Z E N T R A L E R   K R E D I T A U S S C H U S S

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Comments of the Zentraler Kreditausschuss[1] on Working Document ESC/17/2005 –rev1 on implementation of Articles 13 and 18 of Directive 2004/39/EC of the European Parliament and the Council

[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. Preliminary remarks

We are grateful for the opportunity to comment on the European Commission's Working Document on implementation of Articles 13 and 18 of the Markets in Financial Instruments Directive (MiFID). Our comments are based on Working Document ESC 17/2005 – rev1, published on 20 June 2005.

II. Executive Summary

1. Directive or Regulation

Under Article 1, the measures implementing Articles 13 and 18 of the MiFID are to be set out in a Regulation. We believe that this is an inappropriate approach, as no technical rules in the narrow sense are involved. In fact, some issues (e.g. safekeeping) have points of contact with civil law, while others (e.g. risk management) touch on banking supervisory law. Such overlapping could only be taken into account adequately by a Directive.

2. Voice recording of orders placed by telephone

Of major concern to German Banks is the proposed rule that orders placed by telephone must be recorded on a voice recording system. Contrary to the view of the Commission, we believe that both the initial set-up costs and the running costs are not acceptable. Furthermore, the scheme would certainly damage the climate of trust often built up between clients and their personal advisors. We firmly believe that the proposed regulation runs counter to the principle of "better regulation", which should already be applied to the current legislative procedure.

3. Record-keeping requirements

We expressly welcome it that the Commission has dropped the idea of instructing the Committee of European Securities Regulators (CESR) to compile a list of existing record-keeping requirements in the Member States. We reject any delegation of such authority to CESR for general policy reasons, as CESR has no legislative power whatsoever.

4. Organisational requirements/compliance/conflicts of interest

We welcome it that the Commission evidently intends to take into account the varying scale and complexity of investment business in its regulatory proposals. We therefore greatly welcome the clear wording of Article 21(1)(b). At the same time, we feel that, to be consistent, equivalent wording is required in Article 3 as well.

III. Specific remarks

1. Article 1 (Directive or Regulation)

Under Article 1, the measures implementing Articles 13 and 18 of the MiFID are to be set out in a Regulation. We believe that this is an inappropriate approach, as no technical rules in the narrow sense are involved. In fact, some issues (e.g. safekeeping) have points of contact with civil law, while others (e.g. risk management) touch on banking supervisory law. Such overlapping could only be taken into account adequately by a Directive.

2. Article 2(1) (Definitions)

We see no need to define the term "depository" at Level 2. The definition should be deleted, as the effects of such a definition on all areas connected with investment business are unclear. It should instead be recognised that the connected areas are highly complex and that such complexity cannot be ignored.

3. Article 2(5) (Definitions)

The definition of "personal transaction" in (b)(ii) ("or with whom he has close links …") and b) iii) ("the relevant person has a direct or indirect [material] / [significant] interest in the outcome of the transaction …") is too vague. It must be clear to both the employees and the investment firm which specific transactions are covered by Article 9.

4. Article 2(5), footnote 1 (Definitions)

The footnote refers to the definition of "transaction" in Working Document ESC/7/2005. This reference does not create the required clarity. For one thing, publication of Working Document ESC/7/2005 was followed up by presentation of Working Document ESC/7/2005 – rev2. It is not clear how the term "transaction" will be defined until a final proposal has been presented. For another thing, we would point out that the regulatory objectives of Article 25 and Article 13 are quite different. Any definition which ignores this will lead to differentiation problems when implemented.

The actual purpose of Article 2(5) can only be to cover purchases and sales. We therefore suggest deleting footnote 1 and wording Article 2(5) so that only the transactions specified would be covered.

5. Article 3(1)(2) (new) (Organisational requirements)

We suggest inserting a second subparagraph after Article 3(1)(g) with the following wording:

> "All the measures implemented by the investment firm in relation to the organisational requirements shall be adequate and proportionate taking into account the nature, scale and complexity of the business of that firm, and the nature and range of investment services and activities undertaken in the course of that business."

This would make clear that the measures to be taken must be adequate in relation to the business and structure of the investment firm.

6. Article 4 (Compliance)

The proposals on compliance are possibly too broad. We see the danger of the duties of the compliance function being understood as unlimited at Level 3 and thus of multiple performance of one and the same duty within an investment firm.

