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Comments

of the Zentraler Kreditausschuss[1] on the Consultation Paper of the Committee of European Securities Regulators (CESR)

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

- Lending to Retail Clients
- Aspects of the Definition of Investment Advice and of the General Obligation to Act Fairly, Honestly and Professionally in the Best Interests of Clients
- Best Execution

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[1] The ZKA is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Bundesverband deutscher Banken (BdB), for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public-sector banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks financial group, and the Verband deutscher Hypothekenbanken (VdH), for the mortgage banks. Collectively, they represent more than 2,300 banks.

I. Introductory remarks

The consultation paper published by CESR on 3 March 2005 contains proposals on key issues of the MiFID. Substantial changes and additions were made compared to the first consultation paper, and these had to be evaluated within four weeks. Although this procedure complies with the letter of the consultation process, we would point out that many of the proposals are either new to the consultations (Chapter 1:"Lending to retail clients" and Chapter 3: "Best execution") or have been significantly expanded and changed compared to the previous draft (Chapter 4: "Market transparency"). It would thus have been helpful if CESR had sought greater input from market participants during the over five-month drafting phase. This would have made the process easier for all concerned and reduced the time pressure. In the short time available, it was not possible for market participants to make a definitive assessment of CESR's advice.

II. Executive summary

1. Neutrality regarding existing business models and market structures

There is a danger that CESR's advice will have a significant impact on existing business models, market structures and future innovations. Co-operation between investment firms is highly complex and affects not only the execution of orders, but also clearing, settlement, custody and other services. A single aspect such as best execution therefore cannot be considered in isolation.

2. False image of the customer

Some of CESR's advice is based not on the concept of a responsible and knowledgeable investor, but on the idea that the client needs protecting from himself. As a result, it threatens to interfere drastically in direct banking, for example, despite the fact that this business model is extremely popular among customers and has given no cause for complaint up to now.

- The tendency to blur Article 19's clear distinction between client relationships based on investment advice and those based on simply providing information is to be rejected. Otherwise, the differentiation at Level 1 reflected in the special rules (Article 19(4) to (6)) would be undermined. Furthermore, investment firms offering normal direct brokerage are not in a position to provide customer advice when extending credit.
- The information requirements discussed in the consultation paper would be extremely onerous to comply with and go far beyond what is needed to ensure an adequate level of investor protection. In particular, requiring the disclosure of percentage breakdowns of order flows would be excessive, in our view.

- If clients elect to issue specific instructions, this should not be penalised (mandatory warning, ban on solicitation); client instructions are deemed to have priority status by Level 1 and are standard practice in direct brokerage.

III. Specific comments on the advice in Chapters 1 to 3

Chapter 1: Lending to retail clients under Article 19(1)

Q 1:
Do you agree with the proposed advice in this area, including the proposed limitations on the scope of the obligation?

Q 2:
Do market participants consider that investment firms have to obtain the necessary information about the retail client's investment objectives in addition to his financial situation?

The ZKA totally rejects the idea of conducting a mandatory suitability test before extending credit to a customer in connection with an investment service. This would blur the fundamental distinction drawn at Level 1 of the MiFID between client relationships with advice and suitability tests and those without. Arguments against CESR's proposal are as follows:

- At Level 2, CESR cannot exceed the scope of Level 1. It is not legally possible to fall back on a general rule such as Article 19(1) if a situation is already covered by specific rules (Article 19(4) to (6)).
- Requiring "information-only" clients to undergo a mandatory suitability test would be massive state interference in the business models of direct banks, in particular. These banks' business models[2] are based on the very idea of not having to take a customer's individual circumstances into account.
- What is more, the exemptions (Box 1, no. 2) are inappropriately narrow. The examples describe cases in which the customer has failed to fulfil his contractual obligations. In these cases, there is no room for a suitability test at all. It is also totally unclear what a retrospective suitability test is intended to achieve.

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[2] The number of orders executed without advice via direct brokerage by a few big specialist direct banks alone totals around 25 million a year in Germany. This is without counting the orders executed by the large number of universal banks also offering investment services without advice (multi-channel banking).

