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CESR Consultation (*CESR/10-417*)

'Technical Advice to the European Commission in the Context of the MiFID Review – Investor Protection and Intermediaries'

A response by:
The British Bankers Association;
Association for Financial Markets in Europe; and
The Futures and Options Association

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Introduction:

The British Bankers Association (the 'BBA'), the Association for Financial Markets in Europe (AFME) and the Futures and Options Association (the 'FOA') welcome the opportunity to response to the Committee of European Securities Regulators (CESR) consultation on its "Technical Advice to the European Commission in the context of the MiFID Review – Investor Protection and Intermediaries (CESR/10-417)".

The British Bankers' Association is the leading association for UK banking and financial services sector, speaking for over 200 banking members from 50 countries on a full range of UK and international banking issues. All the major institutions in the UK are members of our Association as are the large international EU banks, the US banks operating in the UK, as well as financial entities from around the world. The integrated nature of banking means that our members engage in activities ranging widely across the financial spectrum encompassing services and products as diverse as primary and secondary securities trading, insurance, investment bank and wealth management as well as conventional forms of banking.

AFME, the Association for Financial Markets in Europe, promotes fair, orderly, and efficient European wholesale capital markets and provides leadership in advancing the interests of all market participants. AFME was formed on November 1st 2009 following the merger of LIBA (the London Investment Banking Association) and the European operation of SIFMA (the Securities Industry and Financial Markets Association). AFME represents a broad array of European and global participants in the wholesale financial markets, and its 197 members comprise all pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME provides members with an effective and influential voice through which to communicate the industry standpoint on issues affecting the international, European, and UK capital markets. AFME is the European regional member of the Global Financial Markets Association (GFMA). For more information, visit the AFME website, www.AFME.eu.

The Futures and Options Association is the industry association for some 170 international firms and institutions which engage in the carrying on of derivatives business, particularly in relation to exchange-traded transactions. The FOA's membership includes banks, brokerage houses and other financial institutions, commodity trade houses, power and energy companies, exchanges and clearing houses, as well as a number of firms and organisations supplying services into the futures and options sector. For further information please visit the FOA website, www.foa.co.uk.

Part 1 – Telephone Taping

Question 1: Do you agree with CESR that the EEA should have a recording requirement? If not, please explain your reasoning.

We support the implementation of an EEA recording requirement.

However, we consider CESR's proposal of a five year retention period of telephone records to be excessive. There are significant differences between telephone records and other electronic records. Electronic records are usually specific in what they require and follow a standard format. Telephone records by their very nature are far more wide ranging and contain much data that is not directly relevant to individual transactions.

Telephone records are generally most useful until the transaction in question is confirmed, settled or the first payments in a series have been made. At such time the documentation of the transaction should provide the basis on which issues, investigations and complaints are based.

Given the objectives in section 17 of the consultation paper we believe that a retention period set as a six month minimum would be a more suitable and cost effective requirement. Firms should be allowed to retain telephone records for longer than the minimum should they consider this necessary e.g. where the first payment for a product is more than six months in the future or an existing complaint to which the telephone records are relevant remains unresolved. Furthermore, supervisors would have the authority to request that firms retain specific records should they consider the records may be relevant to any on-going, or future investigations.

The costs of implementing a retention period of 5 years would far outweigh the benefits realised by Competent Authorities in terms of market abuse detection and resolution of client issues. Please refer to our comments under question 11.

Question 2: If the EEA is to have a recording requirement do you agree with CESR that it should be minimum harmonising? If not, please explain your reasoning.

We agree with a minimum harmonising approach to recording requirements.

Question 3: Do you agree that a recording requirement should apply to conversations and communications which involve:

- **the receipt of client orders;**
- **the transmission of orders to entities not subject to the MiFID recording requirement;**
- **the conclusion of a transaction when executing a client order;**
- **the conclusion of a transaction when dealing on own account?**

We agree with the above recording requirements. The recording process should help provide a complete and accurate audit trail concerning how a transaction is marketed, sold and executed.

