Date: 16 May 2005
Ref: CESR/05-350

MiFID Consumer Day – 22 March 2005
Issues on regulation of intermediaries and markets under MiFID

"Summary of the main conclusions"

1. Introduction

On 22nd March 2005, CESR hosted in Paris a Consumer Day on CESR's work on the Markets in Financial Instruments Directive (MiFID) mandates. A list of the 12 consumer representatives who participated in the roundtable is available in Annex I.

The discussion on the Intermediaries section was facilitated by Callum McCarthy, the Chairman of CESR's Expert Group on Intermediaries and on the Markets section by Karl-Burkhard Caspari, the Chairman of CESR's Expert Group on Markets. The discussion was based on documents which raised some of the major issues that the Groups have been discussing in their work under MiFID (Annexes II and III). In their opening remarks, the chairmen thanked the representatives of national and European consumer organisations for making time available for this hearing and briefly introduced the process of work relating to provisional mandates for technical advice on the MiFID.

The importance CESR attaches to receiving comments on its advice from representatives of retail clients and consumers was stressed and CESR expressed its concern that the responses received to previous consultations carried out on MiFID, had not reflected sufficiently this set of stakeholders. CESR made it known that it intended to organise similar meetings in the future to continue and develop this dialogue further.

General issues

Consumers´ representatives raised some general issues which might help to increase responses from consumers' representatives to CESR consultations. They stated that consumer associations do not necessarily have either the financial knowledge or staff to be in a position to prepare considered responses. In addition, financial services were not always a high priority for consumers.

However, on a practical level, the need for translations from English to national languages was mentioned as a factor which represents an obstacle to their active participation. They also stated that CESR's consultation papers are not always reader friendly. In particular, they would welcome having executive summaries and explanations of the proposals and the reasons why they are especially important from consumers´ point of view.

CESR representatives noted the proposals with interest. Regarding the translations or other help, it was pointed out that the national CESR members are most likely to be the natural contact point in this respect.

Finally, the representatives highlighted the importance of investor education and the need to have it high on the political agenda.

2. Specific questions for discussion on intermediaries

2.1 Scope of the services of investment advice

Consumers' representatives supported the approach to cover generic information within the scope of investment advice. It was felt that this would best serve the interests of investors and also because in practice, it would be difficult to distinguish between generic and specific advice.

It was, however, noted that to encourage the provision of generic advice only by some public entities, the scope of authorization requirements should not include these entities. In the alternative, some representatives suggested that MiFID only apply to generic advice if it leads to a transaction in a financial instrument. This could permit firms to participate in consumer education projects as long as this did not become combined with their sales process.

2.2. High level principles of Article 19(1) of the MiFID

Loans to investors

Attendees were unanimous in their support of the view that firms should be required to assess the suitability of any loans or credits granted by investment firms in connection with transactions in financial instruments. Representatives agreed that investment firms have to obtain all necessary information (including investment objectives) about the retail client's investment objectives in addition to his financial situation. This is part of the ordinary "know-your-customer" obligation.

Applicability of best execution to portfolio managers and order receivers and transmitters

Representatives generally supported CESR's proposal on best execution and its extension to portfolio managers and order receivers and transmitters executing orders. One representative suggested CESR should adopt a benchmark for transactions executed in regulated markets which would serve as a safe harbour and investment firms would have to demonstrate that orders executed on a different basis would provide better conditions. However, it was mentioned that such an approach can not be envisaged at level 2 since it would be in contradiction to the text of the MiFID.

Similarities with the rules on outsourcing were recalled, whereby a firm outsourcing services or activities keeps its regulatory responsibility.

2.3. Information requirements

Information on conflicts of interest

Representatives agreed with CESR's approach and considered it an appropriate protection for retail investors. They favoured disclosure of an outline of the conflicts policy and noted that it was important to keep it under review. The need to inform the client about the specific cases of conflicts of interest in each circumstance in which it arises was also emphasised, that is to say beyond, the disclosure or the conflicts policy.

Other representatives were worried about the increased use of web sites as a means of disclosure to clients and emphasised that investment firms' websites should not be the only mechanism for disclosure of information about the conflict policy as there are investors who are still not familiar with internet facilities or who do not have easy access.

Information on services and/or products / Marketing

All representatives agreed that retail investors should receive clear information about the services that the firm might provide to the clients and the subsequent reporting obligations. Even though lengthy documents are not necessarily read by consumers, it was considered that these should, nonetheless, be available. In addition, some advocated that consumers be given "fact sheets" or "standardised documents of key information" (containing information on products/kinds of transaction/risks/cost structure and price) before provision of investment services and this fact sheet should be kept under review.

Timing and content

Representatives of the consumers warned CESR about the possibility to offer and to provide services to consumers over the phone due to negative experiences of frauds of so called "boiler rooms" and cold calling. A representative from the Commission clarified that it is the Distance Marketing Directive, not MiFID that covers cold calling. Nevertheless, some consumer representatives favoured any information requirements that would have the effect of making cold calling more difficult.

2.4. Process driven protection

Absence of all or any information by retail client requested by investment firm

Consumers' representatives did not agree with CESR's approach regarding the consequences of the absence of information by retail clients requested by investment firms. They were of the opinion that if the retail client failed to provide any information that is required to be obtained by the investment firm and the necessary information is not otherwise available to the investment firm, the investment firm should not provide to the client any kind of investment services.

