COMMITTEE OF EUROPEAN SECURITIES REGULATORS

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FEEDBACK STATEMENT

CESR Technical Advice to the European Commission in the context of the MiFID Review – Investor Protection and Intermediaries

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Executive summary

In this Feedback Statement, CESR has sought to respond to comments made in response to its consultation paper "CESR Technical Advice to the European Commission in the context of the MiFID Review - Investor Protection and Intermediaries" (Ref. CESR/10-417). The CP was published on 13 April 2010. CESR's Technical Advice was published on 29 July 2010 (Ref. CESR/10-859).

This Feedback Statement sets out CESR's response to the issues respondents raised in respect of the following points:

Requirements relating to the recording of telephone conversations and electronic communications: CESR's technical advice to the European Commission (Commission) proposes that the existing discretion in Article 51(4) of the MiFID Level 2 Directive be replaced by a minimum harmonisation EEA recording obligation. CESR considers that such a regime would be an important step forward in terms of certainty, consumer protection, and surveillance of markets.

Execution quality data (Article 44(5) of the MiFID Level 2 Directive): CESR proposes requiring execution venues to produce regular reports demonstrating the quality of execution in shares.

MiFID complex vs. non-complex financial instruments for the purposes of the Directive's appropriateness requirements: CESR's technical advice to the Commission proposes amendments to clarify and to deliver a more graduated risk-based approach to the distinction between complex and non-complex financial instruments for the purposes of the Directive's appropriateness requirements.

Definition of personal recommendation: CESR's technical advice to the Commission proposes an amendment to the wording of Article 52 of the MiFID Level 2 Directive to clarify that investment advice can be provided through distribution channels.

Supervision of tied agents and related issues: CESR's technical advice to the Commission proposes amendments to the MiFID tied agents regime.

MiFID options and discretions: CESR's technical advice to the Commission proposes areas for further convergence with respect to the options and discretions in MiFID and its implementing measures.

I. Introduction

1. Embedded in the Markets in Financial Instruments Directive (MiFID) and its implementing measures (the MiFID Level 2 Directive 2006/73/EC and Regulation 1287/2006) is a process for reviewing certain of its provisions. On 13 April 2010, CESR published a consultation paper (CP) titled "CESR Technical Advice to the European Commission in the context of the MiFID Review - Investor Protection and Intermediaries" (Ref. CESR/10-417). The CP consulted on CESR's technical advice to the Commission on the continued appropriateness of certain provisions in MiFID relating to investor protection and intermediaries issues, as part of the MiFID Review.

2. CESR's final Technical Advice to the Commission in the context of the MiFID Review - Investor Protection and Intermediaries was published on 29 July 2010 (Ref. CESR/10-859). In parts of that Technical Advice paper, CESR identified and proposed drafting for European Union legislative changes to the MiFID Level 1 and MiFID Level 2 Directives. In other parts, CESR provided technical advice to the Commission without setting out specific drafting proposals for legislative changes, but merely setting out CESR's view on the policy approach that should be

adopted. CESR's Technical Advice will be used by the Commission to report to the European Parliament and Council on possible changes to MiFID.

3. The consultation period for CESR/10-417 closed on 31 May 2010 and CESR received 80 responses. CESR is grateful to all respondents for taking the time to provide their views. This CESR Feedback Statement (FS) comments on points raised in response to the CP.

4. A list of all non-confidential respondents can be found in Annex I, and the responses can be read on CESR's website at http://www.cesr.eu/index.php?page=responses&id=160.

II. Part 1: Requirements relating to the recording of telephone conversations and electronic communications

5. Article 51(4) of the MiFID Level 2 Directive provides Member States with the discretion to set their own national rules about the recording of telephone conversations and electronic communications (which are described in the rest of this chapter as 'recording requirements') or to have no such rules. In addition, Article 51(5) of the MiFID Level 2 Directive required the Commission to report on the continued appropriateness of Article 51(4) of the MiFID Level 2 Directive by 31 December 2009. The CP set out CESR's draft advice to the Commission for the purposes of that review.

6. In its CP, CESR asked the following questions:

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

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.

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?**

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

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?

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.

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.**

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.

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.

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

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.

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

Scope of the recording requirements

7. More respondents disagreed than agreed that there should be a mandatory recording requirement across the board. The vast majority of respondents that supported the principle of a mandatory EEA recording requirement also supported the minimum harmonisation approach advocated by CESR. Some respondents stated that the speed at which professional trading is carried out required a fast approach to clear up any miscommunication without delay. Some of these respondents also said that the proposed telephone recording requirement would allow for monitoring and checking of behaviours in firms in relation to market abuse. Several respondents thought that an EEA telephone recording requirement would send strong signals to the market on detecting and penalising market abuse.

8. Some respondents agreed that the scope of the recording requirement should be:

    a. the receipt of client orders;
    b. the transmission of orders to entities not subject to the MiFID recording requirement;
    c. the conclusion of a transaction when executing a client order; and
    d. the conclusion of a transaction when dealing on own account.

9. In addition, most respondents agreed that the recording requirement should be limited to lines explicitly designated to receive orders or orders taken through a trading room.

10. Respondents that did not support the principle of a mandatory EEA recording requirement argued that the Article 51(4) discretion should be retained. These respondents said that the introduction of a mandatory EEA recording requirement would lead to a situation where smaller banks and/or banks operating on a decentralised basis would not be in a position to offer investment advice and the receipt of orders over the telephone to clients across the whole area in which they operate. It was argued that this could lead to a significant reduction in the landscape of investment service providers and was perceived as conflicting with efforts to ensure better client protection, whilst unnecessarily limiting clients' options to communicate with their banks.

