Date: 29 July 2010
Ref. CESR/10-860

CESR's Responses to Questions 15-18 and 20-25 of the European Commission Request for Additional Information in Relation to the Review of MiFID

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Conduct of business rules

CESR considers that the European Commission (EC) questions 15 to 25 raise some more general issues that CESR develops below. These issues concern the way some existing MiFID conduct of business rules are applied by investment firms, as well as problems related to client protection with which CESR members were confronted during the financial crisis.

1) Clarification of some definitions and scope

CESR believes that it is necessary to ensure that the scope of MiFID is as clear as possible. Clarity facilitates compliance and also means that competent authorities can take effective action to protect investors.

CESR believes that there is a degree of ambiguity about the way in which MiFID applies to some aspects of the issuing of securities. Underwriting and placing are performed on behalf of the issuer or owner of the relevant financial instruments. However the issuance or placing of securities involves the sale of financial instruments to investors. In some cases it is very clear that the sale of the financial instruments involves the reception and transmission of orders or the execution of client orders by an intermediary. If an investor subscribes to an issue of new securities through an intermediary who is not acting on behalf of the issuer then that intermediary is clearly receiving and transmitting or executing an order on behalf of a client. However, the directive does not explicitly mention whether or not an investment firm acting on behalf of an issuer can as part of the same transaction be acting on behalf of the investor as well.

It cannot have been the intention of European legislators to leave investors unprotected in circumstances where they would have a reasonable expectation that an investment firm is acting on their behalf. Therefore, CESR believes it would be helpful to clarify this as well as the situation when an investment firm or credit institution issues its own securities.

The issue of a credit institution issuing its own securities was raised in a question to the Commission's Q&A database on MiFID. The question asked and the response given was as follows:

Question: *Are the "know your client" requirements applicable to the credit institutions (banks) in those cases where they issue their own securities for primary trading (bearing in mind the fact that such MiFID rules are not applicable to the regular issuers)?*

Answer: *Public offering is not a MiFID service or activity in itself; the regulatory obligations in respect of public offerings are primarily addressed in the Prospectus Directive 2003/71/EC and these obligations apply to any issuer (subject to certain exceptions), regardless of whether it is a credit institution or another corporate entity.*

Conduct of business obligations apply when a MiFID service is provided in the subsequent sale and distribution of such issued securities to clients. The nature of the obligations will depend on the type of the client to whom the service is provided. This would include providing appropriate risk warnings and product information, performing a suitability or an appropriateness test if required (including relevant "know your client" requirements) and going through the client classification process.

For example, a credit institution issues shares and distributes them to its clients through its branch network. When a client visits the branch the computer of the branch sales person reminds the sales person to engage in a conversation with the client to see if the client would be interested in subscribing to the new shares issued by the credit institution. The sales person effectively takes the initiative in recommending the investment to the client, who accepts the investment.

In this case, MiFID does not apply to the public offering of shares by the credit institution, which is governed by the Prospectus Directive. However, MiFID does apply to the sale of a financial instrument

–an advised sale of own shares in the above scenario. The 'know your client' requirements will therefore apply to the advised sale and the credit institution will need to perform a suitability test on its client.

CESR believes that it is necessary to consider revisiting MiFID to see if greater clarity can be provided in this area. Such work could look at the treatment of clients entering into transactions (advised or not) with an investment firm or credit institution in relation to the firm's own securities and securities of other issuers, including where these are part of a public offer of securities.

CESR also believes it is necessary to amend the technical wording of MiFID in other areas in order to clarify the scope of the directive. In particular, the review should clarify the treatment of the common situation where an investment firm is simultaneously both dealing on own account and providing an investment service to a client. This will require an examination of several provisions that use the word "order": for example, in the best execution regime and in the client reporting requirements (investment firms must report transactions to clients when they have "carried out an order" according to Article 40 of the Level 2 Directive), since such terminology appears inappropriate outside traditional broker markets and may be wrongly understood as ruling out the application of these provisions to dealer markets in all cases.

2) The execution-only regime

Article 19(6) of the MiFID Level 1 Directive provides that under the execution-only regime the investment firm should comply with its obligations under Article 18. This provision can cause confusion if it is wrongly interpreted as the only conduct of business rule firms need to comply with under the execution-only regime. CESR considers that it should be made clearer that, even under the execution-only regime, firms must comply with all the applicable conduct of business rules (such as, for example, the obligation under Article 19(1) to act honestly, fairly and professionally in accordance with the best interests of its clients) and the Article 19(3) obligation to provide appropriate information to clients to help them take investment decisions on an informed basis).

Furthermore CESR is of the opinion that the condition of Article 19(6), according to which the service is to be provided at the initiative of the client, should be clarified further (recital 30 of MiFID provides some guidance on the phrase) in order to enhance the protection of the client. Some CESR members were, for example, confronted with the practice that clients who used to be in an advice relationship, and therefore should be treated under the suitability regime, were asked by some firms to execute their transactions under the execution-only regime when the intended transactions were not considered to be suitable for those clients.

3) Disclosure measures for OTC derivatives and other complex or tailor-made products

Recital 44 of the MiFID Level 2 Directive refers to the right of a professional client to ask for information from investment firms and the obligation on investment firms to respond to reasonable and proportional requests for information. As a result of the financial crisis, CESR believes that there is a case for strengthening investors' right to request information for professional and retail clients who trade OTC derivatives and other complex or tailor-made products, although on an appropriately calibrated basis. CESR thinks that it is worth exploring strengthening the right of retail and professional clients to request information in the following two areas:

- First, prior to the transaction, a risk/gain profile in different market conditions.
- Second, independent quarterly valuations of such complex products. A right of this sort would require a definition of the meaning of "independence" for valuation purposes.

As part of considering these proposals it would obviously be necessary to assess the potential costs for investment firms, particularly in relation to the proposal for independent valuations.

4) Specific organisational requirements related to the launch of new services or products

Many of the recent incidents detrimental to investors resulted from the inappropriate design of new products, the existence of distribution and sales policies that are not compliant with Articles 18 or 19 of the Level 1 Directive or the lack of adequate controls around product development.