Non-complex financial instruments

There was a full agreement as to the approach that the definition of a "non-complex instrument" under Art. 19(6) of the MiFID excludes all derivatives. Respondents also raised the problems of UCITS investing in derivatives, which should be excluded as well. However, the Chairman explained that the level 1 text already classifies UCITS as "non-complex."

Best execution

Disclosure on information on execution venues and of information on the percentage of a firm's orders

The group did not seem very interested in getting venue lists. They were more interested in the context around the venue lists and perhaps the characteristics of the venues. Attendees were divided regarding the proposal to require firms to disclose statistics of executed trades, some considered this as essential information, others felt that this would not be relevant for consumers. Some of the representatives mentioned that it would be sufficient to disclose such information on a firm's web site and keep it under periodic review. Strong attention was given to the conflicts of interest in cases of internalisation; these conflicts should not damage retail investors.

Representatives of consumers supported all other proposals of the discussion paper concerning best execution.

Risk Warning on Client Instruction

Representatives supported CESR's approach, i.e. that firms must provide risk warnings to clients on the specific instructions given by clients that conflict with the firm's own execution policy or arrangements.

2.5. Organizational protection

Record keeping

Representatives considered that record keeping requirements on the provision of investment advice by the investment firm should be imposed. However, it was felt that it is not necessary to identify specific means but rather to keep the obligation at the level of a general principle.

Record of phone conversation

Representatives found the requirement of recording of conversations relating to orders that take place over the telephone of great significance. The data should be available also to clients on their request. This will increase the level of legal certainty and reduce litigations between firms and clients.

2.6. Customer Agreement

All representatives were of the opinion that retail client agreement has to be in written form and considered that the approach in CESR's advice on the specific content, the format and the time of conclusion of the retail client agreement for the provision for investment services, provides a necessary protection to retail clients and an important degree of clarity in their relationships with firms. One representative, however, considered that the choice of the legal form of the contract should be left to national legislation.

3. Specific questions for discussion on Markets

3.1. Requirements for instruments to be admitted to trading on regulated market

Shares

Consumer representatives pointed out the importance of the quality of the company i.e. having appropriate history and solid financial position. Some pointed out that there would be cases where the company would not necessary meet those requirements and they could still be allowed to trade but with appropriate information and necessary warnings. Another important item is the need of having an adequate number of shares in public hands.

They also noted that a prospectus is not necessarily the right instrument for investor protection due to the content of the information or the fact that it is available too late from a consumers' point of view. Additionally, they noted that IPOs should also be covered and CESR should propose appropriate requirements for the placement.

CESR representatives noted that the content of the MiFID related primarily to the instruments and the content of the information that is covered by other Directives.

Bonds

The representatives stressed the need to have available adequate information on bonds i.e. the prospectus. They also noted that from a consumers' point of view there is no real market in these instruments.

Units in Collective Investment undertakings

The representatives highlighted the need to have information on the investment strategy of UCITs and pointed out that more emphasis should be put on costs related to the instruments.

CESR noted the importance of those issues but also pointed out that the message would be forwarded to a specific Expert Group on Investment Management which focuses more on those issues.

Derivatives

Representatives noted that adequate information on derivatives is essential. On the other hand when consumers invest in those products they are likely to use the (advisory) services of an intermediary who has the obligations under the conduct of business rules.

3.2 Market transparency

The representatives argued for wide availability of the information. They did not consider the proposed 5 best levels as always sufficient. They also expressed reservations regarding the proposed exemptions from transparency.

Furthermore, they raised the point of costs in this respect. The information may not be useful for consumers if it is not available free of charge.

CESR representatives explained that while promoting transparency the MiFID also recognises the need to have certain exemptions and CESR's proposal should try to balance the different interests. Regarding the price of the information, the Directive expressly mentions that it should be available on a reasonable commercial basis.

ANNEXES:

Annex I – List of participants
Annex II – Discussion paper on Intermediaries (CESR/05-192)
Annex III – Discussion paper on Markets (CESR/05-193)

ANNEX I

MiFID Consumer Day – 22 March 2005

"List of representatives of national and European consumers' association and organisations"

Country	Name of the representative	Organisation
Austria	Dr Michael Knap	Interessenverband für Anleger (Austrian Shareholder Association)
Belgium	Mr Jean François Biernaux	Test-Achats Association belge des consommateurs
Denmark	Mr Claus William Silfverberg	Danish Shareholders Association
Finland	Mr Jouni Kinnunen	Finish Shareholders' Association
France	Ms Marie Claude Robert Hawes	Commission consultative épargnants et actionnaires minoritaires
Germany	Ms Dorothea Kleine	Verbraucherzentrale Bundesverband German national Consumer Association
	Mr Manfred Westphal	Verbraucherzentrale Bundesverband German national Consumer Association
Spain	Mr Manuel Pardos Vicente	ADICAE Financial Services Consumers Association
	Mr Fernando Herrero Saenz de Eguilaz	ADICAE Financial Services Consumers Association
United Kingdom	Mr Paul Salvidge	Consumer Panel Secretariat Financial Services Authority
Europe	Mr Peter Paul de Vries	VEB
	Mr Fernando Zunzunegui	FIN-USE

ANNEX II

Date : March 2005
Ref : CESR/05-192

Issues on regulation of intermediaries under MiFID

"Discussion paper"

1. Introduction

In accordance with the Lamfalussy Process,[1] the European Commission asked CESR to deliver its technical advices on possible implementing measures, so called "Level 2 measures", *inter alia*, of the Directive on Markets in Financial Instruments 2004/39/EC (MiFID).[2]

In giving its advice on possible implementing measure, CESR has been asked by the EU Commission to take full account of the following criteria:

- The protection of investors and market intergrity by establishing harmonised requirements governing the activities of authorised intermediaries;
- The promotion of fair, competitive, transparent, efficient and integrated financial markets as well as the promotion of competition;
- To strike a right balance between the objective of establishing a set of harmonised conditions for the licensing and operating of investment firms and regulated markets and the need to avoid excessive intervention in respect of the management and organisation of the investment firm;
- The amount of detail included in the advice should be very carefully calibrated case by case; the advice should ensure clarity and legal certainty but 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.