11. The overwhelming majority of CESR members continue to believe that it is appropriate to have a minimum harmonising EU recording requirement. They believe that such a requirement would not be unduly burdensome for smaller investment firms or credit institutions with a decentralised operating model. Recording requirements have not put such providers of investment services out of business or unnecessarily limited clients' options for communicating with their investment service providers in Member States that already have recording requirements of a similar scope to those CESR set out in the CP. A small minority of CESR members - supported by the statements of many of the respondents - continues to believe that the introduction of a minimum harmonising recording requirement raises proportionality issues for smaller firms, as experiences in some Member States may not be comparable to those of other Member States with highly fragmented markets.

12. Other respondents provided partial support to the proposals for recording requirements. Some respondents supported a recording requirement covering staff on trading desks, but were opposed to covering high-street/retail branches.

13. A number of respondents said that any recording requirement for portfolio managers created duplication without any substantive benefits. CESR is conscious of the need for a recording requirement to be proportionate, but also believes that it is important for competent authorities to have access to recordings that may be relevant to supervisory and enforcement work. It has therefore proposed that investment firms, when providing the service of portfolio management, should only be subject to a recording requirement when communicating with entities that are not subject to the MiFID recording requirement.

14. Several respondents said that the recording requirements should not apply to all conversations and communications with clients or potential clients, but only to conversations and communications involving orders. In addition, some respondents did not agree that there should be a compulsory recording requirement for transactions with private clients. These respondents

said that firms' relationships with these clients were close and personal and therefore argued that recording is not required to resolve disputes. These respondents said that the existing market abuse mechanisms were sufficient. Another respondent thought that there should only be a recording requirement for entities that decide to accept that method for communicating transactions. CESR's proposed recording requirements do not apply to all conversations and communications with clients or potential clients. It does not believe that there are grounds for exempting 'private clients' from the recording requirement. These clients deserve protection as much as other clients and, in instances of market abuse involving private clients, it will be as important to have relevant recordings as with conversations involving other types of clients.

15. On the exemptions to the recording requirements proposed in the consultation paper, some respondents noted that all categories, sectors and market participants should be covered in the rule. These respondents argued that smaller entities could jeopardise the purpose of the recording requirement in a similar way as larger entities. One respondent noted that CESR should prevent regulatory arbitrage through the creation of a loophole in recording requirements that can be exploited by investors who do not wish their telephone conversations to be recorded. In addition, this respondent said that CESR should reduce any advantage a firm may obtain by undertaking a transaction in a different EEA jurisdiction. Another respondent noted that the use of an employee limit raised issues around outsourcing and agency arrangements. Some of these respondents noted that any exemption (employee and orders) regime would need to be practical, carefully calibrated and based on a clear rationale and subject to cost-benefit analysis. The exemptions proposed in the CP have not been included in the technical advice to the Commission because of the practical issues they raise.

16. One respondent said that orders relating to investment fund subscription and redemption orders should be exempt from recording requirements, and argued that they do not raise market abuse issues and are subject to record-keeping requirements. This respondent also stated that the transmission of orders from final distributors/intermediaries to regional or global distributors as part of the fund distribution chain (often MiFID licensed firms belonging to the same group as the fund management company) should be exempt from the requirements as it does not entail direct contact with investors, and does not give rise to market abuse. This respondent stated that most of its members believe that in case of fund unit orders received directly from investors by a fund related MiFID entity (a very small number, as fund distribution is mostly intermediated in the EU), conduct of business rules already apply, as well as telephone recording for 5 years. This respondent proposed that telephone recording should be optional for the MiFID entity, particularly if direct orders represent a very small part of all fund orders (proportionality should be applied). CESR accepts that risks of market abuse with different categories of financial instrument are not the same. However, it believes that it still makes sense to include all financial instruments within the scope of a recording requirement to provide a uniform level of investor protection.

Retention period

17. Most respondents thought a retention period of between 6 months to 1 year was appropriate. These respondents said that disputes concerning miscommunication and investigations into market abuse do not begin after a time lag, and stated that competent authorities can request that specific recordings are kept for longer where necessary. CESR continues to believe that a retention period of 5 years is appropriate. It does not see why the retention period should differ from the general retention period for records kept under MiFID.

Costs

18. Some respondents did not think that the costs of the recording requirement would outweigh the benefits. Some respondents considered that a more in-depth analysis and impact assessment was required. Other respondents noted that in highly fragmented markets, such as those in Austria or Germany, the costs of implementing the recording requirement would be extremely high and the incidence of market abuse was low.

Issues

Data protection

19. Some respondents said that data protection and privacy issues had not been fully addressed, particularly the interaction with directives such as the EU's Data Protection Directive (95/46/EC) and the Privacy and Electronic Communications Directive (2002/58/EC). CESR notes that the Commission has recently consulted on whether there is a need to provide further clarity on the interaction between the provision in the Market Abuse Directive (MAD) concerning the right of competent authorities to "require existing telephone and existing data traffic records" and the Privacy and Electronic Communications Directive. More generally, CESR believes that the fact that many Member States already have recording obligations means that there is no fundamental clash between such an obligation and existing EU data protection and privacy legislation.