MiFID requires investment firms to have "adequate policies and procedures" designed to detect and minimise any risk of non-compliance with the obligations set forth by MiFID, but this appears to be too high-level. Although many firms have such controls already, it appears necessary to strengthen compliance controls around new products (new for the market or for the individual firm). Some CESR members have already, or are in the process of, highlighting the importance of such controls and detailing the types of systems and controls firms should set up.

Accordingly, CESR believes that under MiFID investment firms should be required to have specific organisational requirements to ensure that for new products and services offered to retail and professional clients (and variations to existing products and services):

- as part of acting in the best interests of the client under Article 19(1) of MiFID that an assessment is made of the compatibility of the product or service with the characteristics and needs of the clients to whom these products will be offered;

- the compliance function, in discharging its responsibilities under Article 6 of the MiFID Level 2 Directive, has the responsibility for ensuring that procedures and measures are in place to ensure the product or service complies with all applicable rules including those relating to disclosure, suitability/appropriateness, proper management of conflicts of interest and inducements;

- that under Article 7 of the MiFID Level 2 Directive, an investment firm has policies and procedures in place to ensure that the risks to the firm of new products and services are adequately managed in the light of the level of risk tolerance that the investment firm has set;

- where appropriate, products and services are stress tested to identify how they might perform in a range of market environments and how clients could be affected;

- investment firms review periodically the distribution and performance of products and services to ensure that what is occurring in practice corresponds to what was originally envisaged in terms of the performance or the product or service and its distribution; and

- information about products and services should be inside of the scope of the compliance reports to senior management required under Article 9(2) of the MiFID Level 2 Directive.

As per the second paragraph of Article 6 of the MiFID Level 2 Directive, these organisational requirements would obviously have to:

"… take into account the nature, scale and complexity of the business of the firm, and the nature and range of investment services and activities undertaken in the course of that business."

Part of the nature of the business that would need to be taken into account would be whether an investment firm is a 'product provider' or 'distributor'. For example, a requirement such as stress testing the characteristics of a product sits more naturally with a product provider than a distributor, although the distributor will need to know about the characteristics of the product. Regarding conflicts of interest, it is indeed important that the corporate compensation mechanisms are built on criteria that do not conflict with the best interests of the customer. Specific focus should be placed on the remuneration of 'relevant persons' (as defined in Article 2(3) of the MiFID Level 2 Directive) in relation to the various types of products offered in order to limit the risk that those products offering the best remuneration to the firm's relevant persons are pushed in front of other (less lucrative) products that would be more in line with the best interests of customers.

Such a reform would of course help to protect both retail and professional clients. In order to improve efficiency of external control, CESR believes that periodic reports to the firm's senior management, and to regulators on request, should be made by investment firms regarding their new products and financial innovation, presenting their added value for clients and the type of clients for whom those products are suitable.

General assessment

Complex/non-complex financial instruments and appropriateness test.

Q15: In the feedback statement to the CESR consultation paper "MiFID complex and non-complex financial instruments for the purposes of the Directive's appropriateness requirements", CESR raised some concerns about the classification of UCITS, which are always classified as non-complex instruments under Article 19(6) of MiFID and referred to the European Commission initiative on this topic. In addition to the work already carried out, please consider technical criteria to possibly distinguish UCITS between complex and non complex financial instruments for the purposes of the execution-only regime.

In CESR's Feedback Statement[1] on the MiFID complex and non-complex financial instruments, CESR recalled that Article 19(6) treats all UCITS as automatically non-complex and raised the question as to whether this remains a correct approach. As CESR reported in its Feedback Statement, responses to the consultation on this point were sharply divided. Some respondents felt that the treatment of the UCITS category for the purposes of the appropriateness requirements could better reflect the nature of the underlying investments, while a majority of respondents felt that (given the agreed EU UCITS regime) all UCITS should continue to be treated as automatically non-complex for the purposes of the appropriateness requirements. This majority view was also again expressed in responses to CESR's consultation on draft technical advice to the Commission in the context of the MiFID Review (CESR 10-417).

CESR recognises that making any definitive proposals on the UCITS category at present is difficult. Any definitive proposal raises wider issues about the established and agreed EEA UCITS regime (which regulators deem suitable and which is a powerful global brand) that are outside the scope of CESR's current exercise. However, CESR believes that there is a case for considering treating structured UCITS and UCITS which employ complex portfolio management techniques as complex financial instruments for the purposes of the appropriateness test (this is a concept that would need to be elaborated possibly through binding technical standards).

The Commission should be aware that there are several practical issues that would flow from considering some UCITS funds as complex financial instruments which would also need to be considered:

– first, whether it would be left to investment firms distributing UCITS to determine whether any individual fund was complex or non-complex or whether fund operators should be required to provide such information to distributors;

– second, how information about the classification of a UCITS as complex or non-complex financial instrument would be communicated to clients, particularly given that the nature of the UCITS may change over its lifetime, and how the way that classification relates to the Synthetic Risk Reward Indicator in the Key Investor Information document would be explained to clients (because complexity and risk may differ);

[1] CESR/09-558.

– third, whether non-UCITS collective investment schemes (and other substitutable products if the scope of the appropriateness test were to be extended through the PRIPS initiative) would be treated consistently with UCITS in determining whether or not they are complex financial instruments; and

– fourth, whether the appropriateness test should be applied to direct sales by UCITS management companies to prevent an unlevel playing field between direct and intermediated sales of UCITS.

Q16: Please assess possible additional criteria to further refine the scope of financial instruments under Article 19(6) MiFID, such as:

Q16(a): Extending the element of the admission to trading on regulated markets - currently only required in the case of shares - to other financial instruments,

Q16 (b): Taking into account the element of the risk of the financial instruments (e.g. high quality rating of the financial instruments involved).

See CESR's technical advice on the MiFID review.

Q17: Please assess the possibility, in addition to or as an alternative to the assessment under Q16, to require a general consideration of the ability of the client to understand the implications of execution-only services in terms of reduction of applicable protections.

Regarding the execution-only regime, CESR considers that it is unclear whether an additional requirement (beyond what MiFID already requires) for firms to undertake a general assessment of the client's ability to understand the implications of execution-only services - in terms of reduction of the client's applicable protections - would provide additional benefits to the client. In particular, the difference in outcomes between such an assessment and the appropriateness test is considered to be unclear; as both requirements may relate to the same criteria - knowledge and experience of the client. If the intention of proposing the new requirement is to avoid firm's mis-selling execution-only services to retail clients, any new requirement should (as now) focus on the types of financial instruments that can be bought under the execution-only regime and the other eligibility conditions (such as the "initiative" test) rather than on a further ex ante assessment.