Chapter 2: The definition of investment advice (Article 4(1)(4)) – generic and specific advice

Q 1:
Do you believe that investor protection considerations require the application of the above conduct of business requirements from the point at which generic advice is provided or do you believe that sufficient protection is provided in any event to allow the definition of investment advice to be limited to specific recommendations?

We do not consider it necessary to extend the rules to generic advice. Investment advice may be deemed to have been given if information has been provided about a specific investment, which has been professionally reviewed and evaluated with the investor's individual circumstances in mind. Broadening this definition could result in considerable legal uncertainty and make it difficult to differentiate advice from advertising or general information.

Q 2:
Do you believe that considerations relating to the scope of the passport and the scope of the authorisation requirements point towards the inclusion or exclusion of generic advice from the definition of investment advice?

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Chapter 3: Best execution (Articles 19(1) and 21)

Involvement of another investment firm
The examples of co-operation arrangements between investment firms shown in figures 1-4 on pages 16-17 are incomplete; they focus exclusively on the execution of orders and ignore other aspects such as clearing, settlement, custody and additional services. Yet it is co-operation across various areas, entered into on the basis of a conscious business-policy decision by the investment firm, which reduces the costs of performing investment services; this allows favourable pricing for the customer. The complexity of these arrangements means that it is not in the client's interests to select the intermediary for execution on a case-by-case basis.

The diversity of the complex relationships between investment firms is such that they cannot be squeezed into rigid supervisory formulae. This point is particularly important when it comes to monitoring a third party which has been involved. The centralisation of services and

the associated cost benefits should not be eroded by additional expenditure on monitoring the intermediary. In cases where the intermediary selects the venue, monitoring must therefore be confined to a review of the service provider's ongoing suitability. Paragraph 23 does not make this sufficiently clear, in our view.

Inclusion of portfolio management

There is no one-size-fits-all answer to the question of whether portfolio managers are also subject to best execution obligations. This will depend on how much, if any, discretion the portfolio manager retains. For example:

- If the client already has a securities account with a bank and the portfolio manager acts vis-à-vis the bank as the client's agent, he has no influence on which bank will execute the order.
- If, in this case, the portfolio manager issues an instruction regarding the execution venue, he must act in line with the best execution principle.
- If, on the other hand, he leaves it to the bank to select the venue on the basis of its own execution policy, he himself will have no best execution obligations.

Information requirements

The following points are key, in our view:

Information on the frequency of execution at individual venues/via individual intermediaries

We reject any requirement to disclose information on the percentage of orders executed at individual venues/via individual intermediaries. For reasons, please see our detailed reply to question 110.

Risk warning

We firmly oppose having to provide a risk warning if a client issues specific instructions. Level 1 deems a client instruction to have priority status. This fundamental decision must not be undermined at Level 2 by penalising client instructions. It is common practice in Germany to place orders over the internet[3]. The business models of the banks involved normally envisage that customers will decide for themselves where their orders should be placed and indicate their choice by clicking on the corresponding exchange. Prices on the various exchanges may be viewed in real time or with a slight delay to assist them in their decision. Requiring these banks to issue a warning would mean they would have to caution against using their own business model. This would constitute serious interference in their business operations and, given the fundamental nature of such a step, it would need to have been taken

[3] See footnote 2.

at Level 1 of the Lamfalussy process. What is more, it would be virtually impossible to explain to experienced clients that they have to be warned against their own decisions when making straightforward transactions.

The above reservations apply even more to the idea of preventing firms from soliciting client instructions. This would penalise the kind of business model outlined above, which, by its very nature, is normally based on the assumption that the client will issue specific instructions. Since it was decided at Level 1, after extensive discussion, that Article 21 should explicitly permit client instructions, this is unacceptable.

