.

Q2: *Are there other criteria that firms might wish to consider in determining the relative importance of the factors? Do you think that the explanatory text clearly explains the meaning of all the different factors in respect of the different financial instruments?*

Answer: Extending the list to include further factors is not necessary since all material aspects have been covered. The explanatory text provides a sufficiently clear explanation of the meaning of all the different factors.

Q3: *How might appropriate criteria for determining the relative importance of the factors in Article 21(1) differ depending on the services, clients, instruments and markets in question? Please provide specific examples.*
Q4: *Please provide specific examples of how firms apply the factors in Article 21(1) to determine the best possible result for their clients.*

Answer: A specific regime for determining the relative importance does not give firms sufficient latitude to meet the different client requirements. For instance, a large order of a professional client concerning a blue chip share would have to be treated differently than a warrant order of a small scale investor. Also based on liquidity, a differentiation might become necessary. The number of differentiation criteria are legion. This means that it would be unrealistic to attempt drawing up an exhaustive list of such criteria. Hence, based on the interests of their clients, firms need to be allowed to pursue a differentiated order placement policy.

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Questions for consultation

Q.1: *What investment services does your firm provide?*

Answer: Generally speaking, the credit institutions represented by us provide the entire range of investment services. Sometimes this also takes place with the involvement of the companies belonging to the specific financial network structure (Verbund) or with the involvement of companies belonging to the group.

Q 2: *How many venues does your firm access now? Does your firm expect to access more venues after the Directive becomes effective?*

Answer: At present, German investment firms offer access to a host of different trading venues. Along with the German stock markets, this also includes access to EU stock markets. Outside of the European Union, German investment firms offer access to the world's major stock exchanges. Within Germany investment firms either have direct access or they have access through institutions that form part of the financial network structure (Verbund) or of the group structure. Abroad, there are some cases where direct access exists via the corporate group or financial network structures

(Verbund). This notwithstanding, non-domestic transactions very often feature involvement of a foreign broker.

In the context of the trading venues, we would like to specifically highlight one aspect: Already on the grounds of competition, investment firms must secure that they have access to all venues which allow best execution on a continuous basis. Yet, this does not mean that they must grant access to all trading venues worldwide; it is our understanding that this is by no means intended by the provision. For an investment firm and its clients, particularly the integration of each and any exotic trading venue is a solution that would not be financially viable. During the review, investment firms should be able draw upon the expertise of foreign brokers or *general brokers.* Hence, contractual safeguards need to be adopted in order to ensure that the verification of access is performed by the *general broker.* The obligation of careful selection of the *general broker* under due consideration of the aforementioned criteria shall remain incumbent upon the investment firm.

It is unlikely that MiFID will lead to an increase in the number of access to venues. Its coming into force might even have the opposite effect if excessive logistical demands were placed upon the firms. This would thus limit the choice available.

Q 3: *What factors does your firm consider in selecting and reviewing venues?*

Answer: A difference needs to be made whether a firm has direct access or whether it enjoys indirect access to the execution venue.

In the event of direct access, the following criteria will generally play a role: product (share, bond, warrant, structured securities, funds) liquidity/order penetration, order volume, price, service at the execution venue.

When selecting the broker, this decision will be based on e.g. the following criteria: reputation, presence, care and due diligence, punctuality/swiftness, technical infrastructure/integration possibilities, service quality, reporting, contractual terms (e.g. costs, provision of collateral), structure of the client orders.

Q 4: *Please provide specific examples of costs you consider in evaluating venues.*
Q.5: *How do costs affect your decisions about venue selection?*

Answer: For instance broker fees and currency expenses could be mentioned here.

Q 6: *Do you take account of implicit costs such as market impact? Is the question of implicit costs only relevant to firms that act as portfolio managers?*

Q.7: *What specific events have led your firm to re-evaluate venues in the past? Please provide examples of how your firm has changed the venues that it accesses as the firm, its clients, or markets have changed.*

Answer: In Germany, the introduction of the electronic trading system Xetra has been a significant milestone. On the part of investment firms, Xetra introduction has led to a major review of their execution policy. Wherever this appeared appropriate, changes have been made. This primarily applied to highly liquid titles.

Q.8: *Have we identified the key criteria?*

Answer: The key criteria have been identified. Covering this topic exhaustively right down to the last detail would not be a realistic undertaking.

Q.9: *What data is available to carry out these reviews? If no data is available, are market solutions likely to provide it?*

Answer: Already today, there is several data which exists in the market (e.g. rates or sales figures). Yet, this data is not always accessible in a consolidated format or in a very detailed form. Previously, there has never been any need for this, either. If the requirements should really change in this respect, then the market will find an appropriate solution in order to provide the requisite data.

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Questions for consultation

Q.1: *What kinds of monitoring arrangements do firms use now?*
Q.2: *How frequently do firms monitor execution quality?*
Q.3: *What data is available to aid firms in their monitoring obligations? What does the data cost?*
Q.4: *In what respects does the frequency with which firms monitor execution quality depend on the types of instruments, clients, markets and investment services in question? Please provide specific examples.*
Q.5: *What, if any, market data do firms consult in order to monitor execution quality?*
Q.6: *What additional data do firms expect to use after the Directive's transparency requirements become effective?*

Answer: Since, already on the grounds of its own vested interests, an investment firm will seek to always provide the client with the best possible solutions, it will automatically also keep a constant eye on the market, i.e. monitor the latter on an ongoing basis. However, this should not be misinterpreted as a bureaucratic process for a regular review of compliance with the abstract criteria.