Specifically, the relationship of Article 4(1), sentence 2 to Article 5 (risk control) remains unclear to us. We feel it would be advisable to make clear that any duty performed by the risk control unit need not be performed by the compliance function as well.

With regard to Article 4(2), we believe it should be made clear in the recitals that the compliance function need not monitor every single measure and every single procedure. This would place an impossible burden on it.

7. Article 4(2) (Compliance function)

The addition of the word "independent" in connection with the compliance function is likely to lead to misunderstandings. What matters is that the independence of the compliance function is geared not to the organisational structure but to the operational structure, i.e. the actual fulfilment of the compliance requirements. We therefore suggest deleting the word "independent". The definition drafted by IOSCO[2], which is worded as follows, could be used instead:

> "An investment firm shall maintain a permanent, ~~independent~~ and effective compliance function, which **must function independently** and shall have the following responsibilities: …".

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[2] IOSCO Consultation Report "*Compliance Function at Market Intermediaries*" of April 2005, p. 4

In addition, we suggest wording Article 4(2)(a) as follows:

> "*to monitor and assess on an adequate and regular ~~ongoing~~ basis:*"

This would ensure that the responsibilities of the compliance function are proportionate to each investment firm.

<u>8. Article 5(2)(b) (Risk control function)</u>

The changes to the risk control function go beyond existing supervisory rules and those planned under Basel II. A requirement to report to external auditors is inappropriate. Risk control units report directly to the management and are designed chiefly to oversee and control internal operations. Reporting to external auditors should continue to take place through the management.

Moreover, the risk control function should only be required to report to the internal audit function in special cases. Also, it is unclear what the risk control function is to report on under the new Article 5(2)(b).

<u>9. Article 7 (Senior management)</u>

We understand paragraph 1, sentence 2 to mean that the periodic review does not have to be carried out personally in each case by senior management but that senior management can also delegate this task to subordinate units within the investment firm.

We suggest rewording paragraph 2(a). There is no need for a requirement, on top of the obligation to report at least annually (see (b)), to report on a "frequent and ongoing basis". Instead, an additional requirement to immediately report any deficiencies identified would be sufficient. We therefore suggest wording Article 7(1)(a) as follows:

> "a) **in the event of any deficiencies** ~~on a frequent and ongoing basis~~, reports on the matters covered by Article 4, 5 and 6 (compliance, risk control and internal audit)
> indicating in particular whether the appropriate measures have been taken in the event of any deficiencies; and"

<u>10. Article 8 (Complaint management)</u>

Paragraphs (b)–(d) should be deleted, as the requirements they contain are already covered adequately by (a). Paragraph (b) would have to be dropped at any rate, as it is not a sensible investor protection measure but a bureaucratic requirement. Alternatively,

consideration could be given to requiring investment firms to contact the client of their own accord within 15 days if the complaint has not been settled within this period.

11. Article 9(2) (Personal transactions)

In our view, the proposed wording does not ensure the required agreement of paragraphs 1 and 2. The persons covered by paragraph 2 should only be those persons who could be subject to a conflict of interests or who have access to price-sensitive information by virtue of their activity on behalf of the investment firm. We therefore suggest wording Article 9(2)(a) as follows:

> "Each relevant person **according to paragraph 1** is aware of the restrictions …".

In addition, Article 9 (2)(b) should be worded as follows:

> "The firm is informed promptly of any personal transaction entered into by **such** relevant person …".

12. Article 9 (3)(b) (Personal transactions)

We welcome the proposed additional wording stipulating that paragraphs 1 and 2 are not to apply in the case of personal transactions in units in collective undertakings. Transactions in government bonds should also be exempted.

13. Article 10.1 (Outsourcing)

We suggest wording paragraph 1 as follows:

> "For the purposes of Article 13(5) of the Directive an operational function is critical or important if a defect or failure in its performance would cast **serious** doubts upon the continuing compliance …".

This restriction is necessary, as otherwise the scope of the outsourcing provisions would become too broad.

14. Article 11 (Outsourcing)

The wording does not make sufficiently clear whether core management functions may also be outsourced. We believe that clarification is required to the effect that outsourcing of core management functions is not possible.

In addition, we call on the Commission to provide evidence that the requirements cannot lead to a distortion of competition between banks and pure investment firms. In this

connection, we refer in particular to the consultations of the Committee of European Banking Supervisors (CEBS).