Clarification

20. Some respondents sought clarification with respect to the requirements where orders are transmitted cross-border. If recording requirements were introduced under Article 13 of MiFID, then investment firms would have to follow the requirements of their Home Member State.

Alternative proposal

21. Some respondents considered that as an alternative approach, if CESR comes to the conclusion that the solutions put in place by those Member States that have not so far opted for telephone recording are equally acceptable to achieve the identified objectives, the Committee could consider harmonising elements of telephone recording among those Member States where telephone recording is considered necessary. CESR does not believe that the solutions currently in place by individual Member States are equally acceptable. This can only be rectified through some form of harmonisation across the EEA rather than within a subset of countries.

22. Written records were proposed as an alternative, and more cost-effective, proposal to tape recording. In this respect, some respondents noted that on 1 January 2010 Germany implemented a legal obligation for conversations between clients and investment advisers to be documented. These respondents deemed the introduction of a new recording requirement unnecessary, and considered the proposal to be a disproportionate additional documentation requirement. However, the majority of CESR members do not believe that written records are an effective alternative to a recording requirement. They do not capture the entire content of a communication including, with voice communications, the tone of a communication.

III. Part 2: Execution quality data (Article 44(5) of the MiFID Level 2 Directive)

23. The MiFID best execution obligation (Article 21 of MiFID) requires firms to take all reasonable steps to obtain, when executing orders, the best possible result for their clients taking into account price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order (execution factors). The execution arrangements by which the firm achieves the best possible result should be set out in an order execution policy and should include details of the venues used to achieve the best possible result.

24. Firms are required to review, on a regular basis, the execution venues used to deliver the best possible result for the client and to consider whether they need to make changes to these execution arrangements. This assessment should require data on execution performance, for each of the venues, over a period of time.

25. In the MiFID Level 2 Directive, the review clause in Article 44(5) states that "the Commission shall present a report to the European Parliament and to the Council on the availability, comparability and consolidation of information concerning the quality of execution of various execution venues". In the CP, CESR consulted on whether or not regulatory intervention is required to ensure that investment firms have the necessary information to select appropriate execution venues to include in their execution policies.

26. In the CP, CESR stated that the Directive could give to ESMA the discretion to introduce binding technical standards and requirements for execution venues to produce regular reports on execution quality in shares. CESR said that if these reports are prescribed the metrics should at least cover price, speed of execution and likelihood of execution for individual shares.

27. In the CP, CESR asked respondents the following questions:

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?

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

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

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?

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?

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?**

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.

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?

Venue selection

28. The majority of the respondents agreed that the availability of data about prices, costs, volumes, likelihood of execution and speed across all trading venues are important for firms to make effective decisions about venue selection. One respondent said that factors such as costs and prices should be prominently considered, given retail consumer interests. However, another respondent said that the introduction of standard execution data that is solely based on price may, in the medium-long term, lead to a situation where the use of such data becomes the standard market practice, putting pressure on banks which take guidance from other factors such as execution speed and the likelihood of execution. Some respondents also noted that other factors were arguably more important for the investment outcomes and the satisfaction of retail investors, including for example the quality of investment advice and the timing of orders.

29. CESR is aware that in producing data on execution quality it will be easier to measure some aspects of execution quality than others. However, just because it is not possible to produce data covering all potentially relevant execution factors CESR does not believe that it follows that no information on any aspects of execution quality should be produced. Any data produced would not change an investment firm's obligations to consider all relevant factors when putting in place arrangements designed to achieve best execution.

30. Other respondents did not consider that firms need data on prices, costs, volumes, likelihood of execution and speed across all trading venues to make effective decisions about venues. These respondents argued that aggregated data on the "likelihood of execution" and "speed" will not be useful as they differ based on factors such as distance and types of submitted orders and measures of aggregated price destroy the information content (what is required is real-time depth-of-book data, which is currently widely distributed).

31. One respondent said that Systematic Internalisers (SIs) should be excluded from an obligation on execution venues on the basis that the decision to execute through an SI was not driven by the same factors as those in determining which execution venues should form part of an investment firms' execution strategy. CESR's view is that, given SIs are execution venues that investment firms have to consider including in their execution policies, there remains a case for including them within the scope of any execution quality data obligation.

32. Some respondents thought that execution venues' performance against execution quality for shares would be useful for the best execution annual review and said that such information for bonds was readily available.

33. Several respondents noted that firms had adequate information on which to make decisions about venue selection for shares. Others argued that execution venues already produce regular information on their performance or could make such information available through commercial solutions. These respondents did not support regulatory intervention in this area.

605 reports

34. Other respondents noted that if execution venues produce regular information on their performance against definitions of various aspects of execution quality in relation to shares, they would be capable of doing so themselves or by using a third party as happens frequently with the 605 reporting in the United States (US). Some of these respondents considered the challenge was to ensure that each venue applied a consistent approach in terms of how the benchmarks are calculated as identified in the CP.

Metrics

35. Some respondents thought that the lack of a single European Best Bid and Offer (EBBO) could lead to inconsistencies in approach which would lead to this data being treated sceptically by the firms it is intended to help. One respondent said that it would be more useful for third parties to

provide analytics to these firms that cover the competing venues with a consistent methodology. This respondent argued that a commercial solution will mean that providers will compete on price and innovation to deliver suitable services to large or small brokers.

