ZENTRALER KREDITAUSSCHUSS
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Comments of the Zentraler Kreditausschuss[1] on a Provisional Mandate to CESR for Technical Advice on Possible Implementing Measures concerning the Future Directive on Financial Instruments Markets (ISD2)

- Call for Evidence -

Published by the Committee of European Securities Regulators (CESR) on January, 20th 2004

19 February 2004

1 The ZKA is the joint committee operated by the central associations of the German banking industry. These associations are the *Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR)*, for the cooperative banks, the *Bundesverband deutscher Banken (BdB)*, for the private commercial banks, the *Bundesverband Öffentlicher Banken Deutschlands (VÖB)*, for the public-sector banks, the *Deutscher Sparkassen- und Giroverband (DSGV)*, for the savings banks financial group, and the *Verband deutscher Hypothekenbanken (VdH)*, for the mortgage banks. Collectively, they represent more than 2,500 banks.

A. General

(a) Need for a cost-benefit analysis

We attach paramount importance to the European Commission's forthcoming technical implementing measures to be adopted at Level 2 of the Lamfalussy procedure which will govern the implementation of a Directive on markets for financial instruments (ISD2). In future, the requirements as regards the activities of investment firms in Europe will be determined by these implementing measures.

Against this backdrop we explicitly welcome the fact that, in its provisional mandate to CESR, the European Commission has explicitly laid down that, in terms of a **cost-benefit analysis**, there is a need to strike the right balance between the regulatory objectives (harmonisation, investor protection) pursued by the technical implementing measures on the one hand and the necessary degree of flexibility for investment firms on the other hand (see point 2.3 of the provisional mandate).

We therefore kindly request CESR to take this responsibility very seriously. Unless this is the case, we have strong concerns that provisions may be stipulated which would hardly serve investor protection whilst, on the contrary, they may even lead to a clear increase in prices for investment services - prices which, finally, the investors would have to pay.

(b) Legal nature of the individual implementing measures

We see with great concern that the Commission wishes to use to the instrument of a Regulation also for those forthcoming provisions which will directly regulate relations between an investment firm and its clients or employees. We are well aware of the fact that this decision on the part of the Commission is beyond the remit of CESR's sphere of influence. Yet, this decision has one implication for CESR: It means that there is an increased need for CESR to carefully assess whether its advice is compatible with those national provisions in existence under, e.g. civil law or labour law that have not been harmonised.

It is also necessary to take into account an individual firm’s entitlements to a certain degree of organisational discretion. Frequently it will be the case that only the legal instrument of a Directive

will be able to sufficiently take account of national jurisdictions and highly heterogeneous structures, sizes and operations of the various undertakings. In order to mitigate the potential danger of incompatible clashes between the forthcoming provisions on the one hand and the national legal frameworks and different corporate organisational structures on the other hand, whenever there are uncertainties, the fact that the Commission plans to largely revert to the instrument of a Regulation, should induce CESR to issue **less detailed provisions**.

We shall gear our comments on the individual areas of the Call for Evidence to the structure of the Commission's preliminary mandate:

B.3.1. Organisational requirements

B.3.1.1. Compliance obligations and treatment of personal transactions

CESR should gear its advice on the requirements with regard to the **compliance task** to those requirements which have already been laid down in Art. 10 of ISD1. Amendments should only be considered in those cases where the existing legal situation is *de facto* encumbered by certain shortcomings. We feel that this will largely not be the case.

Hence, this would result in Level 2 provisions that are similar to those which can also be found in the national implementations of the provision on internal control procedures as contemplated by Art. 10 (2), 1st indent of ISD1. *Inter alia*¸ these provisions particularly stipulate the need to guarantee ongoing monitoring of the correct provision of investment services and ancillary services (compliance). Here, preference should be given to a **functional and not to an organisational approach**. This means that 'compliance' needs to be understood as a function consisting of different tasks which need to be performed within the investment firm. The allocation of tasks should be subject to entrepreneurial discretion. Such a concept clarification prevents imposing on undertakings the way in which they need to be organised internally and this will also protect the preservation of corporate idiosyncrasies**.**

In terms of the type of workflow management and organisational structure as well as ongoing monitoring, we subscribe to the need to subject investment firms to requirements that are in line

with their structure, size and business operations. Yet, the specific selection and implementation of suitable organisational and technical measures in order to achieve these deliverables should be left to the discretion of the individual investment firm. Hence, in terms of the workflow management and organisational requirements, we advocate in favour of **guiding rules of a general nature** which still leave enough room for a company specific implementation and customisation.