Question 4: If you do not believe that a recording requirement should apply to any of these categories of conversation/communication please explain your reasoning.

No comment.

Question 5: Do you agree that firms should be restricted to engaging in conversations and communications that fall to be recorded on equipment provided to employees by the firm?

We agree that all business deemed as being in scope of the CESR proposal should be conducted via equipment provided by the employing firm. There may be extenuating circumstances in which a relevant call may be taken on a non-firm issued device and firms should be given suitable guidance on how to best manage such circumstances.

We do not support recording of calls or other electronic communications made or received on a device not issued by a firm (i.e. an employee's personal device).

Question 6: Do you agree that firms providing portfolio management services should be required to record their conversations/communications when passing orders to other entities for execution based on their decisions to deal for their clients? If not, please explain your reasoning.

We agree that these conversations should be recorded.

Question 7: Do you think that there should be an exemption from a recording requirement for:

- **firms with fewer than 5 employees and/or which receive orders of a total of €10 million or under per year; and**
- **all orders received by investment firms with a value of €10,000 or under.**

No. Given the stated objectives of the recording requirement in section 17 of the consultation paper we see no reason for any de minimis exemption and the requirements should apply to all Firms.

Question 8: Do you agree that records made under a recording requirement should be kept for at least 5 years? If not, please explain why and what retention period you think would be more appropriate.

No. We believe that there are significant differences between telephone records and other electronic records. Electronic records are usually specific in what they require and follow a standard format. Telephone records by their very nature are far more wide ranging and contain much data that is not directly relevant to individual transactions. The retention period for telephone records proposed is too long. The costs of implementing a retention period of 5 years would far outweigh the benefits realised by Competent Authorities in terms of market abuse detection and resolution of client issues. Please refer to our comments under question 11.

The searching of a large amount of data in any discovery process is a very expensive, time consuming and labour-intensive process. The data retention process should be managed in such a way as to minimise the retention of unnecessary data, and ultimately minimising the associated costs faced by the industry.

Telephone records are generally most useful until the transaction in question is confirmed, settled or the first payments in a series have been made. At such time the documentation of the transaction should provide the basis on which issues, investigations and complaints are based.

Given the objectives in section 17 of the consultation paper we believe that a retention period set as a six month minimum would be a more suitable and cost effective requirement. Firms should be allowed to retain telephone records for longer than the minimum should they consider this necessary e.g. where the first payment for a product is more than six months in the future or an existing complaint to which the telephone records are relevant remains unresolved. Furthermore, supervisors would have the authority to request that firms retain specific records, should they consider the records may be relevant to any on-going, or future investigation.

Question 9: Are there any elements of CESR's proposals which you believe require further clarification? If so, please specify which element requires further clarification and why.

There are no elements of CESR's proposal that we believe require further clarification.

Question 10: In your view, what are the benefits of a recording requirement?

When used as a tool for dispute resolution close to the time of the transaction telephone records are an effective tool to provide clarity and certainty and thereby help firms manage their operational and transactional risk.

Telephone records often reduce the scope for a prolonged dispute and speed the manage settlement and resolution process.

Question 11: In your view, what are the additional costs of the proposed minimum harmonising recording requirement (for fixed-line, mobile and electronic communications)? Please specify and where possible please provide quantitative estimates of one-off and ongoing costs.

CESR's proposal will prove very expensive to implement and maintain. A full cost-benefit analysis should be carried out before the proposals reach any further stage, so CESR is able to demonstrate and evidence how such a significant spend can be justified in terms of market abuse detection and client resolution process. We have given below some typical estimates of costs our members expect to incur should CESR push ahead with its proposals to record both landlines and mobiles (on the basis of both a 6 month and a 5 year retention period). When surveying these figures CESR should be clear that they relate to the average spend per firm, and will have to be multiplied many times over in order to represent the total cost across the industry.

Our members current systems do not have capacity to support a retention period of 5 years. Estimates from our membership have indicated that the total set-up and ongoing works required for a retention period of 6 months (for both mobile and landline records) will cost EUR 1,300,000. This rises incrementally to EUR 12,500,000 when looking at a 5 year retention period.