36. Some respondents noted that the potential costs of an obligation on execution venues to provide regular information on execution quality relating to shares will greatly depend on the specific benchmarks calculated. The cost of this could vary enormously depending on the standards imposed. CESR agrees that costs are dependent on the exact nature of the reports, but believes that useful information could be provided through reports at a relatively modest cost of the sort indicated in the CP.

Issues

37. A number of respondents cited problems with developing European execution reports along the lines of the US rule 605 reports - these included:

    - Costs (implicit and explicit) and the likelihood of settlement are not included in the reports. NYSE Euronext qualifies the nature of the data they provide in the US by stating that "the data does not take into account many criteria that encompass a cost-effective order routing strategy".
    - Differences in market structures and computation methods between market centres in the US also affect the quality, comparability and usefulness of the reports, as do the exclusions of certain types of orders and orders received and executed outside normal market hours. In addition, the data does not take account of the economic impact of order flow payment on brokerage customers or the costs of institutional trading. The reports are aggregated (at security level) and therefore do not provide any basis for evaluating actual best execution performance achieved by a broker on behalf of its clients; and the reports are not really used in the US, although some small retail brokers use them to justify selection of a SI. Few consider the reports and the granularity they offer valuable.
    - Trades can be executed away from the order book in the UK which would be excluded from the quality reports; the use of algorithms and order routing to split orders and route to different venues; and the speed of execution is only applicable for marketable orders - otherwise this could simply be an inverse measure of proportion of retail limit orders parked on the book.

38. CESR agrees that any reports on execution quality data produced by execution venues could never tell the full story about the quality of execution. They would need to be assessed alongside other information.

39. Other respondents said that they would not support any proposal for the introduction of an EBBO as it would mean that other best execution factors would not be appropriately considered to ensure "best-efforts" obligations are met. The "one size fits all" solution does not meet the varying best execution needs of market participants. Off book and OTC transactions would not be reflected. All the venues listed on for the EBBO are not available to all market participants. The EBBO highlights the difficulty in defining a price benchmark that could be used for execution quality data, given the different business models of brokers. CESR notes that the fact that some data vendors already offer information on the EBBO means that it is possible to produce such statistics. Performance against the EBBO is obviously not definitive evidence of whether or not best execution has been achieved. But price is an important component of total consideration for retail clients and is also likely to be important to many professional clients.

40. Views were split as to whether there should be an obligation to produce reports on regulated markets (RMs), multi-lateral trading facilities (MTFs) and SIs. Some of the respondents did not support this and suggested making the existing obligations on investment firms clearer, so that investment firms are required to perform this analysis. These respondents said that existing and new services would provide the mechanism to do so at a reasonable cost. One respondent said that they could see no issue with the obligation falling on RMs, MTFs and SIs specifically, but

questioned the potential value of the data they would produce compared to that which a third party could provide on commercial terms. CESR agrees that it is important for investment firms to take effective steps to monitor the quality of the execution that they deliver and to review their execution policies in line with their obligations under the directive. But attention to the way in which investment firms discharge those obligations in this does not mean that the issue of execution quality reports by execution venues is irrelevant.

41. Several respondents supported restricting the coverage of the obligation to liquid shares particularly given that it is only in this area of the market that multi-venue competition really exists.

42. Several respondents supported uniform execution quality metrics across different trading venues relating to the same period of time. These respondents said that such metrics should be submitted to a careful consultation process. Other respondents thought that CESR should consider some complementary measures to encourage industry-driven solutions. One respondent argued that key metrics of execution data should be undertaken on a voluntary basis. CESR acknowledges that close consultation with stakeholders would be necessary in agreeing definitions of metrics for execution quality or the contents of execution quality reports.

Frequency of reports on execution quality

43. There were a number of views on the frequency of data quality reports ranging from one month, to quarterly and then to semi-annually. However, some respondents noted that a "one size fits all" approach on frequency was not appropriate. CESR notes that the same amount of information would need to be captured whatever the frequency of the reports and believes that the content of the reports rather than their frequency will be the key determinant of their cost.

44. A large number of respondents agreed that now is not the time to make a proposal for execution venues to produce data on execution quality for other financial instruments besides shares.

Cost-benefit

45. Respondents noted that CESR should take very careful account in its advice to the Commission of the likely costs of the different policy proposals designed to underpin or improve data quality. It is important to be aware of where such costs might disproportionately fall (small firms). Some respondents also noted that the costs would be affected by the metrics defined. One respondent raised concerns that very detailed requirements for data providers might lead to higher prices for investment firms and also for clients. CESR believes that further work is necessary on cost-benefit issues but believes that reports, if they are not over-engineered, could be produced at a reasonable cost.

Other issues

Post-trade data quality

46. Several respondents noted that CESR should undertake further work on post-trade data quality and transparency, including harmonisation of standards to improve comparability and the publication of data free of charge. One respondent noted that the introduction of discrete post-trade services would make post-trade data more affordable and would facilitate the aggregation of post-trade consolidation services by existing commercial vendors. Another respondent considered that improvements to post-trade transparency should indeed be seen as a pre-condition for a fully informed discussion of the questions raised by CESR. Improving the quality of post-trade data is an issue on which CESR has provided technical advice to the EC.

IV. Part 3: MiFID complex vs non-complex financial instruments for the purposes of the Directive's appropriateness requirements

47. The MiFID appropriateness requirements aim to increase the protection of clients (particularly retail clients) who are contemplating transactions in MiFID-scope financial instruments without receiving advice from an investment firm. It reduces the possibility of complex products being sold on an "execution-only" basis to retail clients who do not have the experience and/or knowledge to understand the risks of such products.

