**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/23/2005-rev1

# Draft Commission Working Document on conduct of business rules, best execution, client order handling rules, eligible counterparties, clarification of the definition of investment advice and financial instruments

15 September 2005

[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 Pfandbriefbanken (vdp), for the Pfandbrief banks. Collectively, they represent more than 2,300 banks.

## I. Introduction

Thank you for giving us the opportunity to comment on the European Commission Working Document on implementing measures for the articles of the Markets in Financial Instruments Directive (MiFID) dealing with conduct of business rules, best execution, client order handling rules, eligible counterparties and definitions. Our comments relate to Working Document ESC/23/2005-rev1, circulated on 6 September 2005.

## II. Executive Summary

### 1. Marketing communications

Marketing communications must of course comply too with the general requirement to be fair, clear and not misleading. However, we believe that any attempt to define a "*marketing communication*" is bound to fail in this context. The forms that marketing communications can take are so varied that a definition will always have shortcomings. Ultimately, a definition would not solve any problems but only raise new ones. It therefore makes sense to drop the idea of a definition and thus of establishing special requirements for marketing communications.

### 2. Best execution (List of execution venues and relative importance of the factors)

We believe that a complete list of the execution venues is inappropriate. Investment firms often have at least indirect access to more than 50 execution venues. A complete list of these venues is of no additional benefit to investors. In our view, a generic description of the venues that are accessible by an investment firm makes more sense.

Determining the relative importance of the factors that have to be taken into account when choosing the execution venue for orders from retail investors goes beyond level 1. It is also inappropriate. Determining the relative importance of these factors is the job of investment firms, not the Commission. This is the only way to accommodate the real interests of retail investors, who in our experience are strongly interested in prompt execution of their orders.

### 3. Form requirement (Durable medium)

The Commission makes the information that is to be provided to clients subject to a form requirement (durable medium). This requirement is to apply to the terms and conditions of any agreement, all the required information and any changes thereto, periodic statements and statements of assets. We would ask the Commission to take a very critical look at whether the

term "*durable medium*" lifted from the Distance Marketing Directive is actually suitable for the MiFID.

### 4. Inducements

Article 25 meets with considerable fundamental reservations. Although Article 13 (3) of the MiFID, in conjunction with Article 18 thereof, contains comprehensive and exhaustive rules on conflicts of interest, the proposal now seeks to define inducements more precisely by referring to the general requirements of Article 19 (1) of the MiFID. We regard this as circumvention of the special rules in order to introduce further requirements not covered by the MiFID. The relevant provisions of the MiFID do not, however, prohibit conflicts of interest or thus inducements either. We therefore believe that the proposed rules need to be restricted.

## III. Specific comments

### 1. Article 1 (Regulation or directive)

Given that the subject matter is closely linked to liability-related issues, particularly concerning information and advice, we believe that a directive is essential. Only then will it be possible to fit European requirements harmoniously into national civil law regimes.

### 2. Article 2 (2) and Article 6 (3), old version (Compound product)

We welcome deletion of the definition of "*compound product*" and deletion of the information requirement originally planned in this connection. An obligation to provide information geared to the individual components of compound products would not be any help to investors. For instance, to take an equity bond as an example, knowing that this product can be explained as a combination of a deposit and the sale of a put option is of no benefit.

### 3. Article 2 (8a) (Marketing communications)

Marketing communications must of course comply too with the general requirement to be fair, clear and not misleading. However, we believe that any attempt to define a "*marketing communication*" is bound to fail in this context. The forms that marketing communications can take are so varied that a definition will always have shortcomings. Ultimately, a definition would not solve any problems but only raise new ones. It therefore makes sense to drop the idea of a definition and thus of establishing special requirements for marketing

communications. A marketing communication will have to be defined in practice on a case-by-case basis.

**4. Article 2 (6) (Durable medium)**

In Article 2 (6), the Commission sets a form requirement ("durable medium"). It is to apply to the terms and conditions of any agreement, all the required information and any changes thereto, notices and statements of assets (see Articles 4, 12-14, 20). We would ask the Commission to take a very critical look at whether the term "*durable medium*" lifted from the Distance Marketing Directive is actually suitable for the MiFID.