15. Article 13(1) (Record-keeping requirements)

We welcome deletion of the final part of Article 13(1).

16. Article 13(4) (Orders placed by telephone)

Article 13(4) stipulates that orders placed by telephone must generally be recorded on a voice recording system. The Commission's proposal therefore goes even further than the recommendations made by CESR, which state that, where such a recording requirement would be unreasonable due to the limited number of orders placed by telephone or unreasonable in general, the competent authority may exempt investment firms from this recording requirement either in regard to individual telephone lines or in general.

We, on the other hand, believe that paragraph 4 should be deleted.

The justification given in the Commission's Explanatory Text ESC/18/2005, i.e. that initial studies had shown that the required recording systems were not necessarily expensive and could be had for less than €100, is unacceptable. The costs estimated by the Commission should by no means be sufficient to allow compliance with the strict recording and record-keeping requirements (see in this connection particularly Article 14(3)). Furthermore, it remains unclear how the amount quoted by the Commission is to be understood (per advisor or per bank?; once-only or annually?).

Some ZKA member banks have obtained concrete offers for a voice recording system that would ensure systematic and easily accessible recordings. These offers all showed that banks would face costs of around €200 a year per investment advisor for every single telephone line. For a big bank or savings institution using 1,000 telephones to contact clients, this would mean extra costs of €200,000 annually. These costs would result in a substantial increase in the price of individual orders. Assuming an average of 3,300 securities transactions for cooperative banks, it can, for example, be calculated that each securities order would be €3 more expensive on average.

For your information, we enclose concrete offers from telephone system suppliers obtained by Hamburger Sparkasse (leasing) and Raiffeisenbank Rosenheim (buying) (with an English translation of each). These show that simply leasing or buying voice-recording systems which meet the above requirements would cost each bank a medium-sized six-figure euro amount. Running costs such as rental, retention costs, etc. are not included in this amount.

Neither CESR not the Commission has explained yet where the problem with orders placed by telephone lies. The new recording requirement appears to have been triggered solely by a general and unfounded lack of trust in investment firms to comply properly with their already existing obligations to record clients' instructions and the time of issue and execution of an order. Mere distrust cannot, however, justify new supervisory rules, particularly rules with such far-reaching negative consequences as in the present case. Such an approach would also be at odds with the aim of better regulation in the Commission's draft Green Paper on Financial Services Policy (2005 – 2010) and would, in particular, completely ignore the commitment made by the Commission to establish thorough and convincing economic impact assessments before launching a new proposal and demonstrate an evidence-based expectation that any new European proposals for financial services legislation and implementing rules will yield significant economic benefits (see page 5 et seg of the Green Paper).

The consequences should be seen clearly: The enormous costs associated with voice recording would ultimately require the establishment of call centres to allow banks to remain competitive. However, this means that the service which is currently widely used by clients, whereby they regularly deal with the same advisor at their local bank/savings bank branch, could no longer be maintained for investment business. This would constitute far-reaching interference with an established business model that meets the wishes of clients.

An exemption, as proposed by CESR, is inappropriate and inadequate in our view. It means that the whole issue, particularly the question of the scope of the exemption, would be shifted to Level 3 and investment firms would be required to demonstrate that they qualify for an exemption. On the other hand, banks that did not benefit from an exemption would find it difficult to understand why they were required to conduct voice recording.

We are therefore strongly in favour of deleting Article 13(4).

17. Article 14(1)–(3) (old numbering) (Record-keeping requirements)

We expressly welcome the proposed deletion of Article 14(1)-(3). At the same time, we reject the delegation of authority to CESR proposed in Working Document ESC/17/2005 for general policy reasons. CESR has no legislative power whatsoever and the deletion should therefore be retained.

<u>18. Article 14(1) (new numbering) (Record-keeping requirements)</u>

We believe that the retention period of five years stipulated in paragraph 1 is far too long. Given the large number of records that will have to be retained in future, a requirement to keep such records for a period of five years is likely to lead to an enormous increase in costs for investment firms. It would be adequate from a supervisory standpoint if records were to be retained until the conclusion of the next external audit, possibly plus a fixed period during which the competent authority could be expected to examine the audit report and thus exercise the right to extend the retention period in accordance with paragraph 2. This additional period should not exceed twelve months.