In any definition of what is to be considered a **personal transaction**, attention should be paid to only include those individual transactions where – in the execution of the order – there is a danger that the employee will gain an advantages over an investment firm's client. By way of example: In transactions involving UCITS that are not listed, such an advantage can be ruled out *a priori* because both transactions will be equally subject to the next share price determined by UCITS.

In **terms of employees**, i.e. in terms of the specific requirements, there should be a differentiation based on whether, in the course of their duties, these respective employees have access to inside information on a regular basis or not. By way of an example for definitions that are fit for purpose, please find enclosed in **Annex 1** a digest from the employee guiding principles of the German supervisory authority, the Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin).

Furthermore, it is necessary to bear in mind that provisions aimed at an efficient prevention and control of conflicts of interests partly constitute a massive interference with employees' personal rights. So as to ensure that they are fit for purpose in the practical implementation, clear legal rules governing interference with employee rights are therefore of the essence. Yet, these rules should refrain from simultaneously stipulating detailed organisational provisions for undertakings. The reason is, that this might result in considerable conflicts with national rules and regulations governing e.g. labour issues or, for instance, company law.

Last but not least, one should be aware of the fact that there is also a close link between provisions on employee transactions and Articles 18 and 13, Paragraph 3 ISD2, meaning that bullet points 3.1.1 and 3.2 of the Call for Evidence cannot be seen in isolation.

B.3.1.2. Obligations related to internal systems, resources and procedures

We see an urgent need to fix certain **limits when it comes to the establishment of organisational requirements**. CESR should abstain from issuing detailed recommendations for the organisation of investment firms. Investment firms are very heterogeneous by nature and abstract legal provisions could not possibly reflect the entire gamut of different real world settings in which they are embedded. 'Reasonable steps' can only consist in those provisions which specify the obligations in clearer terms without pinning down the last details for the precise way in which these obligations are to be met. By way of example, some of the obligations which may be thus defined are given below in a non-exhaustive list:

- Providing safeguards against system failures;
- Ensuring sufficiently skilled staff for business operations;
- Providing sufficient resources for the compliance activity.

B.3.1.3. Obligation to avoid undue additional operational risk in case of outsourcing

Requirements with regard to the outsourcing of services should be designed in a way so as **not to curtail the possibility for cost-saving cooperation between investment firms**. This could be achieved, for instance, by specifying that the transfer of investment services and ancillary services from an authorised investment firm to another authorised investment firm shall not be defined as 'outsourcing'. On a more general note, in order to provide legal certainty, we strongly feel that there needs to be a list defining what outsourcing actually means.

B.3.1.4. Record keeping obligation

In the recommendations for implementing measures concerning the record keeping obligation one should never lose sight of the actual underlying purpose of this obligation. This obligation is aimed at allowing the competent supervisor authority to verify the correct execution of a transaction or of a service. As a consequence, the record keeping obligation is only warranted as long as the records may document potential breaches in the correct execution of a transaction or provision of a service. CESR should take account of existing EU provisions on data protection.

Furthermore, it is necessary to bear in mind that, already today, one possible approach to compliance with supervisory requirements is based on **organisational instructions**. Any record keeping obligation exceeding this level should therefore only be stipulated in those cases where the associated additional input of financial and organisational resources on the one hand is offset by an equally proportionate amount of added benefit on the other hand. Yet, more specific comments on these record keeping obligations must be reserved for a later point i.e. when the precise content of the individual obligations will have been determined.