Furthermore, one aspect should receive particular attention: The monitoring scope shall and must be restricted to those venues which do not feature any direct access. Corresponding reviews of the execution policy of a broker are not possible. The only obligation that can be made incumbent upon investment firms consists in the need to inform themselves by drawing upon the usual sources of information in compliance with the duty of care and due diligence. Any proactive enquiry obligation beyond this would clearly be too far-reaching in scope.

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Q.1: *How frequently do firms review the venues to which they direct orders on behalf of clients?*
Q.2: *Do firms re-evaluate their trading venues:*

- *whenever there is a material change at any of the trading venues ?*
- *whenever there is a material change at the firm that affects its execution arrangements?*

whenever the firm's monitoring indicates that it is not obtaining the best possible result for clients on a consistent basis?

Q.3: *What difficulties would firms face in reviewing their execution arrangements in response to each of the foregoing events?*

Answer: Generally, market monitoring will take place on an ongoing basis. Hence, no exact information can be provided concerning the frequency of *reviews.* For example, in those cases where there is either a significant change in the corporate policy of the own organisation or a significant change in the business policy of the execution venues, an investment firm will invariably carry out a review of its execution policy and will adjust the latter if needs be.

Q.4: *Do venues make firms aware of material changes in their business?*

Answer: Generally, at least in the case of significant innovations, the execution venues shall provide information on changes pertaining to the business policy.

Q.5: *Please provide examples of instances in which firms have changed the venues that they use.*

Answer: In Germany, the introduction of the electronic trading system Xetra has been of major importance and has induced many investment firms to review their execution policy. Wherever it appeared appropriate, changes have been made. This primarily applied to highly liquid titles.

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We invite comment on the following issues regarding information to clients and potential clients:

Q.1: *At present, how many venues do firms access directly? Indirectly?*

Answer: At present, German investment firms offer access to a host of different trading venues. Both domestically and partly also in other European countries, at least within group structures or financial network structures (Verbund), there is direct access to venues. Particularly abroad, investment firms' access is mostly of an indirect nature and is generally secured through foreign brokers. This applies both with regard to European and non-European markets. Whilst this number tends to be lower for smaller operations, large companies generally access 30 to 50 venues directly. Here, it is worth bearing in mind that one foreign broker will frequently have access to several execution venues.

Q.2: *Should an investment firm be required to provide clients and potential clients with information on the percentage of a firm's orders that have been directed to each venue?*

Q.3: *For example, should an investment firm be required to disclose to clients and potential clients what percentage of its client orders were executed in the trading venues to which the firm directed most of its client orders (to cover, at least 75% of the transactions executed)?*
Q.4: *How frequently should investment firms make this information available to clients? On a quarterly basis, for example?*
Q.5: *Should firms be required to update the information to reflect recent usage? How frequently?*
Q.6: *Are there any other categories of information that a client or potential client needs to be adequately informed about the execution services provided by firms?*

Answer: Investment firms should not be obligated to divulge information on order routing *vis à vis* (potential) clients. Whilst this information is irrelevant for the client, it would significantly increase the administrative effort in an unnecessary manner. As far as his order is concerned, the client shall receive each and any necessary information immediately after order execution (cf. also recommendations on Art. 19 (8) MiFID, Box 10). The decision as to whether a firm wishes to additionally disclose general information – e.g. for customer retention purposes or in order to achieve a USP over its competitors - should, however, be left to the investment firm's own discretion. At least under prudential supervision aspects, there appears to be no need for this. Besides, any further information lacks a legal mandate since the investment firms are merely obligated to provide the client with information or, moreover, a notice concerning their execution policy or any material changes to their order execution arrangements and their execution policy (cf. MiFID, Art. 21 (3) and (4)).

Q.7: *Should the information provided by portfolio managers and firms that receive and transmit orders be different from that provided by brokers? What are key differences?*

Answer: We can conceive of no case where there would be a need for the provision of such information.

Q.8: *Have all of the key conflicts of interest been identified?*

Answer: The issue of conflicts of interests should be dealt with exhaustively under Art. 13 paragraph 3 and 18.

Q.9: *When should firms be required to provide required disclosure to clients and potential clients?*
Q.10: *Is there any reason to impose different timing requirements for disclosure under Article 21 than are required in the Level 2 measures under Article 19(3)?*

Answer: Both under Art. 21 (6) c) MiFID and under the Commission Mandate, timing requirements as contemplated by explanatory text and by Q. 9, Q. 10 – also when such timing provisions should exclusively relate to the execution policy – lack any legal mandate. Should CESR decide to uphold its recommendations concerning the timing of information notwithstanding the fact that this would be inconsistent with the provisions contained under MiFID and the Commission's Mandate, then we, at least, recommend the following policy for first-time information of existing clients (in Germany alone, there are approximately 35 million portfolios) and any further information on material changes: The possibility of sending this information together with the annual asset statement (cf. item 8 of the recommendations on MiFID, Art. 19 (8), Box 10) should be seriously considered. This would result in considerable cost savings (postage) which otherwise would have to be borne by the client. What is more, the waiver of real-time information would appear to be justified in the foregoing cases because the execution policy only becomes a relevant issue in the absence of a client instruction. Last but not least, we would like to highlight that Art. 21 (4) MiFID equally refrains from stipulating any timing requirements for such information.