Existing clients

The rules on information requirements need to include an alternative arrangement for existing customers (35 million securities accounts in Germany alone). It would be excessive to require investment firms to provide such clients with information any time the execution policy changes as proposed in Box 4, no. 1. Instead, it should generally be possible to send this information once a year together with these clients' annual asset statements. We believe this proposal to be reasonable because the investment firm must in any event adjust its execution policy in good time, thus ensuring that the investor's interests regarding the execution of individual orders remain safeguarded.

Q 30:

a) *How do firms compare venues (or intermediaries) that offer inducements with those that do not?*
b) *Where the fees and commissions that firms pay to execution venues or intermediaries include payment for goods or services other than execution, please indicate the circumstances in which firms might determine how much of these commissions represents payment for goods or services other than execution? Under what circumstances do firms consider the entire commission as payment for execution?*

There is no one-size-fits-all answer to these questions. Inducements come in numerous different forms and, though a market reality that certainly cannot be ignored, they do not have the significance CESR appears to attribute to them. When discussing their importance for portfolio managers in paragraph 28, CESR points out quite rightly that inducements must be only a secondary consideration. This also applies to investment firms in general.

Selection of an execution venue

Q 56:

Please suggest situations and circumstances in which a firm might satisfy the requirements of Article 21 while using only one execution venue.

Depending on the circumstances involved, using a single execution venue or intermediary may be the only appropriate solution. This applies, in particular, if overall considerations going far beyond best execution argue in favour of directing orders to only one venue or intermediary. In the final analysis, the decisive factors will be aspects such as costs (e.g. additional technical interfaces to guarantee prompt transmission of the orders) and efficiency in the overall handling of the transaction (including clearing, settlement, custody and other services).

External and internal costs

Q 65 for consultation:

Do market participants consider that the distinction between internal and external costs is relevant? Does the investment firm have to take into account also internal costs? If so, which ones?

It is not totally clear from the question and the preceding explanatory text precisely what CESR understands by “internal costs”. If they are meant to refer exclusively to the expense of accessing and creating a technical interface to an execution venue (including the associated back office costs, cf. reply to question 56), they are of key importance to the investment firm when determining and updating its execution policy and execution arrangements. Investment firms therefore certainly have to take these into account when selecting or changing an execution venue. The same applies to the question of selecting or changing an intermediary.

If, on the other hand, CESR is referring to the commission investment firms charge their clients, this has no relevance to the selection of an execution venue. The level of the commission charged should be left to the forces of competition (cf. paragraph 62 of the consultation paper).

From the client’s perspective, it is the total costs that are relevant.

Frequency of venue assessments

Q 82:

How do you assure that your execution arrangements reflect current market developments? For example, if you do not use a particular execution intermediary or venue, how would you know whether they have started to offer "better execution" than the venues and intermediaries that you do use?

The question implies that investment firms have to keep up to date on all intermediaries and execution venues. It must be sufficient, however, for the investment firm to obtain their

information from generally accessible sources and sources made available to them by the execution venues and intermediaries. Any obligation to carry out investigations and research is to be rejected. This would be to ask the impossible and would certainly increase the costs of executing clients' orders considerably.

Data availability

Q 87:

Are intermediaries likely to inform investment firms that manage portfolios or receive and transmit orders about material changes to their business?

Yes.

Breakdown of order flows

Q 110:

a) *Please identify and estimate the specific costs that investment firms will incur to identify the execution venues and intermediaries that have executed or received and transmitted their client orders and to collect historical information about what portion of their client orders they directed to each such venue or intermediary. For example, what costs would be associated with determining what percentage of client orders an investment firm directed to each venue or intermediary it used in the last 12 months, based on both the number of trades and the value of trades?*
b) *Please explain what competitive disadvantage or other damage to their commercial interests firms would experience if they were to publish the percentage of their business that they direct to different execution venues and intermediaries.*

We firmly oppose having to disclose information on the percentage of orders directed to individual venues. Article 21 offers no basis for this whatsoever. Furthermore, we strongly caution against assuming that the information would be easily accessible. Although it is true that the raw data will generally exist, the programming required to process and evaluate it would be extremely time-consuming and costly. The precise costs can only be estimated and would vary from one investment firm to another depending on how much time and money it had to invest in new IT equipment. The total per firm would doubtless be close to 10 million euros, however. Such a requirement would be excessive. Furthermore, it might allow competitors access to sensitive information. Limiting the information to the venues *directly accessed* by the investment firm would make the figures meaningless.