However, CESR has already begun discussions on a potential **mandatory record keeping obligation for each and any client orders via telephone** and the associated client information obligation thereof. This is utterly objectionable. Whilst such an approach is standard market practice for transactions with institutional clients and makes sense for such transactions, we feel that this kind of approach would be completely inappropriate in the case of private clients. In practice, differences in opinions concerning the content of issued securities orders are extremely rare. Due to the mandatory immediate securities contract note and the corresponding cross-checking by the client, potential issues are detected and clarified at an early point. The effective client benefit in terms of easier evidence potentially resulting from such a measure in those very rare cases where a client order has not been taken down and forwarded correctly, comes at a disproportionately high financial and organisational cost needed for technical hardware changes in thousands of banks and savings banks branches on the ground.

B.3.1.5. Protection of client's financial instruments and funds when a firm holds financial instruments and funds belonging to clients

Provisions for the protection of financial instruments belonging to an investor and clients' funds, in our view, only allow a **minimum harmonisation**. Any other approach would constitute an excessive interference with the custodian law prevailing in the various Member States. Firstly, this lacks any European regulatory mandate. Secondly, we see no need for any such obligation. ISD1, Art. 10 (2), 2nd indent already contained a wording that is identical with ISD2, Art. 10 (7). To our knowledge, the implementation of these provisions has not given rise to any problems.

B.3.2. Conflicts of interest (Art. 18 und 13 (3))

When issuing its advice, pursuant to the provisions of the European Commission's preliminary mandate, CESR is held to take account of the proportionality of individual measures and the various degrees of risks inherent in different investment services with regard to the clients' interests. We therefore take it that CESR, under this injunction, will issue differentiated advice based a) on **the type of investment services** (e.g. investment advice or execution-only) b) on the **frequency with which conflicts of interest may arise** within an investment firm. In preparing these provisions, attention should be paid to ensure that these provisions are feasible and realistic for investment firms. CESR should refrain from issuing detailed organisational provisions. Such provisions would fail to live up to the heterogeneous structure and size of investment firms.

One example would be Chinese Walls: The creation of confidential areas is, for instance, a necessity in the case of large universal banks; yet, for smaller investment firms, any mandatory obligation to establish Chinese walls would be virtually impossible. Furthermore, CESR's action should be informed by the basic understanding that it will never be possible to completely prevent potential conflicts of interest. It is the investment firms which are duty-bound to prevent potential conflicts of interest from leading to an abuse of their clients' interests (cf. ISD2, Art. 13, Paragraph 2, “that risks of damage to client interests will be prevented“).

Should CESR decide to recommend **information obligations** concerning eventual conflicts of interest, then first of all, it will be necessary to bear in mind that such an obligation only exists when there are **inadequate organisational or administrative measures** for managing conflicts of interest (cf. ISD2, Art. 13, paragraph 2). Also the scope of the information obligation hinges on the type of the service. The critical point in this respect is whether, concerning a certain product or a certain service, an awareness of the potential conflict of interest could affect the client decision or not. Hence, the degree of consumer confidence in a given investment firm will play a pivotal role in this respect. Thus, for instance in execution only transactions, there will rarely ever be a need to disclose conflicts of interest, since the clients’ investment decision proper will be completely divorced from the investment firm’s sphere of influence.

Pursuant to Level 1 (cf. ISD2, Art. 13, paragraph 2), in any category of services, the disclosure's scope of detail is limited to the **'general nature'** of a conflict. Any forthcoming disclosure obligation regulating the disclosure of details of contractual agreements between the investment firm and third parties would be incompatible with this premise. We also feel it is necessary to take into account that statutory or contractual confidentiality obligations may render the disclosure of such information to third parties virtually impossible.

B. 3.3. Conduct of Business Obligations when providing investment services to clients (Art. 19, §§ 2, 3, 7 and 8)

B.3.3.1. Publicity and marketing communications

When stipulating the requirements with regard to 'marketing communication' we feel it is necessary for CESR to take **existing competition rules** (e.g. the rulings by the European Court of Justice) **and regulations** as a benchmark thus avoiding the creation of a segregate law for investment firms only.