Inducements requirements

Q18: In a 'Level 3' context, CESR already focused on inducements in 2007[2] and in 2009[3] and is currently finalising a report on good and poor practices. The different aspects of Article 26 of the Implementing Directive have been considered, such as the different categories of inducements, the conditions provided in order to allow firms to provide or receive commissions and other benefits (e.g. the requirement to disclose certain inducements or the design to enhance the quality of the service to clients and the ability not to impair compliance with duty to act in the best interest of the client), and the classification of "proper fees" (Article 26(c)).

We ask CESR to share its supervisory experience and to consider whether, in the different national contexts, the existing regime is able to deliver an appropriate level of investor protection or whether further action may be needed. This may include focusing on the following areas: 1) classification of different categories of inducements; 2) disclosure regime under Article 26(b)(i); 3) conditions under Article 26(b)(ii).

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[2] CESR/07-228b.

[3] CESR/09-958.

The CESR report on good and poor practices regarding inducements[4] (and the associated feedback statement) summarises CESR's findings and reactions concerning the application of the MiFID inducements rules in the EEA. As a CESR document, this report reflects the views of the various European supervisors.

Further to that report the following points can be highlighted:

- the vast majority of investment firms seem to understand correctly the **classification** regime under the MiFID inducements rules;
- there are differences between investment firms regarding the level of **disclosure** (which can hinder access to and comparability of information). Moreover, the MiFID inducements rules do not deal properly with the (frequent) situation where it is, in practice, impossible to disclose inducements in advance;
- several firms seem to have difficulties understanding or applying properly the "**enhancement condition"** under Article 26(b)(ii).

Those points are developed below, together with CESR's concerns about them as well as CESR members' experience.

Classification regime

The classification issue seems to concern mainly the way firms comply with the MiFID and is therefore probably better dealt with through Level 3 work. By providing guidance, the CESR report on good and poor practices regarding inducements should be helpful. Level 3 work also offers the necessary flexibility to handle the great diversity of situations that can be encountered regarding that issue.

Disclosures

CESR and its members have noticed that the disclosure requirements - especially those in relation to inducements made or received in connection with the distribution of financial instruments[5] - are not applied uniformly, which raises investor protection issues.

More especially, three types of problems have been identified:

- the content of the disclosures to be provided to clients varies considerably from firm to firm, limiting the ability of the client to use that information in making decisions about particular firms and services, and there is uncertainty concerning the distinction between a summary and full disclosure;
- MiFID does not foresee any ex-post reporting while it appears that - in practice - it is not always possible to disclose a priori the exact amount of inducements (in many cases, firms may only be able to disclose ex ante the method of calculating inducements using bands);
- investment firms have considerable discretion as to how they make disclosures about inducements and as a result these disclosures are not necessarily well integrated with other product or service specific information.

CESR has expressed its view regarding the content of the disclosures in its report on good and poor practices concerning inducements (CESR/09-958 - see paragraphs 95 to 97, as well as paragraphs 113 and 114).

As stated in CESR's report on good and poor practices regarding inducements (see paragraphs 89 to 91), supervisors have also observed that most investment firms disclose third party payments made or received in a summary form.

[4] CESR/09-958.

[5] The distribution of financial instruments is indeed the area that impacts the most retail clients and where the most problems have been identified.

The combination of incomplete disclosures (as a consequence of varying interpretations of the disclosure requirements) with the widespread use of summary disclosures can create problematic situations. For example, summary disclosures are generally provided at the beginning of the client relationship. When investment advice is provided at a later point and the client does not request additional information concerning the inducements according to Article 26 MiFID Level 2 Directive, the client may be uncertain about the precise amount of inducements the firm will receive for the financial instrument that has been recommended to him.

Concerning the reporting requirements, firms cannot always disclose a priori the exact amount of inducements (or provide a priori detailed information about that amount) but only provide, by using bands, the method of calculating such an amount. Some firms disclose, on a voluntary basis, the exact amount ex-post. CESR regards this as a good practice, as this enhances the quality of the information received by the client and thus investor protection.

Furthermore, CESR's work also illustrates the difficulty in distinguishing between summary and detailed disclosure, the content of both being, in fact, quite similar.

Also, where payments from third parties are linked to specific products it would help if the relevant disclosure about the payments under the inducement rules were to be linked to other information about the product.

Finally, three further remarks can be made:

– One CESR member (BaFin) has found that in practice - due to the difficulty firms have in implementing the "enhancement condition" - the disclosure requirements appear to be a more effective tool in combating conflicts of interests arising from payments received from product providers than the "enhancement condition" (this highlights - if needed - the importance of disclosures but does not mean however that the "enhancement condition" is useless).

– In one Member State (France), a study conducted on financial products offering special tax benefits highlighted that inducements may not be transparent enough for investors and that fees may be significantly increased by the high level of commissions given to distributors, who do not always provide a level of advice proportionate to the amount of the fees received.

– Another Member State (UK), has developed rules which would allow investment firms providing investment advice to continue to be paid by a rebate from the commission the client pays to a product provider but prevent the product provider from setting the amount of the rebate (which would have to be agreed between the client and the adviser).

"Enhancement condition" and ""best interests of the client condition"

CESR is of the opinion that the "enhancement condition" is an important question. CESR has however observed that the "enhancement condition" appears to be difficult to handle and assess. It requires a subjective assessment, and has thus been interpreted differently by firms, sometimes creating an unlevel playing field. Accordingly, it has appeared that external auditors charged with assessing compliance with code of conduct requirements had difficulties in reviewing firms on their compliance with the inducement regulation and more especially the "enhancement condition". The difficulties often concern the question as to which measures are deemed to enhance the quality of services provided to clients.

The difficulty in applying the "enhancement condition" is also linked to the different distribution systems and market structures in the EEA Member States.

Recital 39 of the MiFID Level 2 Directive seems to provide wide protection for investment advisers when receiving payments from product providers.