48. Article 19(6) of MiFID lists specific types of instruments and products that can always be treated as non-complex for these purposes. Article 38 of the MiFID Level 2 Directive then provides a set of criteria for 'other non-complex' products not specifically listed. These provisions together also indicate some specific types of MiFID products that should always be treated as "complex" for the purposes of the appropriateness requirements. However, MiFID does not seek to provide definitive or complete lists of all types of products and how they should be categorised. Since MiFID was agreed, CESR and its members have received requests for clarification of how types of products might be categorised. This led on to Level 3 guidance that was published last year. This work identified several weaknesses in the existing MiFID text.

49. In the CP, CESR proposed that MiFID should be amended in certain areas in the interests of clarity, and deliver a more graduated risk-based approach. CESR emphasised that the proposals do not reflect any changes that may be necessary in the future as a result of the outcome of discussions on a new EEA regime for Packaged Retail Investment Products (PRIPs).

50. In the CP, CESR asked the following questions:

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

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

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

51. Some of the respondents agreed with CESR's view that any type of share that embeds a derivative, including convertible and callable shares, should be treated as "complex" for the purpose of the appropriateness test. Several of these respondents also supported the production of binding technical standards that ensure consistency of application and treatment of UCITS, including those which might be treated as complex for the purpose of the appropriateness test.

52. Other respondents, whilst supporting a consistent EU-wide approach to the treatment of financial instruments as either complex or non-complex for the purposes of the Directive's appropriateness requirements, had reservations on various aspects of the proposals.

53. Many respondents did not support binding technical standards to distinguish which UCITS ought to be treated as complex for the appropriateness assessment under Articles 19(5) and 19(6). In general, these respondents considered the proposed classification of UCITS was justified by the EU standards applying to UCITS (according to risk, delivery of information to their potential clients, subjection of limits imposed by regulations, the prospectuses and supervision by competent authorities of their Member States) which are higher and stricter requirements than those affecting the other financial instruments that Article 19(6) considers non-complex. Other respondents noted that the market for UCITS is regulated and had been

conceived for retail products. These respondents also noted that greater transparency would be provided by the Key Investor Information document (KII) which would correctly assess the different categories of UCITS products and the diverse risks. These respondents said that consumer protection is best served from such a risk-based and client-point-of-view approach, rather than from a financial or technical analysis of intrinsic features. Other respondents noted that the potential treatment of some types of UCITS structures as not automatically non-complex would be too strict in terms of investor protection and would lead to great uncertainty, which could limit product diversity and impose an unnecessary burden on the industry. Some of these respondents noted that a partial exclusion from the definition of complex/non-complex should be avoided as it would create problems for distributors and advisors in terms of defining UCITS as well as access to information regarding underlying investment strategies. The latter was considered to directly affect investor understanding. Therefore, several of these respondents considered the current regulatory regime for Collective Investment Undertakings for the purposes of the Directive's appropriateness requirements was accurate and appropriate.

54. CESR decided that it was not appropriate to deal with the issue of the treatment of UCITS for the purposes of the appropriateness test in its technical advice to the Commission. It acknowledges that this raises some important and difficult issues. A possible policy approach is outlined in CESR's response to the 'European Commission's request for additional information from CESR in relation to the review of MiFID' (Ref. CSER/10-860, see Question 15), although CESR also points out some of the practical difficulties that could arise from changing the current approach.

55. A number of respondents also disagreed with the MiFID classification of products according to the notion of complexity. Several other respondents thought that the notions of "risk" and "complexity" were being confused and stated that the two are not interchangeable. One respondent said that the definition of complex financial instruments should be based on the notion of risk. These respondents argued that some very simple products can be risky and some complex products can be low risk. These respondents thought that it would be useful for CESR to clarify its position. One respondent suggested that it would be more correct within CESR's technical advice to refer to "a more graduated approach, based on the capability of retail investors of understanding the risks involved in relation to each financial instrument" instead of the current reference to "a more graduated risk-based approach".

56. Some respondents did not believe that the issue of complex/non-complex products should be re-opened at all in the current MiFID review.

57. Following on from the Level 3 work that CESR did on the appropriateness test, CESR does not believe that issue of complex/non-complex products can be ignored. The current language in the directive gives rise to uncertainty and does not necessarily achieve what it was intended to do as effectively as it might.

58. Some respondents supported CESR's proposal to clarify the reference to shares (Article 19(6) of MiFID), but considered that the proposal should be amended to cover shares admitted only to trading on MTFs (the examples provided were AIM and Aim Italia). One respondent said that it was inappropriate to treat shares as non-complex specifically under the condition that they are traded on an EU regulated market or on an equivalent third country market. This was considered to make the trading venue the determining factor for (non-)complexity. This respondent considered that the focus of European banks should instead be on the substance of the investment product rather than its trading venue. CESR accepts that admission to trading on a regulated market can be seen as a proxy for certain economic characteristics of a share. However, it does not believe that it would be proportionate to treat every financial instrument on a case-by-case basis according to the specific venues on which it may be traded, for the purposes of determining whether or not they are complex or non-complex.