B.3.3.2. Appropriate information to be provided to the clients or potential clients

Any definition of appropriate information to be provided to the clients or potential clients should take account of the fact that Level 1 differentiates between the **different kinds of investment services** rendered. As far as execution only transactions are concerned, for illustration purposes we would like to refer, e.g., to the German banking community's information manuals on securities and forward transactions which have been in use for several years now. In this respect we feel that a standard information on the "**types of**" financial instruments and investment strategies will be sufficient; any potentially more detailed information need shall be reserved to the sphere of personal client investment advice. Similarly, it should be possible to provide general information on trading venues by way of a standard information manual; this is especially true since pursuant to ISD2, Art. 21, paragraph 3, the investment firm is, additionally, under the obligation of having to provide information on its specific 'execution policy'.

As far as the specific content of the information obligation concerning costs and associated charges is concerned, we feel it would **not be tolerable** if the client and thus competitors of the investment

firm were to be entitled to **receive internal costing data**. Furthermore, it will be necessary to take into account that (particularly abroad) it will not always be possible to exactly determine associated costs; here, a ballpark figure will have to suffice.

In order to avoid unnecessary encumbrances, any duty to provide information on the investment firm should exclusively be **limited to the case of new clients**.

In terms of the service range offered, universal banks should be able to opt for exclusively informing the client of the fact that any other standard investment service is also being offered.

Furthermore, under the aspect an appropriate and balanced approach (i.e. cost-benefit ratio), a cautious approach with regard to the stipulation of obligations concerning repeat information seems to be in order. These types of obligations may incur a considerable amount of monitoring work. Obligations should at least be based on the **actual information need on the part of the client** and not on any mandatory, formulaic repetition after specified time intervals.

B.3.3.3. Client Records

In our view it is worth highlighting that, as far as client records are concerned, ISD2 explicitly warrants reference to other documents and legal texts. Here, **an incorporation by reference**, for instance to General Standard Terms and Conditions or price lists, should be sufficient. Any provisions making the signature and storage of each individual relevant document in the form of a client folder mandatory, would be incompatible with this approach. One further aspect that needs to be taken into account with regard to incorporation of legal texts by reference is that, to date, the civil law does not yet stipulate any mandatory statutory legal requirement concerning an incorporation by reference. As a consequence, a corresponding regulatory obligation should – at most – only apply in the case of a new client.

B.3.3.4. Reports from the firm to its clients

The cost-benefit analysis plays a pivotal role also in the field of the reporting obligations. The critical point should be enabling the client to logically comprehend transactions.

In addition to this, it will be necessary to **differentiate between reports triggered by a given transaction, notices from any ongoing custody contract and notices on the basis of a concluded portfolio management agreement**. One matter that is particularly objectionable is the already ongoing discussion within CESR concerning a potential introduction of a reporting obligation on custody account movements in the custody account statement.

On the other hand, in the framework of portfolio management, it will be necessary to distinguish between ad-hoc reporting obligations and reporting obligations in specified intervals. When it comes to periodical reporting obligations, the regulator should refrain from fixing any set window of time for providing the client with the reports. Especially in the case of portfolio management, catering to the clients' individual requirements is essential; hence this should remain the preserve of the agreement between the client and the bank.

B.3.4. Best execution obligation (Art. 21)

There is one important qualification lacking in the introductory part of the mandate, i.e. that Level 1 requires that all "**reasonable steps**" need to be taken in order to achieve best execution of client orders. Yet, this qualification will be of paramount importance for the technical implementing measures.

B.3.4.1. Criteria for determining the relative importance of the different factors to be taken into account for best execution

Since this would involve a considerable amount of additional time and technical effort and it would lead to a considerable increase of execution costs, the implementing measures need to ensure that the best execution obligation is complied with, so that – in line with the Level 1 provisions - there will be **no case by case assessment**. Furthermore, any wide-ranging review obligation would collide with the duty of immediate trade execution. Especially in the case of volatile securities, such a kind of obligation may lead to a situation where, once the review has been completed, prices may already have undergone fundamental change. This kind of impact is not in the best interest of the client, either. Preventing any overly rigid prioritisation of said parameters will be of decisive importance in order to safeguard the necessary flexibility that is indispensable for business operations.