CESR has already provided the Commission with its technical advice on some areas of the MiFID [CESR's Technical Advice on Possible Implementing Measures of the Directive 2004/39/EC on Markets in Financial Instruments, (Ref.: CESR/05/024c)]. The technical advice on the remaining substantive areas will be submitted to the European Commission by 30 April 2005.

CESR tried to answer to questions regarding these areas with an advice that could be flexible enough to address the specificities of:

- market structures (regulated markets, OTC markets and MTF)
- size of intermediaries (small players/medium and large players)
- different products (equities/bonds/derivatives)
- different services (advisory/non-advisory, portfolio management)
- different nature of clients.

Objective of the discussion

1 The approach proposed by the Committee of Wise Men can be summarised very briefly as follows: Level 1 consists of EU legislation setting out the high level objectives that the securities legislation must achieve, together with the framework of basic regulatory requirements. Level 2 consists of EU legislation setting out some of the technical requirements necessary to achieve these objectives together with more detailed regulatory requirements. Level 2 legislation can only be made within the scope of enabling powers contained in the level 1 legislation. The content of the Level 2 legislation under MiFID is the subject to CESR's advice. Level 3 measures are intended to ensure common and uniform implementation by the use (amongst others) of common interpretative guidance and standards agreed amongst regulators in CESR. Level 3 does not consist of EU legislation. Level 4 involves the enforcement of level 1 and 2 legislation by the Commission. CESR is therefore particularly active in carrying out functions described under Levels 2 and 3 of the Lamfalussy process.

2 The Directive on Markets in Financial Instruments was adopted by the European Parliament and Council on 21 April 2004 (OJ L145/1 of 30 April 2004). It currently sets a deadline of 30 April 2006 for full national implementation. However, this is likely to be delayed to 30 April 2007, in order to provide firms and Member States with more time to prepare for the new regime.

The discussion will mainly focus on some aspects of the client/firm relationship and should help CESR in realising whether:

- CESR has struck the right balance between the objective of establishing a set of harmonised conditions for the licensing and operating of investment firms and the need to avoid excessive intervention and burden in respect of the management and organisation of the investment firm;
- CESR has focused on the right tools for protection of retail investors;
- there are some missing and/or unnecessary requirements;
- there are particular features of the home markets that appear to demand regulators to have flexibility to impose more extensive requirements that those set out in the Level 2 measures;
- there are circumstances (court procedures, administration of assets for minors or modes of operating (e.g. phone or internet)) where greater flexibility is required than set out in Level 2 measures.

2. Specific questions for discussion

2.1 Scope of the services of investment advice

According to Art 4(1) No. 4 of the MiFID "investment advice" means the provision of personal recommendation to a client, either upon its request or at the initiative of the investment firm, in respect of one or more transactions relation to financial instruments.

Since personal recommendation might be very specific, i.e. recommending one or more particular financial instruments ("Taking your personal situation into account, you should buy 50 shares in Company S, 100 bonds of Company B and 200 units in Collective Investment Undertaking U), or more generic, i.e. recommending types of financial instruments ("Taking your personal situation into account, you should invest 30% of your liquid assets in stocks and 70% in bonds"), CESR is considering the width of the definition of "investment advice".

An advantage of a very broad interpretation of investment advice so that it covers generic recommendations could be enhanced investor protection since the suitability test and other relevant provisions of MiFID – for example, to carry out a fact-finding process, to provide comprehensive information prior to the provison of the service and to require suitability of all recommendations- would apply.

At the same time, considering the prognostic nature of generic information and the free choice of the investor regarding the specific instruments, it may be more difficult to prove wrongful advice in practice. It might also be argued that it is only if a client acts on an explicit or implicit recommendation to buy or sell specific instruments that loss or harm can arise; and, that, so far as retail investors are concerned, generic recommendations that do not involve a transaction are rare. Hence, the inclusion of generic recommendation in the scope, except for some cases (e.g. recommendation to a retired person with an average pension to invest almost all of her assets in illiquid penny stocks), might not be of use for many investors but will increase the burden on firms and the scope of regulation under MiFID.

The imposition of these requirements on firms at an earlier stage of the relationship might also discourage firms from having generic discussions with clients. Certainly, it is unlikely to increase the extent to which individuals can access independent generic advice. These practical implications are therefore in practice more likely to be a concern in relation to new or prospective clients.

On the other hand, it should not be disregarded that a personal recommendation of specific transactions in particular instruments could entail an aggravated risk. In the case of a generic recommendation, the client still has to make up his mind about, or obtain advice on, the concrete instruments for his investment whereas, in case of specific recommendation, he could directly order the recommended financial instrument(s). Thus, the more specific the recommendation the higher the influence on the client's decision to act on the advice, particularly on inexperienced investors. Moreover, especially specific

recommendations increase the risk of churning or mis-selling. A narrower definition would also be clearer and allow for a more precise determination of the services covered.