59. In addition, some respondents argued that shares categorised as non-complex for the purpose of the appropriateness test should only cover ordinary shares (voting or non-voting), while other

respondents considered that preferred shares should be also be included as automatically non-complex. In addition, several respondents considered that it was not appropriate to exclude shares in non-UCITS from being treated as automatically non-complex. These respondents consider that the proposal contradicts CESR's approach to the Article 38 criteria, and would be discriminatory because it would exclude investments equivalent to shares in companies, such as non-UCITS Exchange Traded Funds (ETFs). CESR does not believe that its proposal to clarify the reference to shares in Article 19(6) of MiFID is discriminatory. Shares in non-UCITS collective investment undertakings are clearly of a different nature to shares in companies and they also stand outside the regulatory framework of UCITS. It is therefore appropriate that the criteria in the MiFID Level 2 Directive should be used to determine whether or not they are complex or non-complex.

60. One respondent said that the Directive should be amended to extend the UCITS approach and treat as non-complex, benchmark certificates which track performance of a benchmark index and do not as a rule have an embedded option. CESR believes that rather than overcomplicating the Level 1 text, it is better that such financial instruments are judged against the criteria in the MiFID Level 2 Directive. It is not clear that all such instruments should be treated as automatically non-complex.

61. Another respondent argued that bonds, banks' Euro Medium Term Notes (EMTNs), and money market instruments such as treasury bills, certificates of deposit and commercial paper (either straight or asset-backed) are traded on non-transparent, unregulated and often illiquid markets (e.g. in 2008) with very difficult access for the retail investor, and queried why they should be treated as non-complex instruments for the purpose of the appropriateness requirements. CESR has sought to work within the existing broad framework of Article 19(6) of MiFID in providing its technical advice to the Commission. Its advice therefore attempts to refine rather than completely remake every aspect of the existing text. However, CESR has proposed refinements to MiFID's treatment of bonds and money market instruments in its Technical Advice to the Commission.

62. CESR also received a request for clarification on how complex products have been categorised and how the PRIPs discussions will impact CESR's MiFID Review work. This respondent also raised concerns that the Alternative Investment Fund Managers Directive (AIFMD) could dictate that investment firms' trusts and non-UCITS retail schemes (NURS) are complex, which could have a material impact on firms' business models in respect of execution-only sales to retail clients. In particular, the respondent was concerned that investment trusts also traded on regulated markets and should not be distinguished from any other such security. CESR's work has been based on the legislative framework as it currently stands. It has not been able to take account of either potential new directives (e.g. on PRIPs) or directives still currently under negotiation (e.g. the AIFMD).

V. Part 4: Definition of personal recommendation

63. Article 52 of the MiFID Level 2 Directive states that where a recommendation is made available exclusively through a distribution channel or to the public, it is not a personal recommendation and does not therefore constitute investment advice under MiFID.

64. CESR clarified the definition of 'investment advice' in an earlier CP ("Understanding the definition of advice under MiFID" - Ref. CESR/09-665) and provided illustrations of situations where firms are deemed, or not, to be providing investment advice and also asked market participants to consider whether the current definition of 'investment advice' under Article 52 of the MiFID Level 2 Directive required greater clarity.

65. In the CP (Ref. CESR/09-665), CESR provided its view that the current wording of Article 52 of the MiFID Level 2 Directive, with regards to the issuance by intermediaries of recommendations exclusively through distribution channels, no longer adequately protects clients against the growing number of intermediaries who now use distribution channels such as the internet and other similar means to provide personal recommendations. Therefore, CESR consulted on its proposed advice that the words 'through distribution channels or' are removed from Article 52 of the MiFID Level 2 Directive in order to clarify that investment advice can be provided through distribution channels.

66. CESR believes that clarification is needed that the provision of personal recommendations exclusively through distribution channels amounts to investment advice as defined under Article 4(1)(4) of MiFID.

67. CESR made clear in its Questions & Answers ("Understanding the definition of advice under MiFID" - Ref. CESR/10-293) on investment advice that a personal recommendation can be provided through means such as the internet or mailings.

68. CESR's recommendation is not intended to represent a change in the substance of what constitutes investment advice. Information provided through distribution channels will only be investment advice where it meets the other criteria for information to be considered a personal recommendation in Article 52 of the MiFID Level 2 Directive.

69. In the CP, CESR asked the following question:

> **24. Do you agree with the deletion of the words "through distribution channels or" from Article 52 of the MiFID Level 2 Directive?**

70. Respondents who supported the CESR proposals said that it would establish a standard European interpretation of personal recommendation for the purposes of the definition of investment advice and create a level playing field. The proposed deletion of "through distribution channels or" from Article 52 of the MiFID Level 2 Directive was considered to reflect the reality that it is possible for the internet to be used to deliver investment advice which fulfils the criteria for a personal recommendation.

71. Respondents that offered partial support to the proposal supported the clarification of Article 52, but thought that the removal of "through distribution channels or" from Article 52 of the MiFID Level 2 Directive could have an impact on investment research. These respondents stated that the definition of investment research is a recommendation that is intended for distribution channels or for the public and therefore falls out of scope of investment advice because a recommendation is not a personal recommendation if it is issued exclusively through distribution channels. These respondents considered that removing the restriction that a personal recommendation cannot be issued exclusively through distribution channels would create concerns among firms that investment research could then be considered as a personal recommendation. One respondent suggested that if CESR were to maintain its proposal to delete

the wording on distribution channels in the definition of a personal recommendation, then the following wording should be added to Article 52: "A recommendation is not a personal recommendation if it is issued exclusively to the public or if it is investment research as defined in Article 24(1)".