The fact that some firms tend not to understand properly the distinction between the "enhancement condition" and the "best interests of the client condition" also contributes to the difficulties surrounding the application of those conditions.

The rule does not seem to take into account the differences that may exist - regarding conflicts of interest and their intensity - depending on the type of service provided.[6] This is particularly true regarding portfolio management and investment advice services, where there is a higher risk of conflicts of interest, due to the fiduciary duty the firm owes to its client (when providing such services, an investment firm is acting in the exclusive interest of its client).

This risk is highest when the firm provides portfolio management due to the fact that the portfolio manager may take a decision for the client without prior consent from the client. It is thus hard to imagine how a firm providing a portfolio management service, for example, can receive inducements from a third party without impairing its duty to act in the exclusive interest of its client.

Here, it is worth considering:
- How the MiFID inducements requirements work in relation to the distribution of financial instruments through portfolio management or investment advice services?
- How conflicts of interest can be dealt with (and can they be dealt with) in such situations?
- How to minimise the product provider influence when it pays inducements to the distributor?

During its recent survey, CESR has observed that few firms have been able to demonstrate appropriately that making or receiving inducements when providing portfolio management services or investment advice services is designed to enhance the quality of the service provided to the client.

In its 2007 paper on inducements (CESR/07-228b), CESR had highlighted that "*the receipt of commission in addition to the management fees received for the service of portfolio management is clearly of a nature that could impair the firm's duty to act in the best interests of its client*". Therefore it has been highlighted that, outside the option to repay to clients any commissions received, "*it would be difficult for portfolio managers to meet the … conditions within Article 26*" (example V).

Taking into account those elements, the CESR members wonder if this does not raise the issue of whether inducements should not be forbidden when portfolio management services are being provided. Possible drawbacks of a ban could be that it might favour group products over third-party products, lead to hard selling and higher turnover of client portfolios.

Tied agents

Q20: Please share your experience regarding any widespread supervisory problems involving tied agents notably concerning any organisational or conduct of business matters related to tied agents and to firms appointing tied agents.

As stated in Part 5 of CESR's technical advice for the MiFID review on investor protection and intermediaries issues, CESR considers that the regime governing investment firms' use of tied agents has worked well since the implementation of MiFID. In particular, CESR does not believe that there is a need to change the rules governing tied agents' supervision and investment firms' oversight of their tied agents. However, this does not rule out the possibility of future work at Level 3 to provide guidance on how investment firms oversee tied agents through effective internal controls and other arrangements.

Underwriting

Q21: Corporate finance business is covered in MiFID under different investment and ancillary services: underwriting and placing, advice to undertakings, including services

[6] Each service does not give rise to the same type of conflict of interest and the intensity of the conflict may vary depending on the service provided.

relating to mergers, services related to underwriting (Annex I, Section A(6) and (7) – Section B(3) and (6)). Investment firms providing the investment services of underwriting and placing should be authorised and are subject to the MiFID requirements. However, further aspects concerning these services are not regulated under the Directive. This includes the relationship between intermediaries and issuers, the process of issuing and allocating the financial instruments, the organisation of underwriting syndicates, the pricing of financial instruments.
Please provide a general description concerning the following aspects:

Q21(a): The process followed by investment firms and credit institutions in providing the services of underwriting and placing in equity and bond markets;

Q21(b): Your experience in supervising entities providing the above mentioned services;

Q21(c): Concrete cases which, over the last years, may have attracted substantial level of criticisms from investors, issuers or intermediaries.

Below are some notes offering descriptions and observations on underwriting and placing.

The underwriting and placing process – some examples.

There is no one single process followed by investment firms and credit institutions in providing the services of underwriting and placing in equity and bond markets across Europe. Processes depend on the instrument involved, the issuer and the *mores* and rules of the local market. Below are descriptions of the process of equity rights issues in the UK and Eurobond debt issues. These are intended to give a flavour of the sorts of processes involved in underwriting and placing, but are obviously far from exhaustive and are not intended to be a model description of how these processes should work.

Underwriting rights issues in the UK. Depending on the funding requirement, multiple underwriters may be engaged. For example, the £13.5 billion Lloyds Banking Group plc rights issue in November 2009 had a total of 21 banks involved, two of them acting as global coordinators (or lead underwriters).

The following steps are involved in a typical capital raising by way of a rights issue (the preferred equity capital raising method in the UK):

- A company will identify the need to raise additional capital (this may be for a new acquisition, to repay debt, alleviate pressure on key financial ratios, offset portfolio losses, etc) and together with corporate finance advisers will decide on how much is required and the type of funding (debt or equity).

- Then the choice of mechanism will be decided (e.g. rights issue, open offer, or "placing").

- Then a lead underwriter(s) is selected and discussions on the precise structure of the issue (issue price, timing) and the detailed work on pulling together financial statements, the prospectus and investor communications begins. This will involve working with law firms, accounting, and investor relations professionals.

- In the lead up to the announcement of the capital raising (usually a few days, but perhaps up to a week, before launch of the issue), the lead underwriters will usually undertake "pre-marketing" activities.

- On launch, the lead underwriters will be at risk for the entire issue until they are able to secure sub-underwriting commitments from institutional investors. Usually the commitments are secured within a few hours after launch.

- Following the close of the issue, any rights not taken up will be placed with sub-underwriters or sold in the market. This is managed by the lead underwriters.

The whole exercise described above will take a minimum of two months and could stretch to six months or more. During this period, the market is constantly moving which makes the whole process very challenging.

The structure and quantum of the capital raising are decided at the very start of the process and, after that planning stage, are generally not open for negotiation – they are decided according to the needs of the company and investor appetite. After this the negotiations will focus on the pricing of the issue. The use of independent financial advisers, other than the issuer's existing corporate broker, to advise on the funding decision is widespread but their involvement in the underwriting negotiations and offer process is limited.

The terms on which the underwriting is to be provided are set out in an underwriting agreement between the underwriter(s) and the issuer. They are generally drafted by the underwriter's legal advisers and follow a fairly standard form, but as with any commercial contract there is scope to alter the standard terms. Restrictions on hedging by underwriters and sub-underwriters (i.e. short selling) during the rights issue have become commonplace in underwriting agreements. Other areas where negotiations may focus are the warranties, indemnities and termination rights. Contractual agreements are also signed between the lead underwriters and any sub-underwriters. These usually mirror the obligations in the underwriting agreement.