For landline calls only, the ongoing costs are estimated to increase incrementally from EUR 35,000 per month for 6 months' storage to EUR 150,000 per month after 5 years' storage.

For mobile phone recording, the ongoing costs are estimated to increase incrementally from EUR 133,000 per month for 6 months' storage to EUR 200,000 per month after 5 years' storage.

For mobile phone recording, the initial set-up costs are estimated at EUR 500,000.

What is clear from the figures above, is the huge impact an increase in the standard retention period from 6 months to 5 years will have on total costs.

Question 12: What impact does the length of the retention period have on costs? Please provide quantitative estimates where possible.

In addition to the costs estimated in our response to Question 11, there are other costs directly proportional to the length of any retention period.

Though not as easily quantifiable, searching, reviewing and compiling voice data when responding to a regulatory enquiry is a hugely time consuming and labour intensive process, involving personnel from various departments within an organisation. For UK firms who currently retain calls for 6 months, setting the retention period at 5 years would see the potential for regulators to request calls over a much longer period, resulting in the need for extra resources to facilitate this.

Part 2 – Execution Quality Data

Question 13: Do you agree that to enable firms to make effective decisions about venue selection it is necessary, as a minimum, to have available data about prices, costs, volumes, likelihood of execution and speed across all trading venues?

We would agree that in order to enable firms to make effective decisions about venue selection it is necessary to have available data regarding price, cost, volume and speed of execution. These are all elements which our members take into consideration when reaching best execution for their clients. We believe that suitable execution quality data is already made available to our members by execution venues.

Question 14: How frequently do investment firms need data on execution quality: monthly, quarterly, annually?

It would be artificial to suggest Investment firms require execution quality data on a monthly / quarterly / annual basis. Rather, they require access to detailed execution quality data on a more frequent basis, and see this as an ongoing process which is a great deal more granular than CESR's proposal.

Question 15: Do you believe that investment firms have adequate information on the basis of which to make decisions about venue selection for shares?

Please refer to our answer to question 18.

Question 16: Do you believe investment firms have adequate information on the basis of which to make decisions about venue selection for classes of financial instruments other than shares?

Please refer to our answer to question 18.

Question 17: Do you agree with CESR's proposal that execution venues should produce regular information on their performance against definitions of various aspects of execution quality in relation to shares? If not, then why not?

Please refer to our answer to question 18.

Question 18: Do you have any comments on the following specifics of CESR's proposal:

- **imposing the obligation to produce reports on regulated markets, MTFs and systematic internalisers;**
- **restricting the coverage of the obligation to liquid shares;**
- **the execution quality metrics;**
- **the requirement to produce the reports on a quarterly basis?**

We consider that investment firms have adequate information in terms of price, cost, volume and speed of execution so as to enable firms to make effective decisions about venue selection.

Any decision by CESR to compel execution venues to produce reports similar to the Rule 605 reports introduced in the United States would be not be appropriate. We do not believe there to be a market failure present and we do not consider that the proposed reports will have a critical influence on execution venue selection. We also consider that the Rule 605 reports as produced in the United States do not provide useful and meaningful comparative information to market participants, regulators or individual investors. Indeed, the Securities and Exchange Commission (the 'SEC') is currently consulting on whether these reports should be modified, or actually required at all.

The reports will not offer data pertaining to particular stocks, at particular points in time. Rather, they will present general-level information. Execution venue's commercial interests ensure there is sufficient information in circulation relating to their execution quality data. If execution venues do not present this information to the market in an easily accessible / understandable format their scope to attract new business will be limited.

Large scale institutions also make use of smart order routing systems to determine the most appropriate venue. These systems instantly search and send the client order to the venue best placed to meet the execution criteria. Smart order routing systems employ a number of different techniques to achieve best execution, which include using real-time data on individual stocks traded on different venues. They also allow orders to be routed away from venues which may be experiencing difficulties at a particular moment in time, so as to execute the order on an alternative venue. The existence of smart order routing systems would limit the use of the execution quality data report proposed by CESR.