72. A number of respondents did not agree with the proposal and considered that if electronic or similar devices are used to give personal recommendations (and hence to give advice) this should not affect the fact that in such cases those channels represent "communication channels" rather than "distribution channels". In addition, other respondents noted that it was of great importance to maintain a clear distinction between personal advice, research, and marketing material. These respondents stated that the definition of personal recommendations should not depend on the medium of communication, but rather on the way in which recipients are addressed. The key criterion in this respect is whether or not correspondence is clearly based on the analysis of an individual's investment needs. While some media are better suited than others to personally address investors in this way, the medium used does not automatically determine whether a communication amounts to investment advice. MAD strictly bans the assimilation between personal recommendation and financial analysis. One respondent did not perceive a need for any change to the current legal text, but stated that if CESR believes there is a need for clarification, the current wording could be maintained, but adding: "and contains no consideration of the personal circumstances of the clients to whom it is distributed".

73. Another respondent noted that CESR had already clarified the scope of Article 52 with specific reference to recommendations made through distribution channels (especially when firms use this channel for providing their clients with investment research) in its feedback statement on "Understanding the definition of advice under MiFID" (Ref. CESR/10-294). This was considered to have clarified the text and removed any risk of misunderstanding and the need to modify Article 52.

74. CESR acknowledges the concerns raised about the impact of its proposal on the possible overlap between investment research and investment advice. However, CESR does not believe that its proposal should significantly change the existing position in this respect. A key differentiation between investment advice and investment research is that the former is based on a consideration of the circumstances of the target audience, whilst the latter is not. CESR believes that this distinction is clear already in MiFID and that it is not necessary to include additional language in MiFID to underline it. Without the change that CESR is proposing, whether or not a communication counts as investment advice is not currently neutral with respect to the means of communication used, and is something which the Questions and Answers CESR has issued on investment advice cannot rectify.

VI. Part 5: Supervision of tied agents and related issues

75. In the CP, CESR asked the following questions:

> **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?**
> **26. Do you agree with the proposed amendments to Articles 23, 31 and 32 of MiFID?**
> **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?**

76. Many respondents did not comment specifically on this section because they, or their members, do not rely on tied agents. Of those that responded, most considered that the tied agents regime had worked well and agreed with CESR's proposals – especially where they are aimed at further harmonisation.

77. However, a number of respondents did not agree with the proposed prohibition of tied agents from handling clients' money and financial instruments. Several respondents considered that tied agents in Europe are an important distribution channel for credit institutions that handle clients' money and financial instruments, with no reported problems. These respondents considered that credit institutions employ robust procedures to ensure that tied agents comply with high standards of integrity. It is also clear that the credit institutions remain fully and unconditionally responsible for any action or omission on the part of tied agents used by them. These respondents did not consider that there needed to be a level playing field between tied agents of investment firms and tied agents of credit institutions, and considered that if tied agents of credit institutions were to be prohibited from handling clients' money and financial instruments it would have an enormous impact on the business of tied agents of credit institutions active in Europe and perhaps even lead to the end of the distribution model of tied agents in some countries. In addition, one respondent stated that as a number of tied agents also have an important activity as insurance intermediary, the proposals could also affect their business as insurance intermediary causing a disadvantage towards those insurance intermediaries not prohibited from handling client money.

78. It was not CESR's intention to bring into question the fact that the current provision in the directive governing tied agents handling client money and/or financial instruments does not apply to the tied agents of credit institutions. For the avoidance of doubt, CESR is not proposing any change in this regard. It simply wanted to draw to the Commission's attention the difference in treatment for passporting purposes between the tied agents operating for investment firms and those operating for credit institutions.

79. Another respondent considered that it would be a huge burden for competent authorities to be obliged to transmit the identity of any tied agent acting on a cross-border basis to a host authority, and will have no added value. CESR is of the view that this burden is eminently manageable and increases investor protection.

80. One respondent asked for clarification on whether a tied agent may act on behalf of several investment firms and/or credit institutions within the same group (group level consideration). Recital 36 of MiFID makes it clear that tied agents can only act on behalf of one investment firm in relation to the provision of investment services. However, Recital 37 makes it clear that this is without prejudice to the rights of tied agents to undertake activities under other Directives.

Part 6: MiFID options and discretions

81. MiFID and its implementing measures include 41 discretions, allowing Member States to implement non-harmonised requirements at a national level. Although the use of discretions within MiFID is fully legitimate, the Ecofin Council conclusions of December 2007 aimed at reducing discretions, and the Ecofin Council conclusions of May 2008 and June 2009 intended to enhance European supervisory convergence more generally.

82. The Road Map on the revision of the Lamfalussy process set up by the Ecofin Council in December 2007 invited Member States to keep under review the options and discretions implemented in their national legislation and to limit their use wherever possible. In a similar way, the Communication of the European Commission of 4 March 2009 took on board the recommendations of the de Larosière Group on the need to develop a harmonised core set of standards to be applied throughout the European Union, and the Ecofin Council recalled in its meeting on 9 June 2009 the following goal: Moving towards the realisation of a single rulebook, with a core set of EU-wide rules and standards directly applicable to all financial institutions active in the Single Market, so that key differences in national legislations are identified and removed.