There are four ways underwriters seek to reduce the underwriting exposure that arises on signing an underwriting agreement. All of these methods might be used to mitigate risk. These include: pricing at a deep discount; pre-marketing; securing sub-underwriters; and hedging trades. Pre-marketing involves making the major shareholders of the company insiders up to a week (or perhaps longer) before the public announcement of the capital raising in order to get strong indications of their appetite for the issue and their likely level of sub-underwriting participation. The number of insiders could therefore be relatively large but all such investors will have policies and procedures in place for handling inside information. The lead underwriter(s) use their sales people to syndicate the underwriting risk amongst a group of sub-underwriters. These may be other banks, institutional shareholders or even hedge funds. As sub-underwriting is a risk mitigation tool of the underwriter, it is up to them to determine how much of the issue to syndicate – the issuer does not normally get involved in this decision. Hedging trades usually take the form of market index put options where the issuer makes up less than 10% of the index.

Underwriters/advisors communicate regularly with the issuer and its board in the lead up to the launch of the capital raising to appraise them of market conditions and the likelihood of deal success. This communication becomes very frequent during the capital raising subscription period.

Underwriting in the Eurobond debt markets. In the Eurobond debt markets, underwriting normally takes place on a soft basis. An obligation only arises for the underwriters after a process of book building has been completed. Investment firms and credit institutions compete to win mandates from issuers. Their proposals will cover various aspects of the detail of the issue including the fees they expect to receive. Issuers will then select a few of the bidders to run the issue and the successful bidders then work as a single team in providing a service to the issuer. Communication with the issuer is on a joint basis and they are normally responsible for an equal share of the offer and they operate a single 'pot' order book for the issue rather than individual books.

The issuer negotiates the fees it will pay the bookrunners (each of whom may have suggested different fees in their bids). Fees will vary with market conditions, the creditworthiness of the issuer and the sort of instrument to be issued. This competitive bidding and negotiation over fees contrasts with the situation in the US where there is a schedule of fees for different types of issue.

The subsequent key steps in the process of the issue are then all subject to the approval of the issuer. This will include the information that will be given to investors about the issue, the approach to allocation that the intermediaries will take and the price of the transaction. Investors get equal access to information about the issue with relevant announcements being made through dealing screens.

As part of finalising the details of a transaction the bookrunners are likely to have 'pre-sounding' conversations with investors in order to get a sense of the likely appetite amongst investors for an issue. Such discussions will work from a common script. In certain cases this will involve wall-crossing a small number of investors to enable a more detailed conversation to be held about a prospective issue. Such wall-crossing conversations are more likely to happen where volatility in markets makes it more difficult to get a sense of likely investor appetite for an issue from more general conversations that do not require investors to be wall crossed.

The pricing of an issue is agreed with the issuer. Price normally mainly reflects market conditions at the point of the issue and the current price of comparable issues.

During pre-sounding or following the announcement of an offer but before the book opens investors may give the bookrunners indications of their likely appetite for the offer. These indications do not bind the investors and are not taken as firm orders by the bookrunners. Once the book opens the bids received are transparent to the issuer but not to investors. Books traditionally have been open for a period of up to two days but recent strengthened investor appetite and market volatility has frequently seen them open for only two hours. Authorisation is sought from the issuer to close the book.

Once the book has closed and the underwriter is on risk, then allocation takes place based on the parameters that have previously been indicated to the issuer. A broad range of criteria normally influence allocations. These will include a desire to balance long and short term investors, the degree of commitment that investors have shown to an issue or an issuer and judgements about the extent to which orders have been inflated. Issuers can, if they wish, go through the allocation line-by-line with the bookrunners before agreeing it.

Underwriting and placing – supervisory concerns
Competent authorities have long been concerned by potential problems connected to the offering of equity and debt securities. This is because of the potential conflicts of interest between:

- the investment firms and credit institutions undertaking the underwriting and placing and the issuer of the equity or debt;

- the investment firms and credit institutions undertaking the underwriting and placing and investors in the offering of equity or debt;

- the issuer of the equity or debt and the investors in the offering; and

- different investors in the offering.

The specific sorts of potential problems that competent authorities have sought to deal with have included:

- information being provided to investors about offerings on a selective basis and/or being not fair, clear and not misleading;

- inadequate controls over flows of information within investment firms and credit institutions between their corporate finance teams on the one hand and their teams responsible for proprietary trading and execution of orders and portfolio management on the other;

- allocations of securities in oversubscribed offers which have served the interests of the investment firm or credit institution rather than the issuer;

- when acting for investors the distribution of allocations received in an offering which have favoured the interests of some investors at the expense of others;

- pricing of offerings which have favoured institutional investors rather than issuers, or issuers rather than retail investors;

- exploitation of the relative ignorance of retail investors about pricing;

- failing to look after the best interests of retail clients when placing new issues of securities with retail investors; and

- poor record keeping.

General guidance on underwriting and placing

In 1999 CESR's predecessor organisation (FESCO) sought to address some of these issues through a paper on "Market Conduct Standards for Participants in an Offering".[7] This paper attempted to support the EU legislative framework that existed at the time (Public Offers Directive 89/298, Admission to Listing Directive 79/279, Investment Services Directive 93/22 and Insider Dealing Directive 89/592) which was quite high level. The standards FESCO produced covered: information disclosure to the market, information flow within organisations and trading issues.

CESR itself published guidance in 2002[8] on stabilisation and allotment. This was intended to serve as a baseline for further EU work in this area. The material on stabilisation was picked up in the subsequent EU regulation on stabilisation as part of the Market Abuse Directive. The material on allotment applied in distributions where there was a significant retail participation. It did not apply to exclusively wholesale distributions. The Prospectus Directive picked up part of the elements of the CESR standards on allotment.

The FESCO standards were published towards the height of the boom in technology, media and telecom stocks. This was a period when there was a high level of regulatory focus on issues of securities in both Europe and the US. In the light of abuses that the SEC discovered in the US, the FSA in the UK decided to clarify how its conduct of business rules applied to issues of securities. The guidance[9] issued in 2003 covered, amongst other things:

– the overriding responsibility of the firm to have in place systems and controls to ensure the duties owed to clients (both issuers and investors) were identified and discharged appropriately;

– ensuring that the corporate finance client receives unbiased advice on pricing which is not driven by the part of a firm acting on behalf of investors;

– agreeing objectives with issuers on allocations;

– ensuring allocation decisions were not influenced by other business the firm was conducting or hoped to conduct;

– reviewing how systems and controls worked on an issue after the event.