Do you think it is preferable to restrict "investment advice" to recommendations of specific financial instruments or is it necessary to cover generic information?

2.2. High level principles of Article 19(1) of the MiFID

Article 19(1) of the Directive states a general principle of fair treatment of clients. It lays down that investment firm, when providing investment services and/or, where appropriate, ancillary services to clients, must act honestly, fairly and professionally in accordance with the best interests of its clients. CESR has been considering proposals for technical advice under this provision. Currently CESR is proposing level 2 measures on loans to investors and the scope of application of the best execution requirements.

Loans to investors (Non core service under Annex I, Section B, Paragraph 2)

There are valid reasons why an investment firm may wish to provide (or arrange) credit or loan facilities for its client to allow the client to carry out transactions in financial instruments. For example, such facilities may enable the client to take advantage of short term investment opportunities that would be missed if the client had to arrange for funds to be transferred into their accounts from elsewhere. They may also be used by the client to leverage his exposure to a particular financial instrument. Such techniques may change the risk profile and complexity of the relevant transaction. Depending on the circumstances, this increased risk and complexity may or may not be suitable for the client.

In view of the potential effect on the risk profile and complexity of the transaction to which it relates, CESR proposes that when providing a loan or credit of money to a retail client, an investment firm should be subject to an obligation to evaluate the suitability of that loan or credit. The proposed advice would also apply where the investment firm arranges for a third party to grant the loan or credit.

The draft technical advice proposes a number of important limitations to the scope of this suitability obligation. The proposed advice would only apply where the loan or credit is granted for the purpose of enabling the retail client to carry out a transaction in a financial instrument and in the course of, or in connection with, the provision of investment services by the investment firm. The obligation would therefore not apply to the general lending activities of investment firm unless these take place in connection with, or in the course of providing, an investment service.

Do you agree with the proposal that an investment firm should only provide (or arrange for the provision of) a loan or credit to a retail client in the course of, or in connection with, the provision by it of an investment service, if it has evaluated the suitability of the loan or credit?

Do you consider that investment firms have to obtain the necessary information about the retail client's investment objectives in addition to his financial situation?

Applicability of best execution to portfolio managers and order receivers and transmitters

Recital 33 of the MiFID provides that the best execution obligation "should apply to the firm that has the contractual or agency obligations to the client." Therefore, firms that execute orders on behalf of portfolio managers[3] and order transmitters are not subject to the obligations of best execution with respect to the clients of those firms unless the executing firms also have direct contracts or agency relationships with those clients. A similar problem arises if a portfolio manager or order transmitter uses an entity in a third country to execute its client orders if the executing entity is not subject to the requirements of MiFID. As a result, if the obligations of best execution are not applied to portfolio managers and order transmitters, then many of their clients will not enjoy any of the protections of best execution.

[3] CESR uses the term "portfolio manager" to refer to investment firms that manage portfolios and to management companies when providing portfolio management services on a discretionary, client-by-client basis.

In formulating this advice, CESR has set itself two objectives. First, it wishes to establish the principle that regardless of how a firm decides to organise its trading process, if it has a contractual or agency relationship with clients that results in the execution of orders on their behalf, then it must take all reasonable steps to obtain the best possible result for the execution of those orders by complying with all the requirements of best execution. Second, CESR has endeavoured to craft its Level 2 advice in such a way that it does not impose unreasonable burdens on firms that choose to use other investment firms to execute their client orders.

Do you agree with this proposal on best execution?

2.3. Information requirements

There are various information requirements in the MiFID. Article 19(3) requires certain information to be provided to the client about the investment firm and its services before the commencement of the provision of the investment service. According to Article 18(2) where organisational or administrative arrangements made by the investment firm in accordance with Article 13(3) to manage conflicts of interest are not sufficient to ensure, with reasonable confidence, that risks of damage to client interests will be prevented, the investment firm shall clearly disclose the general nature and/or sources of conflicts of interest to the client before undertaking business on its behalf.

2.3.1. Information on conflicts of interest

CESR advice under Article 18(2) provides that investment firms should not provide services before disclosing conflicts that cannot be reasonably managed so as to prevent risk of damage to the client's interests, including the interests of a client having the status of an eligible counterparty, and not to act where the client does not consent. This provides an additional method of preventing significant conflicts from adversely affecting the interests of the client.

Furthermore, CESR advice under Article 19(3) requires an outline of the conflicts policy to be disclosed in all cases as a complement to the disclosure obligation. It also requires information to be provided or accessible to the client in a "durable medium". However, it also proposes an alternative mechanism for disclosure of information about the conflicts policy via the investment firm's website. This should address concerns about the costs of sending this information to every client.

What do you think about such an approach? Do you consider it an appropriate protection for retail investors?

2.3.2. Information on services and/or products / Marketing

Article 19(2) states general principle that information must be fair, clear and not misleading. CESR advice under Article 19(3) specifies the content of the appropriate minimum information that the investment firm should supply to its clients and potential clients. It also addresses the timing and form of the provision of that information.

An investment firm may generally be deemed to have complied with the obligation to provide information where the client has been given the information under this article on a previous occasion and that information is still up to date.

To what extent will retail consumers in practice read client agreements or pre-contractual disclosures, which often will be fairly lengthy? To what extent can benefits to consumers be delivered by providing them with detailed standard information as opposed to the imposition of controls over the way firms carry on business?