B.3.4.2. Trading venues to be included in the trade execution policy

In order to safeguard their practical implementation on the ground, the criteria used by investment firms in order to determine those trading venues which allow best execution need to provide a **sufficient degree of latitude**. It can only be about determining parameters that need to be taken into account during the decision-making process. The definition of the term 'consistent basis' needs to provide breathing space.

B.3.4.3. Information to the clients on the execution policy of the firm

The client should obtain information on essential outlines of the firm's execution policy. Here, cases where the investment firm avails itself of indirect access should also be presented. Last but not least in the clients' own vested interest it will be necessary to ensure that the presentations do not contain an excessive degree of detail (information overkill). By way of **example for an execution policy**, please find enclosed in **Annex 2** a digest from the Special Terms for Dealing in Securities used by the German banking industry.

B.3.4.4. Obligation to monitor and update the trade execution policy

It should be allowed to freely choose the method for making available information to the client. This should also include state-of-the art communication channels. The same applies to information on updates; here any obligation to provide further information should be limited to those cases where material content of the execution policy has been changed.

B.3.5. Client order handling rules (Art. 22)

In delivering its advice on client order handling rules, CESR should refrain from trying to cover each and every possible contingency. Any such undertaking, in our view, would be doomed to failure. The only possible viable solution is the stipulation of principles.

B.3.6. Reporting of transactions (Art. 25 (3), (4), (5) und 5(a))

In the various Member States, at present, the reporting systems established for the purposes of efficient tracking of insider trading have reached rather divergent degrees of sophistication. Whilst stringent supervisory projects have resulted in **highly complex, fully electronic reporting systems** in e.g. Germany and Austria, this is not yet the case for all Member States. Given the extraordinarily high costs which would result from any interference with existing reporting systems, CESR – particularly with a view to the existing, highly sophisticated systems within individual Member States – should carry out an initial stocktaking exercise of the current reporting systems in place in various Member States.

Based on the findings of such a kind of stocktaking exercise, there should then be a careful review into balanced ways of harmonising divergent reporting standards in different Member States. In the technical implementation of these deliverables, interested parties and the supervisory authorities should be granted maximum latitude and flexibility. The obligation to exchange reported information between the supervisory authorities (Art. 25 (6)) or the forwarding of information to the supervisory authority of the most relevant market (Art. 25 (3)) must, under no circumstances, give rise to an obligation for investment firms to prepare their reports in an EU-wide standard IT format. Particularly in the aforementioned Member States, the adjustment of highly complex IT systems would incur an unjustifiable burden.

B. 3.7. Transparency requirements (Art. 28, 29, 30, 43 and 44)

In the introductory text, the note indicating that the post-trade transparency requirements pursuant to Art. 28 shall be limited to shares, is missing. Already for the sake of a clear mandate, this note should be complemented.

In addition, one should generally bear in mind that the provisions need to provide safeguards so that post-trade obligations are not used to by-pass competition between regulated markets, MTFs and investment firms.

In the drafting of technical implementing measures on Art. 28, CESR should take account of the fact that Member States feature very heterogeneous forms of off-floor equity trading. The gamut ranges from systematic OTC trading through banks' in-house internalisation systems, off-exchange own-account trading between banks to occasional fixed price deals which an investment firm closes with its private clients, e.g. in order to execute the client's purchase order concerning a non-liquid second-line stock via own holdings.

CESR should take account of this diversity by way of a corresponding **flexibility and differentiation** in the forthcoming reporting obligations. This particularly applies to the window of time within which the report has to be sent to the competent authority. In this respect, any forthcoming reporting obligations should be especially geared to provisions that can be met 'on a reasonable commercial basis'. Hence, particular attention needs to be paid to an adequate cost-benefit ratio of the implementing measures concerning Art. 28.