The International Capital Markets Association has a Handbook covering underwriting. This deals with issues relating to the underwriting of debt, equity and medium-term note issues. The provisions of the Handbook are not legally binding obligations but set out certain requirements that ICMA members believe should be adhered to in order for the underwriting process to run smoothly.

[7] http://www.cesr.eu/index.php?docid=320
[8] http://www.cesr.eu/index.php?docid=179
[9] See CP 205 http://www.fsa.gov.uk/Pages/Library/Policy/CP/2003/205.shtml

The provisions in the ICMA Handbook mainly deal with the relationship between the lead manager and other investment firms involved in the underwriting rather than the relationship between the lead manager and the issuer or between investors and investment firms. In relation to the underwriting of debt issues there are a couple of provisions dealing with the provision of information to investors. There is also one provision dealing with the "pre-sounding" of transactions which requires the firms involved in a new issue to collectively discuss the potential sensitivity of the information to be disclosed and the procedures for managing the disclosures.

Current regulatory framework

Much of what FESCO said remains of relevance today but obviously the regulatory framework has undergone a complete overhaul. The relevant Directives are now the Prospectus Directive 2003/71, the Consolidated Admissions and Reporting Directive 2001/34, the Markets in Financial Instruments Directive 2004/39 and the Market Abuse Directive 2003/6. This revision of the Directives has led to a more detailed regulatory framework which, amongst other things:

– has very specific information requirements for prospectuses when there is a public offering of securities;

– prohibits market manipulation;

– regulates the stabilisation of new issues of securities;

– sets specific rules dealing with conflicts of interests;

– regulates payments to third parties in connection to the provision of investment services;

– requires firms to have appropriate systems and controls including keeping proper records of their activities;

– obliges investment firms and credit institutions to act in the best interests of their clients; and

– requires information to clients to be fair, clear and not misleading.

This new framework does apply to the relationship between intermediaries and issuers, the process of issuing and allocating financial instruments, the organisation of underwriting syndicates, and the pricing of financial instruments. For example:

– intermediaries have to act in the best interests of the issuer and communicate with them in a way that is fair, clear and not misleading (even where the issuer is a professional client); and

– allocations and pricing are governed by conflicts of interest rules.

It is, however, true to say that the legal framework deals with these issues in a general rather than a specific way reflecting the principles-based nature of part of the regulatory framework. It is also the case that CESR has not updated the FESCO standards or its own 2002 standards in the light of the revision to the regulatory framework. There is therefore no pan-European guidance on the application of the current regulatory framework to the issuing of equity and debt. There is, however, a certain amount of guidance that has been issued by individual competent authorities.

Retail investor protections

Competent authorities in some Member States have paid particular attention to the dangers of detriment to retail clients when integrated intermediaries involved in underwriting and placing financial instruments also distribute products to retail clients.

In 2005 one CESR member issued guidance regarding the application of conduct of business rules to fixed income securities issued by financial institutions and marketed to retail clients. This guidance said:

1. Intermediaries shall establish internal procedures in order to verify that the financial conditions of the issue are market conditions, taking into account the differences that might arise due to volume, credit quality, time to expiration and liquidity. In order to ensure that it complies with this, the firm could:
   - Assign a percentage of the issue, higher than 10%, to institutional investors so that the financial terms of the issue are determined by the wholesale market.
   - Fix the financial terms of the issue according to at least two valuations provided by independent expert firms.
   - Produce a report where it is proved that the issuing price meets the market conditions.
   - Any other mechanism that ensures that the price of the issue is a market price.
2. The firm's structure shall ensure that conflicting areas within the organisation are separated, i.e., areas in charge of price fixing, prospectus preparation and sale to investors (trading desk, corporate finance, financial analysts and sales force).
3. The internal control procedures shall be approved by the Board of Directors or the body responsible for the compliance with the rules of conduct.

In 2009 this same Competent Authority published new criteria on the valuation reports produced by independent experts during the issue of fixed income securities. The reports aim at determining if the conditions of the issue marketed to retail clients are similar to issues marketed to the wholesale market. If no institutional tranche has been planned, the financial institution must provide reports from independent expert firms.

The issuer has to inform this Competent Authority about the selected experts and the reports have to be sent directly it and it may contact the expert firms for explanations.

The expert reports have to contain:

- Cash flows and conditions of the issue.
- Identification of any embedded derivatives.
- Description of the valuation methodology (hypothesis, parameters, yield curve used).
- Components and calculation of the "all in spread".

The reports shall deal with all possible inputs to ensure that the price is aligned with the market conditions, among others:

- Conditions of the recent issues in the same sector and with the same credit rating.
- Conditions of tranches with different seniority of similar issues.
- CDS spreads.
- Relevant data from the secondary markets.
- Recent valuations carried out for institutional investors.

The reports shall express whether the expert considers that the spread or price of the issue is in line with the current wholesale market conditions and with prices of comparable securities. The language should be simple and comprehensive.

If this Competent Authority considers that the issue conditions are clearly unfavourable compared with the wholesale market or comparable products it will ask the firm to include an express warning in the issue prospectus in order to alert the retail clients about the unfavourable conditions. This faculty has been used in certain issues in 2009 and 2010.

If this Competent Authority considers that the reports are biased or confusing for the investor, it may exclude them from the prospectus, insert a warning on the biases in the reports or require the issuer to select a different expert.

Another Competent Authority considers that intermediaries must adopt tools to calculate fair value based on widely recognised methodologies of common use on the market and proportionate to the complexity of the product. The process for determining pricing conditions must be structured in an objective way in order to steer personal discretion. Post-transaction, the intermediary's internal procedures must allow a simple, precise reconstruction of the operations, with particular regard to the conditions applied, benchmarks and mark ups adopted.

Eurobond market developments

2009 was a record year for corporate bond issuance in Europe. Corporate bond issuance was €250 billion, up from €130 billion the previous year. A wider range of companies sought to issue bonds and a wider range of investors sought to gain exposure to corporate bonds.