After all, there is no disputing that the Distance Marketing Directive requires an investment firm to ensure delivery of the terms and conditions of any agreement and certain prior information to clients. In the context of the MiFID requirements, this means that the delivery of every item of information (Articles 4 and 20), every contract note (Article 12), every periodic statement (Article 13) and every statement of assets (Article 14) would have to be monitored by the investment firm. The consequence would be that a confirmation of receipt would have to be requested from the client in every case. This would impose an enormous administrative burden that would not be offset by any benefit.

We assume instead that this requirement is designed by the Commission to prevent only verbal information or information that can be changed at any time from being made available to clients.

We believe this is fully appropriate in the area of Articles 12-14 and Article 20. In the area of Article 4, however, the consequence would be that only information in writing would comply with the requirements of the MiFID. While German banks use written information on a large scale, there are cases in which verbal information is in the client's interest. If, for example, an investor wishes to buy a new type of financial instrument for which no written information is available, the general written information provided to the investor is supplemented by verbal information on this particular type of financial instrument. We are convinced that this is in the client's interest. A strict requirement to provide written information would mean that the client would not be able to buy the financial instrument in question. The Commission should therefore refrain from introducing a strict requirement to provide information via a durable medium.

**5. Article 3 (Requirements for information to clients - "fair, clear and not misleading")**

We categorically reject subjecting marketing communications to the information requirements imposed by Article 19 (3) of the MiFID. Marketing communications are geared to delivering a message – they cannot and are not supposed to provide comprehensive information. It is therefore wrong to subject them, as far as the "fair, clear and not misleading" criterion is concerned, to the same requirements as those applying to the provision of information under Article 19 (3). Particularly problematic under this approach is that the marketing communication itself must already contain the required information (about risks), which in some cases actually has to be prominently displayed. In some forms of marketing communication this is only possible by abandoning the communication's bold and simple style and in other cases, e.g. a newspaper advertisement, it is no longer possible at all. Such an approach is also at odds with the planned Recital 2, Article 4 (1) (see footnote 9), which expressly also allows information to be provided separately from a marketing communication in accordance with Article 19 (3) MiFID.

We therefore urge the Commission to delete the phrase "*including a marketing communication*" inserted in Article 3. At the same time, it should be made clear that the requirements currently contained in Article 3 do not apply to marketing communications. A distinction should at least be made between information about risks and marketing, for example by inserting a new second paragraph as follows:

> "2. In fulfilling the obligations under paragraph 1, the investment firm may take the specific nature of the information in question into account."

**6. Article 3 (c) (Simulated historic returns)**

The ban on using simulated historic returns imposed by Article 3 (c) is unlikely to be in the interest of clients at least where new products are involved. It is only with the help of such historic returns that the way products work in different market phases can be explained to investors.

**7. Article 6 (1) (Information about derivative financial instruments)**

The wording of Article 6 (1) does not make sufficiently clear that, as provided for in Article 19 (3) of the MiFID, information about a certain <u>type of</u> financial instrument is concerned. By way of clarification, "*instrument*" should be replaced throughout by "*type of instrument*".

**8. Article 6 (2) (Instruments incorporating a guarantee)**

In its present form, it would also not be possible to provide the information called for in paragraph 2 ("*details about the guarantor and about the terms and conditions and scope of the guarantee*") in the standardised format referred to in Article 19 (3) of the MiFID.

**9. Article 9 – old (Investor aptitude test)**

We welcome deletion of the investor aptitude test. Such a test would be senseless in practice. Furthermore, we are against delegating definition of the content and format of the test to CESR, as CESR has no legislative authority whatsoever.

**10. Article 9 (2) (Content of marketing communications)**

Paragraph 2 should be deleted. As already explained in connection with Article 3, it is not up to marketing communications to contain the information (about risks) called for under Article 19 (3) of the MiFID. Moreover, such an approach cannot be inferred in any way from the MiFID, nor is it consistent with the planned Recital 2, Article 4 (1) (see footnote 9), which expressly also allows such information to be provided separately.

We completely reject the proposed alternative version of Article 9. It is quite simply unclear, highly detailed and not implementable in practice.

**11. Article 10 (2) and (3) (Information to be requested)**

The additionally incorporated paragraph 4bis should read as follows:

> "4bis. The extent of the information to be requested under Article 19 (4) or (5) of the Directive **may** depend~~s~~ on the nature and extent of the service… involved in them."

This would provide clarification. The further alternative proposal for paragraph 4b in square brackets should, on the other hand, be deleted. Its wording is totally superfluous.