What is the relevance of marketing communications to consumers' decision-making, for example, the extent to which consumers gain an impression of a product or firm from marketing information which remains constant through the decision-making process?

Do you think that it is necessary for all information to be provided to the consumer before commencement of a service in all cases ? Are there circumstances where key information and risks is sufficient?

Timing and content

The provision of certain information in the case of voice telephone communications allows an investment firm, with the explicit consent of a retail client or potential retail client, to provide a restricted set of information (including risk and price information) provided it then goes on to send the full information to the customer immediately after the contact. This is consistent with the Distance Marketing Directive
If the investment firm has already given the information required under this article to the client on a previous occasion and it is still up to date, it should generally not be necessary for the investment firm to provide such information at the start of the voice telephone communication. However, the requirement to make the identity of the investment firm and the commercial purpose of the call explicitly clear should apply to each voice telephone communication to a retail client or potential retail client initiated by the investment firm.

Do you think we struck the right balance between the need to inform the client and the sufficient amount of information? How detailed information should be on the description of the services, the financial instruments and the cost associated?

2.4. Process driven protection

2.4.1. Suitability test and Appropriateness test

Article 19(4) sets out a suitability standard, which applies in relation to the provision of investment advisory and portfolio management services. Article 19(5) sets out an appropriateness standard, which applies in relation to investment services other than investment advice and portfolio management. Article 19 (6) allows investment firms when providing investment services that only consist of execution and/or the reception and transmission of client orders with or without ancillary services to provide those investment services to their clients without the need to obtain the information under specified conditions.

Absence of all or any information by client requested by investment firm

Article 19(4) requires the firm to obtain the information necessary to enable it to recommend suitable investment services and financial instruments. Hence, investment firms must obtain from the client or potential client at least information on his knowledge and experience concerning the investment services and types of financial instruments he is interested in or which the investment firm intends to recommend (e.g. if the client is only interested in shares, the investment firm does not need to obtain other information on the client's knowledge and experience on derivatives such as options or futures).

However the question is what happens when the client does not provide all or any information requested by investment firm. Clearly, the investment firm has to assess whether the information received is sufficient to provide the specific investment advice or portfolio management services envisaged. However, the investment firm needs at least some information from the client or potential client, particularly on his investment objectives, in order to be able to recommend to the client or potential client the investment services and financial instruments that are suitable for him. If the information obtained from the client is not sufficient to conduct the suitability-test in relation to the specific investment advice or portfolio management service envisaged (for instance, advice on extremely complex derivative instruments or high risk portfolio management services), the investment firm may provide to the client the investment advice or portfolio management service which it considers suitable depending on the extent of information provided by the client or potential client,.

Do you agree with this approach where the firm has not been provided with full information?

Even though the service cannot generally be provided if the client does not provide any information, CESR considers whether in exceptional cases the investment firm could still provide the service of portfolio management or investment advice, if the client is not able to or refuses to provide information about his knowledge and experience, his financial situation or his investment objectives and the necessary

information is not otherwise accessible for the investment firm. In such cases CESR considers the investment firm should only provide the services of investment advice or portfolio management if it acts under the assumption of the cautious basis (lowest level of risk to any category of client.

Do you think that adequate investment advice or portfolio management service is still possible on the basis of the assumption that the client has no knowledge and experience, the assets provided by the client are his only liquid assets and/or the financial instruments envisaged have the lowest level of risk if the client is not able to or refuses to provide any information either on his knowledge and experience, his financial situation or its investment objectives?

Or would this assumption give a reasonable observer of the type of the client or potential client the impression that no recommendation should be made or service provided?

Non-complex financial instruments

Article 19 (6) of the MiFID provides conditions under which investment firms may provide investment services that only consist of execution and/or the reception and transmission of client orders (with or without ancillary services) without the need to obtain the know your client information of Article 19(4) or to carry out the appropriateness test of Article 19(5). These conditions include the condition that the services must relate to shares admitted to trading on a regulated market, or in a equivalent third country market, money market instruments, bonds or other forms of securitised debt (excluding those bonds or securitised debt that embed a derivative), UCITS and other **non-complex financial instruments**.

Assuming that a non-complex instrument must be a specific kind of a financial instrument, it has to fall within one of the categories of financial instruments mentioned in Annex I, Section C. Since money market instruments are explicitly mentioned in Article 19(6) as instruments permitted for the service under Article 19(6), they have to be considered as non-complex. This conclusion is underlined by the fact that an investment firm is also allowed to provide the service under Article 19(6) in respect of "other" non-complex instruments. The reference to "other" could only mean that the aforementioned instruments are considered to be non-complex. Bonds and securitised debt are only admitted to the service under Article 19(6) when they do not embed a derivative. Since derivatives are not mentioned in Article 19(6) CESR takes the view that all derivatives have to be considered as complex instruments according to the scheme and purpose of the restrictive preconditions of Article 19(6).

Do you agree with such an approach and the fact that the definition of a "non-complex instrument" excludes all derivatives?

2.4.2. Best execution

The Best Execution regime is an important component of the package of investor protection and market integrity measures in the Directive. It is based around four key requirements. An investment firm must:

- take all reasonable steps to obtain the best possible result for its client when executing an order, taking into account a number of specified factors and any other consideration relevant to the execution of the order;
- establish and implement effective arrangements for complying with the above requirement, including the creation of an order execution policy;
- provide appropriate information about the policy to its clients and obtain their consent to it; and
- monitor the effectiveness of its order execution arrangements and policy.