The frenetic rate of activity in the primary bond market brought a number of strains with it. The normally close relationship between investment firms underwriting issues and investors buying the issues was tested as the range of investors increased. This made it more difficult for the underwriters to judge levels of demand. It also meant that investors were disappointed more frequently with the allocations they received.

This is the background against which concerns have been expressed about the way corporate bond markets have operated. Concerns expressed include:

– *Inappropriate "pre-sounding" of deals*: "Pre-sounding" of deals involves contacting potential investors in an effort to assess the likely demand for a bond issue. It is an important part of the process of underwriting a bond issue. However, institutional investors have expressed concern that the "pre-sounding" conversations have included too much specific information which has then meant that they are constrained in their trading activities because they are in possession of inside information.
– *Inflating of orders*: It is said that some investors routinely overbid for new securities in order to ensure that they receive a good allocation if the issue is oversubscribed. This can help to give a misleading impression of the strength of demand for an issue and disadvantage investors who are required to limit their bids to the allocation they want to receive.
– *Over-marketing of issues*: Linked to the above some institutional investors have complained that some issues have been aggressively marketed by investment firms on the back of an inflated order book.
– *Shadow book-building*: This refers to a process of seeking indications of interest before an issue is announced. This has been associated with a shorter official book-building process which some investors have claimed has left them with insufficient time to properly evaluate a new issue.

The issues set out above all fall within the existing regulatory framework under MAD and MiFID. For example, firms are supposed to have proper controls on inside information and information to clients. But MAD and MiFID do not contain provisions spelling out the specific application of provisions in MAD and MiFID to underwriting and placing and CESR has issued no Level 3 guidance on the application of the new legislative framework in this area.

Equity underwriting fees

In 1997 the UK's Office of Fair Trading referred the market for the underwriting of shares to the Competition Commission to investigate. The Competition Commission concluded its investigation and issued a report in 1999.[10] The report stated that:

"We therefore conclude that the practice of using standard sub-underwriting fees operates against the public interest in that it results or may be expected to result in some issuing companies being charged higher fees than would otherwise be the case."

[10] http://www.competition-commission.org.uk/rep_pub/reports/1999/424under.htm

The Competition Commission decided that there should not be a requirement for sub-underwriting to be a tendering process but made some recommendations for greater transparency (including the production of a booklet on share issuance by the Bank of England[11]).

0n 10 June 2010 the UK's OFT announced that it was going to undertake a market study into equity underwriting and related services.[12]

Conclusion

Underwriting and placing raise a number of important issues about the application of the framework of EU securities legislation. Since the legislation that was brought in under the Financial Services Action Plan these issues have not been specifically addressed. Previous relevant CESR guidance has not been updated. CESR will look again at these issues in order to consider providing Level 3 guidance.

There might be a case for including some specific provisions in MiFID on underwriting and placing in the way that specific conflict of interest provisions are set out for investment research. However, at this point CESR does not have any specific recommendations to make for changes to MiFID.

Q22: The granting of credits or loans to clients in connection with the provision of investment services is currently classified as an ancillary service under MiFID (Annex I, section B(2) of MiFID). The provision of this service increases significantly the exposure of clients to risk. Please consider whether the granting of credits or loans is commonly associated to the provision of investment services and whether, based on supervisory experience, it may raise regulatory or supervisory concerns.

Please refer to CESR's Technical Advice (Ref. CESR/10-859) on complex/non-complex financial instruments (in Part 3 "Additional proposals") which deals with this matter.

Technical information

<u>**Services under Article 19**</u>

Q23: Please provide any available data about the following areas:
Q23(a): The break-down of retail client transactions involving (i) the provision of investment advice, (ii) services covered under Article 19(5) of MiFID and (iii) services only consisting of execution and/or reception and transmission of orders under Article 19(6),
Q23(b) In the case of the provision of services under Article 19(5) of MiFID:
- The frequency of clients' refusal to provide information regarding their knowledge and experience,
- The frequency of warnings to clients concerning the inappropriateness of proposed financial instruments.

<u>**Supervisory experience/observations:**</u>

No CESR member has yet collected comprehensive data on these points, though some are able to report their impressions and general assessment of the prevalence of advised and non-advised transactions in their markets.

Most reported that advised services remain more common than non-advised or execution-only.

One commented that the service of execution and/or reception and transmission of orders under MiFID Article 19(6) is in the main restricted to online brokerage activities. Another noted that it is aware that some clients have opened an account with a credit institution and may employ both

[11] http://www.bankofengland.co.uk/markets/gilts/shareissuing.pdf
[12] http://www.oft.gov.uk/news-and-updates/press/2010/61-10

investment advice given by the credit institution and execution-only services through the same account. (This very fact makes it difficult to gather any meaningful data in this area).

A further member commented that in its experience some firms were claiming to provide an execution-only service but in fact providing advice and recommendations without having obtained the necessary information for an advisory service. This member also reported that standardised warnings under the appropriateness test were possibly being used excessively for any clients with the slightest aversion to risk, and some firms have helped the client with answers to the appropriateness test questions.

One CESR member has carried out a review of how its firms have implemented the appropriateness requirements and published examples of specific responses and approaches to implementation it found, in order to share and promote good practices. This member's review identified what it saw as some evidence of potential benefits to vulnerable consumers as a result of the appropriateness test, especially in terms of helping to promote client awareness of risks associated with more complex products. These benefits resulted from a better highlighting and reinforced disclosure of relevant risks by means of questions asked of clients, warnings given and the encouragement firms give clients to access information the firms make available. Its review suggested that the questions that clients have to answer when taking the appropriateness test force clients to think more carefully than would otherwise be the case about the risks they face in relation to the products they are seeking to purchase, and whether buying such products without advice is wise. This member also found examples of where since the introduction of the appropriateness test there has been an increase in the take up of educational support offered by spread betting firms (seminars, on-line training etc), more use of accounts with stop losses and more clients being rejected. For example, one large firm said it had turned down 50% of prospective new clients under the pre-MiFID regime and this had risen to 75% under the appropriateness test.