B.3.8. Admission of financial instruments to trading (Art. 39)

As an introductory note, we would like to point out that the mandate for these implementing measures no longer consists in Article 39 but in Article 40.

a) Consistency with other Directives

Article 40 as well as the forthcoming relevant implementing measures should be closely geared to the **Market Abuse Directive**, the **Prospectus Directive** and the **Transparency Directive** currently in discussion as well as to the latter’s forthcoming relevant implementing measures. Since these Directives, too, stipulate numerous obligations for the issuer in the context of the corresponding admission to trading, consistency is indispensable.

Prospectus Directive

Already the Prospectus Directive as well as its forthcoming implementing measures currently in discussion, lead to a comprehensive harmonisation in the admission to trading of securities. There is a strong likelihood that all details of the prospectus which, in future, will have to be drawn up for admission to trading, will be laid down in the form of a legal Regulation. Here, there will be a distinction both by issuers and also by different **security categories** (shares, debentures with a

denomination per unit that amounts to at least EUR50,000, debentures with denominations per unit of less than EUR50,000, depository receipts, asset backed securities, collateralised debentures, derivatives (i.e. all debentures which cannot be subsumed under any of the other categories)). These categories should be preserved.

The **admission mechanisms** (authority, deadlines etc.) are specified in detail by the Prospectus Directive; hence there is no need for any further regulatory activity within level 2 of ISD2.

Furthermore, Art. 10 of the Prospectus Directive stipulates as a **post-admission obligation** the need to provide on an annual basis a document that contains or refers to all information that has been published or made available to the public over the preceding twelve months. Also from this point of view, any further provisions within level 2 of ISD2 would appear unwarranted.

Transparency Directive

There is a strong likelihood that, upon adoption, the Transparency Directive will stipulate a large number of post-admission requirements. This includes, *inter alia*, the preparation and publication of annual and semi-annual reports, in the case of stock shares further financial reports during the ongoing year, notices on general meetings of shareholders and dividend distributions as well as announcements of new issues. Furthermore, there will be comprehensive provisions on publication of this information. Therefore, just like in the case of the Market Abuse Directive which makes reference to the Transparency Directive when it comes to publication of ad-hoc notices (Art. 6), there should equally only be a reference to the publication obligations under the forthcoming Transparency Directive.

b) Consideration of the status quo in the execution of the securities transactions

Furthermore, the fact that smooth trading is presently possible, is essentially owed to existing structures meaning that particularly in plans regulating trade and execution in organised markets, one should be mindful of **preserving these existing structures**. The existing body of price determination provisions facilitates trading of transferable securities in a fair, orderly and efficient manner; changeovers, on the other hand, would prevent this very injunction.

In the technical Annex, the Commission calls for the creation of special provisions on derivatives in order to ensure fair, orderly and efficient trading. At least with a view to securitized derivatives, the rationale behind this request is not immediately obvious. Securitized derivatives, to name but one example, constitute securities which have been admitted to trading on the basis of the requirements laid down by the Prospectus Directive. The objective of investor protection is served not only by the prospectus for these securities but also by personal advice which is in line with investor and investment needs; hence we see no demand for any further regulatory activity. At most (if any), there appears to be a regulatory need for **non-securitized derivatives**.

c) Compliance with the regulatory framework of Art. 40 for the implementing measures

At least on some issues, the technical Annex published during the Call for Evidence appears to exceed the provisions laid down in Art. 40. Said Article, for instance, does not contain any mandate warranting the creation of different segments or a separation of the organised market. In practice, such **segmentations** may indeed exist; yet, such segmentation should be left to the respective organised markets' **self regulation.** This would allow these markets – through self-regulation – to set up sectors or special requirements with regard to the issuer in order to attract additional investor appetite in the competitive arena by differentiating themselves from other organised markets. Any European Regulation aimed at creating common standards would go against this. Here, however, especially Art. 3 of the proposal for a Transparency Directive needs to be mentioned, pursuant to which issuers from so-called Acceptance Member States must not be subject to more stringent publication obligations than those contained in Transparency Directive as well as in Art. 6 of the Market Abuse Directive.

Enclosure: Guiding Principles for Staff Transactions
Special Terms for Dealing in Securities