Disclosure on information on execution venues

CESR believes that the information about the execution venues that investment firms access directly should help clients and potential clients to evaluate and compare the nature of the services offered by investment firms. However, CESR has proposed that it should not be necessary for the disclosure to include every execution venue that the investment firm could access indirectly, as such a list is likely to be very long and of little practical use. Limiting this requirement to venues that firms access directly should mitigate the

concerns about overly burdensome or unhelpful disclosure. For all of these reasons, CESR is recommending that firms be required to disclose those venues that they access directly.

Furthermore, investment firms may institute different execution policies and arrangements for different types of clients. If it accesses different venues for its institutional clients, this need not be disclosed to its retail clients.

Do you think that such a disclosure is sufficient for retail investor?

How useful is it to require investment firms automatically to provide retail clients with the names of trading venues in its execution policy and whether the firm has direct or different execution policies and arrangements for different types of clients really matter to the retail investor?

Disclosure of information on the percentage of a firm's orders

CESR also aimed at exploring the potential benefits of information about firms' actual historic use of execution venues and execution intermediaries, including the investment firm itself where it (or its affiliate) executes client orders by dealing on own account as the client's counterparty.

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

Disclosure of information on procedures for the selection of trading venues and their periodic review

In the first consult paper CESR considered whether to require that an investment firm disclose to its clients and potential clients information about the policies it follows in selecting, monitoring and reviewing trading venues and any material changes made to those policies. This could include information about factors used to select venues.

Neverthless, several respondents argued that firms should make this information available upon request but should not be required to send it to all clients and offered:
~ general disclosure of the trading process;
~ detailed disclosure about the factors and how the investment firm considered them;
~ disclosure about any trade-offs that the investment firm is making among the criteria and factors in its execution policy; and
~ disclosure about the investment firm's error correction policy, error rates and client order handling policy.

Do you think that an investment firm should be required automatically to disclose to its retail clients and potential retail clients information about the policies it follows in selecting, monitoring and reviewing trading venues and any material changes made to those policies. This could include information about factors used to select venues?

Or would be disclosure suggested by respondents be sufficient for retail or potential retail investors?

With respect to this disclosure suggested by respondents, do you think that investment firms that execute client orders directly or indirectly should be required to disclose information about their error correction and order handling policies?

Disclosure of information on conflicts of interests

CESR considered whether to require that an investment firm disclose to clients and potential clients any arrangements with venues that involve incentives to select venues for reasons other than execution quality.

Do you think that investment firm should be required to disclose to retail clients and potential retail clients any arrangements with venues that involve incentives to select venues for reasons other than execution quality?

Or do you think that disclosure about incentives under the general provisions would be enough?

Disclosure of information about the relative importance of the factors for retail clients

A number of respondents to the first consultation suggested that price and costs typically are the most important considerations in executing retail client orders. While CESR has no wish to preclude firms from determining that other factors may be more important for some types of retail trading, we are concerned that such determinations might run counter to the expectations of most retail clients. Therefore, we have proposed that where firms determine that other factors are more important than price and costs when executing retail orders, that this is highlighted.

Do you agree with this proposal?

Risk Warning on Client Instruction

Since clients commonly provide specific instructions to investment firms that override firms' execution policies and arrangements, CESR wants clients to understand that specific instructions prevent an investment firm from arranging for their orders to be executed in accordance with the firm's execution policy, which represents the firm's considered opinion about the best way to execute client orders. Specifically, CESR wants clients to understand that specific instructions prevent an investment firm from arranging for their orders to be executed in accordance with the firm's execution policy, which represents the firm's considered opinion about the best way to execute client orders. Therefore, CESR is proposing that firms provide risk warnings to clients who present them with specific instructions that conflict with the firm's own execution policy or arrangements. CESR also wishes to caution firms against soliciting including "client instructions" either as part of their general terms of business or otherwise.

CESR also wishes to remind firms that client instructions are unlikely to address every aspect of a firm's order execution policy and arrangements. Therefore, even if a firm receives a specific client instruction regarding venue selection, that firm still has a duty to follow its execution policy and arrangements with respect to those aspects of the transaction that are not governed by the instruction

Would you agree with such an approach?

2.5. Organizational protection

2.5.1. Record keeping

Article 13.6 requires an investment firm to arrange for records to be kept of all services and transactions undertaken by it which shall be sufficient to enable the competent authority to monitor compliance with the requirements under the Directive, and in particular to ascertain that the investment firm has complied with all obligations with respect to clients or potential clients.

CESR did not advice the Commission on specific record keeping requirements on the provision of investment advice by the investmen firm.

Do you share such an approach or do you consider specific record keeping requirements should be imposed on the provision of investment advice? In the case of the latter, which requirements?

Record of phone conversation

The draft advice proposed that investment firms should keep records of telephone orders on a voice recording system for at least one year.

Concern was raised by respondents regarding the cost of installation and operation of any voice recording system. Respondents were also of the view that records of voice recordings should only be maintained for a period of time proportionate to the operational needs of the investment firm and the complexity of the firm's business. In particular, a number of respondents stated that voice records only needed to be kept for as long as they were required to resolve any transactional disputes with clients or market counterparties or

to resolve internal or external investigations on market abuse conduct that is suspected to constitute market abuse.