**12. Article 12 (3) (f) (Reporting obligations in case of portfolio management)**

Wording should be added to Article 13 (2) (f) to make clear that the periodic statement only has to include the information referred to in Article 12 (3) if the client has not already received this information beforehand. Otherwise superfluous duplication of information would be the result.

**13. Article 14 (3) (b) (Statements of client assets)**

It remains unclear which article of the MiFID is to be fleshed out by Article 14. Assuming that statements of client assets are concerned (showing securities held on the reporting date), it should be noted that the requirement in paragraph 3 for the information included in the statement to be based either on the trade date or the settlement date does not make sense. A statement will usually show client assets annually at the end of the year but not include transactions for the preceding period. There is no need for it to do so either, as clients will have already received confirmations of such transactions in the form of contract notes.

**14. Article 16 (2) (Investment advice)**

We welcome deletion of Article 16 (2), as it makes things clearer.

**15. Article 17 (2) (Best execution – relative importance of the factors)**

The Commission goes beyond level 1 in Article 17 (2). The MiFID does not allow any restriction to specific factors. On the contrary: Determining the relative importance of the factors is the job of investment firms, not the Commission. Furthermore, this restriction is not in the real interests of retail clients, as our experience is that these are strongly interested in prompt execution of their orders.

**16. Article 20 (1) (b) (List of execution venues)**

We believe that a complete list of the execution venues as provided for in paragraph 1 (b) is inappropriate. At present, German investment firms provide access to a large number of execution venues. Besides the German stock exchanges, these include the European stock exchanges and, in a global context, the leading stock exchanges throughout the world. Most domestic investment firms either have direct access to these execution venues or they have access via institutions within their group structure. They make use of similar structures abroad too, although they also frequently employ the services of foreign brokers. Investment firms therefore often have at least indirect access to more than 50 execution venues.
A complete list of these venues is of no additional benefit to clients. Furthermore, extra costs could arise particularly if details of changes to the list always had to be communicated to clients. Against this background, we therefore believe that it makes more sense to provide a generic description of the venues to which an investment firm has access. We thus suggest wording Article 20 (1) (b) as follows:

„b) ~~a complete list of the execution venues included in the execution policy~~ **a generic description of the venues accessible**.“

**17. Article 20 (2) (Precedence of client instructions)**

Under Article 21 (1) of the MiFID, client instructions always take precedence; such precedence must not be tied to any prior warnings. We therefore believe that paragraph 2 should be deleted. Alternatively, it would have to be made clear that business models where instructions from the client are always required – particularly the placement of orders online, for example – are not affected by paragraph 2.

**18. Article 21 (Execution of client orders)**

The word "*improperly*" inserted in Article 21 (3) in square brackets should be included in the final wording of paragraph 3, as it makes things clearer.

**19. Article 25 (Inducements)**

Article 25 meets with considerable fundamental reservations. Although Article 13 (3) of the MiFID, in conjunction with Article 18 thereof, contains comprehensive and exhaustive rules on conflicts of interest, the proposal now seeks to define inducements more precisely by referring to the general requirements of Article 19 (1) of the MiFID. We regard this as circumvention of the special rules in order to introduce further requirements not covered by Article 13 (3) of the MiFID, in conjunction with Article 18 thereof.

The relevant provisions of Articles 13 and 18 of the MiFID do not provide for any prohibition of conflicts of interest and therefore of inducements either. For this reason, paragraph 1 should be deleted. The rules should be based on what Article 18 (2) of the MiFID calls for, namely only disclosure of the "*general nature and/or sources*" of the conflict of interests.

If disclosure of conflicts of interest and thus also of inducements is required, Article 18 (2) of the MiFID calls merely for disclosure of the "*general nature and/or sources*" of the conflict of interest. Paragraph 2 should therefore be brought into line with the requirements of Article 18 (2) of the MiFID.

Should the Commission wish to largely stick to paragraph 1 in its present form despite the existing reservations, which are explained in detail above, we would point out that the wording of Article 25 (1) (b) (ii) goes too far. Article 19 (1) of the MiFID requires that investment firms act in the best interests of their clients. This requirement could be conveyed better by the following wording:

„(ii) the payment of the fee <…> ~~enhances the quality of the relevant service to the client and is not likely~~ **does not** impair compliance with the firm's duty to act in the best interests of the client."