<u>19. Article 14(5) (Record-keeping requirements)</u>

The newly inserted paragraph 5, stipulating that an indicative list of records must be drawn up and kept, should be deleted. We believe that such a provision is superfluous, as paragraph 1 already shows quite clearly the cases in which investment firms are required to keep records.

<u>20. Article 15(1) e) (Safekeeping of client securities)</u>

We suggest providing the following clarification in Article 15(1)(e):

> "take the necessary steps to ensure that client financial instruments … are separately identifiable from the financial instruments belonging to the investment firm by virtue of differently titled accounts on the books of the depository **or by equivalent measures**."

This wording would ensure that equivalent measures serving the purpose of protecting investors, which underlies Article 15(1)(e), would also be appropriate. What matters is that clients' rights in respect of their securities are protected. This can also be ensured by due administration of securities accounts by investment firms.

Alternatively, the following wording could be added to, or replace, Article 15(3):

> "If the applicable law of the jurisdiction in which the client financial instruments are held provides for an equivalent effect and enables the investment firm to comply with the obligation in Article 13(7) and (8) of the Directive to an equivalent extent, it may not take the measures under (e)".

<u>21. Article 17(1) (Safekeeping of client securities)</u>

For the sake of consistency, Article 17(1), sentence 2 should be aligned with Article 16(2), sentence 2. "*Regulatory requirements*" should be included alongside "*legal requirements*", as otherwise the difference in wording would be inexplicable.

Furthermore, the (good or bad) experience factor should be taken into account. Given the emphasis on the exemplary nature of the requirements referred to in sentence 2 by the words "*in particular*", it is important that this factor, which plays an important role in practice, is also considered.

We therefore suggest amending the wording of Article 17(1), sentence 2 as follows:

> "In particular, the investment firm shall take into account the expertise and market reputation of the depository, **its experience with the depository's performance of its services as well as any legal or regulatory requirements** …".

22. Article 17(3) (Safekeeping of client securities)

We suggest adding to the wording of Article 17(3) so that investment firms would not be prevented from using non-regulated depositories. This could be done as follows:

> "If depositories and the holding and safekeeping of client financial instruments are subject to specific regulation and supervision in a jurisdiction, the investment firm shall deposit the client financial instruments with a depository subject to such regulation and supervision **unless it is necessary to use a non-regulated depository to comply with Article 13(7) of the Directive**."

Paragraph 3 should then be deleted for the sake of clarity.

23. Article 18(1) (Use of client securities)

We suggest limiting the scope of Article 18(1)(b) to small investors. This would, for example, be in line with the current situation in Germany, whereby merchants are not subject to such a provision. This arrangement has proved successful particularly in day-to-day business.

24. Article 20, footnotes 7 and 8 (Conflicts of interest)

We welcome the recitals proposed in connection with Article 20. At the same time, we are in favour of including the clarification in the text of the Directive itself.

25. Article 21(2) (Conflicts of interest)

The words "as a minimum" should be deleted, as there is no room for any additional national rules under the MiFID.

<u>26. Article 21(2)(a) (Conflicts of interest)</u>

Replacement of the word “material” by “clear” should be reversed. What matters is that the client is protected against substantial risks.

<u>27. Article 21(4) (Conflicts of interest)</u>

To take all conceivable cases into account, we suggest that the phrase “some or all of the following organisational structures” should be replaced by “**at least one** of the following organisational structures”.

<u>28. Article 21(5) (Conflicts of interest)</u>

The newly inserted final sentence in Article 21(5) (“These structures shall be approved by the competent authorities.”) should be deleted. It would impossible to implement in practice and merely cause unnecessary costs. Instead, in accordance with the general principles, it should continue to be sufficient if the adequacy of alternative organisational structures is examined in the course of the external audit.

<u>29. Article 22 (Conflicts of interest)</u>

We assume that in the cases in which investment firms have taken or take general organisational measures to prevent conflicts of interest (e.g. Chinese walls) recording as specified in paragraph 2 only needs to be conducted once.

<u>30. Article 23 (Conflicts of interest)</u>

We welcome the proposed deletion of Article 23(2), the contents of which would go beyond the basic principles at Level 1. For the same reason, we suggest aligning the wording of Article 23(1)(b) with the wording of Article 18(2) of the MiFID. Consequently, the information requirement would have to be limited to disclosure of the “general nature and/or sources”.