Many firms operating at high volumes already do record orders; but firms do not do so universally. Many respondents noted that the initial set up costs of voice recording systems were equally if not more important than the marginal costs of longer retention periods. This issue was noted to be particularly acute for retail business, where the volume of client calls per line might be low and the number of offices and lines used might be higher, especially where the lines or offices also took orders for non-MiFID instruments or services. This might therefore impede the conduct of such business and act as a barrier to new entrants.

How significant to investor protection do you belive it would be to require the recording of conversations relating to orders that take place over the telephone?

2.6. Customer Agreement

CESR advised the Commission on the specific content, the format and the time of conclusion of the retail client agreement for the provision for investment services.

Do you consider that such an approach provide a necessary protection to retail client?

Annex III

Date: March 2005
Ref: CESR/05-193

MiFID Consumer Day – 22 March 2005

Issues on regulation of markets under MiFID

"Discussion paper"

1. Introduction

In accordance with the Lamfalussy Process,[4] the European Commission asked CESR to deliver its technical advices on possible implementing measures, so called "Level 2 measures", *inter alia*, of the Directive on Markets in Financial Instruments 2004/39/EC (MiFID).[5]

In giving its advice on possible implementing measure, CESR has been asked by the EU Commission to take full account of the following criteria:

- The protection of investors and market integrity by establishing harmonised requirements governing the activities of authorised intermediaries;
- The promotion of fair, competitive, transparent, efficient and integrated financial markets as well as the promotion of competition;
- To strike a right balance between the objective of establishing a set of harmonised conditions for the licensing and operating of investment firms and regulated markets and the need to avoid excessive intervention in respect of the management and organisation of the investment firm;
- The amount of detail included in the advice should be very carefully calibrated case by case; the advice should ensure clarity and legal certainty but avoid formulations which would lead to over prescriptive, excessively detailed legislation, adding undue burdens and unnecessary costs to the firms and hampering innovation in the field of financial services.

CESR has already provided the Commission with its technical advice on some areas of the MiFID [CESR's Technical Advice on Possible Implementing Measures of the Directive 2004/39/EC on Markets in Financial Instruments, (Ref.: CESR/05/024c)]. The technical advice on the remaining substantive areas will be submitted to the European Commission by 30 April 2005.

2. Specific questions for discussion

2.1 Requirements for instruments to be admitted to trading on regulated market

4 The approach proposed by the Committee of Wise Men can be summarised very briefly as follows: Level 1 consists of EU legislation setting out the high level objectives that the securities legislation must achieve, together with the framework of basic regulatory requirements. Level 2 consists of EU legislation setting out some of the technical requirements necessary to achieve these objectives together with more detailed regulatory requirements. Level 2 legislation can only be made within the scope of enabling powers contained in the level 1 legislation. The content of the Level 2 legislation under MiFID is the subject to CESR's advice. Level 3 measures are intended to ensure common and uniform implementation by the use (amongst others) of common interpretative guidance and standards agreed amongst regulators in CESR. Level 3 does not consist of EU legislation. Level 4 involves the enforcement of level 1 and 2 legislation by the Commission. CESR is therefore particularly active in carrying out functions described under Levels 2 and 3 of the Lamfalussy process.

5 The Directive on Markets in Financial Instruments was adopted by the European Parliament and Council on 21 April 2004 (OJ L145/1 of 30 April 2004). It currently sets a deadline of 30 April 2006 for full national implementation. However, this is likely to be delayed to 30 April 2007, in order to provide firms and Member States with more time to prepare for the new regime.

Article 40 of the Directive requires that regulated markets have clear and transparent rules regarding the admission of financial instruments to trading. The rules shall ensure that the instruments admitted to trading are capable of being traded in a fair, orderly and efficient manner (and that in case of transferable securities, are freely negotiable).

CESR has been asked to specify the characteristics of different classes of securities.

It should be noted that securities, especially shares, which are admitted to trading are subject to other parts of EU legislation, which cover for example disclosure requirements of the issue or market abuse provisions. The current work under MiFID should not address those issues, but more closely matters that relate to trading and tradability if the instruments.

CESR´s second consultation document in this issue was published in January and we are now in the process of finalising the final advice. The proposal covers the following classes of instruments: shares, bonds, "securitised derivatives", money market instruments, units in collective investment undertakings and derivatives.

First, for *all transferable securities*, CESR proposes that the instruments should be freely negotiable when they can be traded between the parties and subsequently transferred without restriction. Member states may consider securities which may be acquired only subject to approval freely negotiable if the use if that clause does not disturb the market.

For *shares* CESR proposes that there should be sufficient number of shares in public hands (free float) to maintain a viable market. There should also be appropriate level of historical financial information of the company (with a possibility for exemption where there are satisfactory information and/or other arrangements on the market). Additionally, the intended trading mechanism for shares should facilitate fair, orderly and efficient trading taking into account especially the expected trading activity.

For *bonds*, CESR proposed that there is no need for specific requirements (other than the general requirement in the Directive).

For *"securitised derivatives"* CESR proposes similar type of requirements than for derivatives, which include requirement for the trading mechanism, for the terms of the security, pricing, information for valuation of the security, and clearing ad settlement for the instrument. The issues are explained more in detail later.

For *money market instruments,* CESR propose a special requirement of having adequate information available of the terms of the instrument.

For *units in collective investment undertakings*, CESR proposes additional requirements both for closed end funds and open end funds.

Open end funds should have followed the necessary national procedures of distribution in order to be admitted to trading. The arrangements for trading should be capable of creating a viable market, for example the breadth of distribution should be wide enough, there are adequate market making arrangements or alternative arrangements for investors to redeem the units. Finally, the value of a unit should be sufficiently transparent to investors either by publication of the fund's investment strategy or by the periodic publication of net asset value.