Notwithstanding this, there may be some merit in CESR attempting to define a standard metric for execution data. This could potentially make it easier and more convenient for firms to directly compare a suite of execution quality data across different trading venues. The lack of consistency across the various data sets published means firms are sometimes forced to make judgement calls, often using their own historical data and market expertise. That is not to say there is a failure on the part of firms in linking together different trading venues in the interest of achieving best execution – rather, a universal metric would simply provide a helpful baseline for making comparisons across venues. On this basis we would be opposed

to CESR obligating execution venues to produce periodic reports on execution quality using metrics as defined by CESR. We would however support the first of CESR's two proposed options: "CESR would define key metrics of execution quality data for voluntary use of execution venues and data vendors".

We would ask that CESR excludes Systematic Internalisers (SIs) from any requirements on the basis that the decision to execute on an SI is not driven by the same factors as those in determining the execution venues that should form part of an investment firms' execution strategy. We are also supportive of the requirement only being related to liquid shares given that it is only in this area of the market that multi-venue competition really exists.

Question 19: Do you have any information on the likely costs of an obligation on execution venues to provide regular information on execution quality relating to shares? Where possible please provide quantitative information on one-off and ongoing costs.

None provided.

Question 20: Do you agree with CESR that now is not the time to make a proposal for execution venues to produce data on execution quality for classes of financial instruments other than shares? If not, why not?

We agree that now is not the time for new proposals.

Part 3 – Complex vs. Non-Complex Instruments

Question 21: Do you have any comments about CESR's analysis and proposals as set out in this Chapter?

Whilst the MiFID distinction between complex and non-complex instruments is not without its difficulties, workable solutions have been found so as to comply with the relevant provisions for the purposes of applying the Directive's appropriateness requirements. Our members would not find a fundamental change to MiFID in respect of these provisions helpful at this point in time.

It is CESR's view that shares admitted to trading on an EU regulated market or in an equivalent third country market are 'non-complex' instruments for the purposes of the appropriateness requirements. Accordingly, CESR will permit execution-only services to be provided to retail clients in respect of these products. This is without regard to other venues the same security might be traded on, which could be over-the-counter, on an MTF, outside the EU, or another venue. Those equities traded on an MTF or third country market and not admitted to trading on a regulated market will have to be assessed in accordance with the criteria set out in Article 38 of the MiFID Level 2 Implementing Directive before they can be sold on an 'execution-only' basis.

In practice this means that the approach CESR wishes to adopt will divide a single class of financial instruments – equities – into two categories: those that can be treated as non-complex under MiFID and those that must be subjected to the Article 38 test. In distinguishing between complex and non-complex instruments, our members are challenged by the expression "retail market". This covers a range of customers and products, from high street customers of limited wealth and simple needs through to the private bank clients of a high net worth and with complex needs. However, the basis for this CESR's division – admission to trading on a RM – is somewhat arbitrary and does not necessarily imply that one group of equities is more suitable for retail clients than another. If CESR follows this route, it will be important to apply the Article 38 test in an objective way that does not impose unnecessary obstacles to clients' ability to trade in equities that have the quality and nature of a "share". This should allow the CESR approach to encompass mainstream equities not admitted to trading on a RM in a regime that minimises unwarranted discrimination against retail investor access to that category. Nevertheless, in our view the question of whether a share is complex or non-complex should be decided in the light of the quality and nature of the share as opposed to the venue on which trading takes place. If CESR's proposal was to be carried forward it could result in shares changing their regulatory status in the cases that the listing of the share was migrated from one venue to another; e.g. in UK between the UK AIM market and the LSE Main Market.

The same reservations would apply to CESR's proposed approach to the treatment of debt instruments as outlined in paragraph 151 of the consultation document. Specifically with regard to this paragraph, we would ask that some definitional help be provided concerning the language "incorporate a structure which makes it difficult for the client to understand the risk involved" – many structures may be complex to describe but relatively easy to understand in terms of overall risk.