83. Therefore, based on the work conducted by CESR since 2007[1], options and discretions in relation to MiFID and its implementing measures were considered in the CP with the aim of singling out some possible areas for further convergence in light of the MiFID review, in relation of those options and discretions relating to the investor protection and intermediaries provisions of MiFID and for which it is appropriate at this stage to provide input to the Commission.

84. In the CP, CESR asked:

> **28. Do you agree with the suggested deletions and amendments to the MiFID texts proposed in this chapter?**

85. Many respondents agreed with CESR's proposals for MiFID's options and discretions, and considered that from an investor protection point of view, it is advantageous to have the same level of protection throughout all Member States.

86. However, several respondents did not agree with the CESR proposals to change the recording discretion in Article 51(4) of the MiFID Level 2 Directive (2006/73/EC) to a rule. This issue is dealt with in the first part of this FS.

87. In addition, several respondents did not support the proposals to transform the discretion in Article 61(1) and (2) of MiFID (Powers of host Member States) into a rule. These respondents thought that EU regulators already had the power to request information and considered that the discretion should be with each national competent authority rather than introducing a binding rule to deliver certain information. It was argued that the proposal could lead to burdens for investment firms. CESR does not accept this view. The change proposed does not involve a requirement on competent authorities to request information about branches. Instead, it involves competent authorities having the power to request such information. Exercise of these powers will not be automatic.

[1] In October 2007, before MiFID came into force, CESR published an "Overview of National Options and Discretions under MiFID Level 1" (Ref. CESR/07-703), which showed if and how Members States have exercised discretions in implementing MiFID. In 2008, the Review Panel conducted a mapping on MiFID, focusing on "Supervisory powers, supervisory practices, and administrative and criminal sanction regimes" (Ref. CESR/08-220).

Annex I: List of non-confidential respondents

Alternative Investment Management Association, UK (AIMA)
Association des Banques et Banquiers - Luxembourg Bankers' Association, Luxembourg (ABBL)
Association of British Insurers, UK (ABI)
Association of Danish Mortgage Banks, Denmark (Realkreditradet)
Association Française de la Gestion financière, France (AFG)
Association Française des Investisseurs Institutionnels, France (Af2i)
Association française des marchés financiers, France (AMAFI)
Association nationale des conseils financiers, France (Anacofi)
Association of Private Client Investment Managers and Stockbrokers, UK (APCIMS)
Associazione Bancaria Italiana - Italian Banking Association, Italy (ABI)
Associazione Italiana dei Consulenti Finanziari Indipendenti, Italy (AssoFinance)
Associazione Italiana Intermediari Mobiliari - Italian Association of Financial Intermediaries, Italy (Assosim)
Associazione Nazionale Promotori Finanziari, Italy (ANASF)
Associazione del risparmio gestito, Italy (Assogestioni)
Austrian Federal Economic Chamber - WKO Bank, Austria
Banco Comercial Portugues, Portugal (BCP)
Banque et Caisse d'epargne de l'etat, Luxembourg (BCEE)
BATS Trading Limited, UK
Belgian Asset Managers Association, Belgium (BeAMA)
Bloomberg, UK
Bocconi University, Italy
Börse Berlin, Germany
Börse Düsseldorf, Germany
British Bankers Association/Association for Financial Markets in Europe/Futures and Options Association (joint response), UK
Burgundy, Sweden, Norway, Finland and Denmark
Bundesverband Investment und Asset Management, Germany (BVI)
CFA Institute, Belgium
Chi-x Europe, UK
City of London Law Society, UK
CNMV Advisory Board, Spain
Dansk Aktionaerforening - Danish Shareholders Association, Denmark
Deutsche Bank, UK
Deutsche Börse, Germany
Deutsche WertpapierService Bank, Germany (DWPbank)
European Association of Co-operative Banks, Brussels (EACB)
European Association of Corporate Treasurers, France (EACT)
European Association of Public Banks, Brussels (EAPB)
European Banking Federation, Brussels (EBF)
European Federation of Investors, Belgium (Euroinvestors)
European Fund and Asset Management Association, Brussels (EFAMA)
European Savings Bank Group (ESBG)
Euroshareholders, Belgium
Fédération des Associations Indépendantes de Défense des Epargnants pour la Retraite, France (FAIDER)
Federation Bancaire Francaise - French Banking Federation, France (FBF)
Fédération Européenne des Conseils et Intermédiaires Financiers, Belgium (FECIF)
Fidelity International
Fogain - Spanish Investors Compensation Scheme for investment firms, Spain
Investment Management Association, UK (IMA)
Irish Banking Federation, Ireland (IBF)
KBC Asset Management, Belgium
Liquidnet Europe Limited, UK
London Stock Exchange Group, UK

NASDAQ OMX
National Association Fee Only Planners, Italy (NAFOP)
Nordic Securities Association (NSA)
NYSE Euronext
Quote MTF Limited, Hungary
Spanish Association of Collective Investment Schemes and Pension Funds, Spain (Inverco)
Swedish Investment Fund Association, Sweden (SIFA)
Test-Achats, Belgium
Teste Pour Vous, France (ESTCF)
Thomson Reuters, UK
UNI Europa Finance, Belgium
University of Bologna, Italy
Verband der Auslandsbanken in Deutschland - Association of Foreign Banks in Germany, Germany (VAD)
Verband unabhangiger Vermogensverwalter - Association of Independent Fund Managers, Germany (VuV)
Zentraler Kreditausschuss, Germany (ZKA)