Regarding closed end funds, there should be similar requirements for trading arrangements as described above and the value of the units should be sufficiently transparent to investors as well.

For *derivatives,* CESR proposes that the terms of the contract should be unambiguous and allow for a correlation between the price of the underlying asset (or other underlying factor). The price of the underlying should be considered reliable and be publicly available with some exemptions for commodity derivatives. Sufficient information should be available to typically vale the derivative. The arrangements for determining the settlement price should be appropriate.

- *Do you think the requirements for different classes of instruments are appropriate?*

- *Should there be additional requirements, especially in case of bonds?*
- *What are your concrete proposals?*

2.2. Content of market transparency and possible exemptions of the transparency

The directive includes a comprehensive transparency regime for regulated markets and multilateral trading facilities (MTFs) covering both information on current opportunities to trade (pre-trade transparency) and information on completed transactions (post-trade transparency). The intention is to combat the possible fragmentation in trading with requirements to keep the information available for investors in a way which is possible to consolidate and format a picture of the trading EU wide. The directive points out the need for having the information consolidate, but the consolidation is left for market forces, i.e. there is no legal requirement for any kind of "consolidated tape". It also recognises that the trading venues are not obliged to provide the information for free, but on reasonable commercial terms.

CESR advice, which is current out for second round of consultation, specifies the exact content of the information and exemptions which are allowed.

Pre-trade transparency

On pre-trade the basic requirement proposed by CESR is to have available at least five best price levels, containing information on the aggregate number of shares and orders represented at each price level. In ace of quote driven trading system, it should make available the best bid and offer of each market maker.

While the directive promotes wide transparency, it recognises that in certain situations limited transparency may be beneficial to the liquidity on the market. Therefore several exemptions from the basic transparency are proposed. First exemption covers different "order handling facilities" that markets may provide, for example iceberg orders. While the same effect could be achieved by the investor himself by sending the order in pieces (with a transparency only for each individual piece), it is proposed to have an exemption for such order handling facilities.

Second an exemption is proposed for "negotiated trades". That includes different types of trades where the participants have bilaterally been negotiating the conditions of the trade. While there is not really an opportunity for other investors to be part of that trade it is proposed that in such cases there is no need for pre-trade transparency. In order to qualify for the exemption there are some additional requirements, for example that it is made within the current spread and it meets other conditions imposed by the market for such trades. Third exemption is provided for "crossing systems", where the price on a market is not based on the interaction of buy and sell orders in that market, but as a reference to a price generated by a different trading mechanism.

Post-trade transparency

On post-trade the Directive requires that information for all transactions in shares should be made public as close to real time as possible. The information should include for all trade identification of the share, time of the trade, volume and price. Regarding trades outside regulated market or MTF CESR has noticed that it is not always practically possible to publish the trade in real time and therefore it has been proposed that the publication should happen within three minutes. In cases where the transaction is subject to other conditions that the current market price of the share, the publication is required only when the transaction entails significant price information for the markets.

Treatment of large trades

The Directive recognises that both for pre-trade and for post-trade there is a need for separate treatment of large trades (trades large in scale compared to normal market size, block trades). For pre-trade it is possible to execute the without the basic transparency and regarding post-trade they may be published with delay.

CESR has proposed a regime how to determine the eligible thresholds in its consultation paper. The structure of the proposal contains considerably smaller thresholds for pre-trade than for post-trade. For post-trade the length of the delay is relative to the size of the trade. Additionally in both cases, more demanding requirements are set for shares with more liquidity than for those with less liquidity.

- *Do you think that the level of "basic trade transparency" is appropriate?*
- *How about the proposed exemptions?*
- *What are your concrete proposals?*

2.3. Regulation of systematic internalisation

While the post-trade transparency requirements covered all trading be it on the market or off-market, the pre-trade transparency requirements cover trading outside regulated market of MTF only when it is practised as systematic internalisation. That covers investment firms dealing on own account by executing client orders on an organised, frequent and systematic basis outside RM or MTF.

If a firm meets that requirement it shall publish a firm bid and/or offer for such share for which there is a liquid market. Additionally the Directive (in Article 27) sets some additional requirements on that activity.

CESR should propose implementing measures on several areas around systematic internalisation.

Regarding the definition of which firms should be regarded as systematic internalises, CESR proposes some indicative factors which would be taken on board when considering the matter. First set of requirements relate to the organisational factors of the firm. It shall use a separate business model for its internalisation business or have non-discriminatory rules, procedures or practices governing the internalisation business and have assigned specific personnel and(or automated technical system for the internalisation activity and the activity is marketed and made available for clients on a continuous basis.

Second set of requirements relate to the frequency of the activity. If a firm in internalising more that 20 % of its executed client orders or if its internalisation activity has "a market share" which is bigger that 0,5 % of the total trading in that share (in the most liquid market), it should be regarded as an indication of being a systematic internaliser.

Regarding liquid shares, CESR is proposing to measure the free float of the company, the average number of trades per trading day and the average value of daily trading. As a starting point it is considered that the free float should be more than 1 billion euro. For the second facto member states may choose which criteria to use. The applicable thresholds would be 500 as an average daily trades and 2 million euro for average daily turnover.

Additionally there are proposal on handling the client orders, updating the quotes etc.

- *Do you consider the proposal for systematic internalisation appropriate?*
- *What are your concrete proposals?*