It is, moreover, totally unclear what insight the disclosure of this information is intended to provide. In itself, a certain percentage offers no indication of whether the venue involved was

generally able to guarantee best execution or whether the orders directed there were executed in line with the investment firm's execution policy.

It must also be borne in mind that the data would refer to past transactions. Since information can only be requested at the beginning of the client relationship or in the event of material changes to the firm's execution policy (cf. Article 21 MiFID)[4], the customer would have to be given a combination of historic data and information relating to future policy. In an extreme case, this could even mean having to supply figures about a venue that was no longer part of the firm's execution policy. Such an approach lacks logic, also from the customer perspective, and is therefore to be totally rejected.

We also firmly reject providing a breakdown of orders routed to different intermediaries. These figures would also be misleading since they give no indication of the fact that one intermediary allows access to a number of execution venues.

c) *If firms are required only to make this information available upon request, would that address respondents' concerns about overwhelming clients with too much information?*

Even if the information was made available only on request, the administrative burden would be no less onerous.

d) *Please suggest approaches to focus this information. For example, should this information be disclosed for each execution venue, for different types of instrument, country-by-country, etc.? Should firms should break out this disclosure for different business lines (e.g. retail versus institutional). How?*

We oppose the disclosure requirement in any form.

e) *Should there be information for execution venues that investment firms access indirectly? And, if so, should it be on the main intermediaries to whom the firms usually entrust the execution of their orders?*

We oppose the disclosure requirement in any form.

f) *Please provide specific information about why, in less liquid markets, this sort of disclosure actually might be misleading. Is such disclosure about equity transactions more meaningful or useful than disclosure about transactions in other types of instruments?*

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[4] There is thus no legal basis for the periodic disclosure requirement considered at the hearing on 23 March 2005.

We do not understand the background to the question.

Error correction policy/error rates

Q 115:

With respect to the fourth disclosure suggested by respondents, CESR requests further comment on whether investment firms that execute client orders directly or indirectly should be required to disclose information about their error correction and order handling policies.

We do not understand the background to the question. If error correction policy is intended to mean the way an investment firm deals with orders that have been overlooked or incorrectly executed, we consider this a matter for civil law, not an issue to be discussed in the context of best execution. If, on the other hand, the intention is to require a review of whether each individual order was really executed in a way that delivered the best possible results for the client, this goes far beyond the scope of Article 21 and must therefore be rejected. Under Article 21(5) of the MiFID, an investment firm is merely required to demonstrate to a client on request that his orders have been executed in line with its execution policy.

Obtaining client consent

Q 126:

a) *How might an investment firm gain the necessary consents required under Article 21(3) of the Directive as part of a voice telephone communication?*
b) *What impact would there be on cross-border business and distance marketing if investment firms are not permitted to obtain the client consents required by Article 21 using voice telephone?*
c) *Can respondents suggest a different approach than the one used in paragraph 5 of the advice under Article 19(3) that would permit investment firms operating via voice telephone to satisfy the objectives of Article 21's consent requirements?*
d) *How might firms evidence that they had obtained client consent if they obtained that consent via voice telephone?*

Under Article 21(3) and 4, the client's consent to the execution policy needs to be obtained only at the beginning of the client relationship; if any subsequent changes are made to the policy, the client merely has to be notified. We therefore envisage no major problems for investment firms in this context.

Relative importance of the factors for retail clients

Q 129:

Should investment firms that do not consider speed to be an important factor in the execution of retail orders be required to highlight this judgement?

We do not entirely understand the reason for the question. We assume that investment firms will be obliged in any event to disclose the factors they consider when determining how they will execute orders. We see no reason for further regulation. Should CESR's intention here be indirectly to determine the relative importance of the factors, this would be in violation of Level 1. Article 21 of the MiFID leaves prioritisation up to the investment firms.