We believe that products with embedded derivatives should be treated as 'complex' for the purposes of the appropriateness test. This would include: structured notes; certificates; warrants; convertible shares; callable shares; and structured deposits. With regard to structured products, a distinction should be made between those with 100% capital protection and those with conditional capital risk, whereby capital is secure unless the index falls below a particular trigger (also known as SCARPs – Structured Capital-At-Risk Products).

Question 22: Do you have any comments on the proposal from some CESR members that ESMA should work towards the production of binding Level 3 standards to distinguish which UCITS should be complex for the purpose of the appropriateness test?

Complex products should not be sold to retail investors other than on an advised basis. UCITS has been an exception to that approach due to the text in Article 19 (6). Although, in principal, we agree with CESR's proposal to amend Article 19(6) to render "...those UCITS that use investment strategies or techniques that make it difficult for the client to understand the risks involved" effectively complex, it is not entirely clear what this would mean in practice. It is likely that all UCITS funds

utilising derivatives would, in future, fall into the complex category. Therefore, we would seek some clarity on the status of certain products with a UCITS wrapper in terms of whether they are complex or non-complex - particularly for funds that do not represent a payout based on derivatives, make but use derivatives for risk management purposes or efficient portfolio management. Whatever approach CESR decides to take, further analysis is needed and a market-wide consultation should be undertaken.

Question 23: What impact do you think CESR's proposals for change would have on your firm and its activities? Can you indicate the scale or quantify of any impact you identify?

No comment.

Part 4 – Definition of Personal Recommendation

Question 24: Do you agree with the deletion of the words 'through distribution channels or' from Article 52 of the MiFID Level 2 Directive?

CESR's proposal is to delete the words 'through distribution channels' from the following sentence taken from Article 52 of the MiFID Level 2 Directive: "A recommendation is not a personal recommendation if it is issued exclusively through distribution channels or to the public".
According to Article 52 of the MiFID Implementing Directive, a recommendation is not a personal recommendation if it is issued exclusively through distribution channels or to the public. Article 1(7) of Commission Directive 2003/125/EC – to which the MiFID Implementing Directive refers – defines a distribution channel as a channel through which information is, or is likely to become, publicly available i.e. a large number of persons have access to it. Considering this apparent contradiction, we are unsure of the rationale behind CESR's proposal to remove 'through distribution channels' from Article 52.

We do not feel that CESR's considerations around messages sent to multiple clients are focused enough on whether or not correspondence is clearly based on the analysis of an individual's investment needs. In situations where e-mail correspondence, a webpage, or an interactive software system is used to provide personalised information, as opposed to providing information to the public in general, we would not consider this to constitute a 'distribution channel' and therefore would not see it as being able to make use of the Article 52 exemption. The medium used does not automatically determine whether a communication amounts to investment advice. Firms should continue to examine the surrounding circumstances i.e. target audience, content of message, and language.

On these grounds we are therefore unconvinced as to the reasons behind, and benefit of removing 'through distribution channels' from Article 52. Whilst we do not perceive there to be a need for any change, our membership would prefer keeping the existing wording but adding "and contains no consideration of the

personal circumstances of the clients to whom it is distributed" as opposed to removing the wording altogether.

Part 5 – Supervision of Tied Agents and related issues

Question 25: Do you agree with CESR that the MiFID regime for tied agents has generally worked well, or do you have any specific concerns about the operation of the regime?

No comment.

Question 26: Do you agree with the proposed amendments to Articles 23, 31 and 32 of MiFID?

No comment.

Question 27: Could you provide information on the likely impacts of the deletion of the ability of tied agents to handle client money and financial instruments?

No comment.

Part 6 – MiFID Options and Discretions

Question 28: Do you agree with the suggested deletions and amendments to the MiFID texts proposed in this chapter?

We agree with the proposed changes.

We hope that you will find these comments useful, and remain at your disposal should you wish to discuss this response. In such instances, please contact either Christopher Ford (020 7216 8895; christopher.ford@bba.org.uk) of the British Bankers Association, or Mark Hart (020 7796 3606; mark.hart@afme.eu) of AFME.