Two members highlighted the point that it is important that a firm always makes a correct distinction between services provided at its initiative (were the firm is responsible for the choice of the instrument) and those bought at the initiative of the client. One of these regulators also highlighted the point that it is important to ensure that instruments held by a firm as a result of such different services are properly distinguished where the service requires this. One regulator had found instances of client portfolios which involve a mix of instruments, some bought following advice given by a firm and others bought at the initiative of the client.

One member identified some other situations it had found which it felt raised investor protection issues:

- Sometimes, when a transaction is unsuitable for a client, a firm might suggest to the client that the client transacts on a non-advised or execution-only basis. The regulator feels that firms should not be allowed to make such suggestions.
- Firms often forget that the general duty to act in the clients' best interests under Article 19(1) applies even when they provide execution-only services.

No member reported that clients were routinely refusing to provide the necessary information for an advisory service.

Q24: In the case of warnings concerning the inappropriateness of investments, please consider whether, based on supervisory experience, retail clients may better understand warnings mentioning the specific reasons why the transaction is not appropriate instead of receiving warnings in a standardised format.

Supervisory experience/observations:

One CESR member commented that it was not sure that a more detailed warning would help and that other means might better address any issues identified by the EC. That member as well as another one commented that since the firm is making warnings concerning the inappropriateness of investments on the basis of the client's knowledge and experience only (and not on the basis of, for example objectives or financial situation as for the suitability assessment), it may well be difficult to be more specific in terms of a set of reasons. The specific relevant risks of the particular type of financial instrument should have been set out for the client already, in accordance with the existing MiFID requirements for risk warnings. Furthermore, those CESR members have observed that many warnings are provided to clients as part of an on-line account opening or transaction process. With such channels, standardised warnings (if appropriately drafted) can be the most straightforward but still effective route.

Another member reported that, in its experience, clients in direct contact (phone or face to face) with an investment firm get an oral warning from the representative of the investment firm and a written warning as well. (Furthermore, as a different CESR member said under Q23, some firms now give clients fact sheets and essential basic information regarding complex financial instruments in the form of educational booklets, in order to help the client to improve his knowledge.)

Another member commented, however, that in its view clients do not usually pay much attention to standardised warnings and these warnings thus serve only to provide a defense for the investment firm in case of complaints or suits. Another member replied that they believe individualised warnings are just as likely to be dismissed by clients if provided via an on-line account, electronically or in writing.

Another member suggested that enhanced point-of-sale disclosure should be a focus of the MiFID review, in particular for risk warnings.

Suitability requirements

Q25: Please provide information on your experience in the application of the suitability requirements (Article 19(4) MiFID). Directive 2006/73/EC further specifies these requirements (so called suitability requirements – Articles 35 and 37 of Directive 2006/73/EC). For example:

Supervisory experience/observations:

Several CESR members explained that they have had suitability requirements - or similar requirements - for many years before the implementation of MiFID, and therefore the MiFID requirements have not created a significant change in their regulation of investment advice, even though the drafting of their rules has changed in order to transpose MiFID. However, feedback they have received in their post-implementation review indicated that firms found their reformulated MiFID-based rules to be more coherent and better articulated than the previous rules. Some of those members also commented that they had not identified significant quantifiable benefits for 'professional' clients as a result of the extension of detailed suitability requirements to cover this category of client. However, discussions with firms and their representatives suggested that firms may be applying a greater discipline in their processes for investment advice and portfolio management for professional clients, because of MiFID implementation in this area.

One member noted issues it had found with two firms that were not properly complying with the suitability test. For some members, MiFID required the authorisation and regulation of investment advice for the first time in its own right.

Q25 (a): How do you monitor that intermediaries are adequately organised (internal arrangements and procedures, internal controls) and comply with the suitability requirements?

The monitoring of an intermediary's internal arrangements, procedures and internal controls form an integral part of the day-to-day supervision of a firm by a CESR member. There is a range of techniques used by CESR members to supervise firms, this includes, for example: regular interaction between the supervisor and the firm; routine or ad hoc firm visits; analysis of the firm's management information; and thematic work. Other techniques include reviewing a pool of transcripts from client meetings to assess whether the advice provided was assessed as suitable for the client; and comparing information collected by the firm about its client to the written 'suitability reports' or other records of the recommendations and advice provided to the client to assess whether the recommendations/advice are suitable in the light of the client's objectives, needs and circumstances. Another supervisory tool is the performance of regular reviews – focused on the firms' adherence to code of conduct regulations – carried out by external auditors.

In jurisdictions where firms do not reach the CESR member's expectations or are in breach of the requirements, legal proceedings or other regulatory action may be brought against the firms.

Q25(b): Do you have evidence of any evolution of complaints for unsuitable advice before and after MiFID (provided that a suitability regime was applicable in the jurisdiction concerned)?

The majority of CESR members perform regular reviews of the complaints received by intermediaries; this includes complaints where the cause of complaint is in relation to the suitability of the advice provided by the firm. For some members, this complaints data existed before MiFID was implemented. That said, given the market conditions since the implementation of MiFID and the fact that for some CESR members differentiation is not made between MiFID and non-MiFID products and MiFID or non-MiFID firms in the complaints reporting, in some Member States it is difficult to identify trends which indicate any evolution of complaints for unsuitable advice before or after the implementation of MiFID.

Q25(c): Based on supervisory experience do you think that modifications are needed in the suitability requirements?

CESR members have recently considered whether the suitability requirements under MiFID required modification. However, it was felt that the current requirements were comprehensive, yet sufficiently flexible, to apply to different types of clients, instruments and advised services and therefore did not need modifying.

CESR members would suggest, however, clarifying in the Level 2 Directive that advice about hedging of risks is investment advice.

One member specifically commented that in its experience some clients are reluctant to give detailed information regarding their financial situation, but suggested some specific additions to make explicit some aspects of the information to be collected: that a client should be required to certify that he does not need access to the sums he intends to invest at all times and that he has other assets to cover his daily financial needs. This member also suggested that it become mandatory for a client to sign a document containing the information collected on him, to certify its accuracy and truth. Some members highlighted, on the contrary, that this may be counterproductive: the client investment profile is often attached to the document containing the information about the client. If the client signs that set of documents, the client may be regarded as taking over (from the investment firm) the responsibility of setting the correct profile. This would limit the firm's responsibility regarding the suitability test.