



EUROPEAN COMMISSION

Internal Market and Services DG

FINANCIAL SERVICES POLICY AND FINANCIAL MARKETS
Securities markets

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Working document ESC/18/2005

Explanatory note: Main differences between working document ESC/ 17/2005 and the CESR level 2 advice

1. SCOPE OF THE WORKING DOCUMENT

The purpose of working document ESC/17/2005 is to prepare for future discussions on the draft level 2 implementing legislation with respect to four issues:

- General organisational requirements for Investment Firms, including outsourcing (article 13.2, 4 and 5).
- Requirements relating to the records that an Investment Firm must keep (article 13.6).
- Requirements relating to the safeguarding of client funds and financial instruments (article 13.7 and 8).
- Measures for dealing with conflict of interest (articles 13 and 18).

2. DIFFERENCES OF THE COMMISSION WORKING DOCUMENT WITH CESR'S ADVICE

The Commission working document is largely based on the advice that the Commission received from CESR on 31 January 2005. However we have made some policy adaptations, and some technical modifications and drafting changes in order to transform the advice into a legislative format.

3. OVERALL POLITICAL APPROACH

There are three main political considerations that guided the drafting of the text and that might have caused divergences from the approach taken by CESR.

- (1) Investor protection – we have decided to be very exacting when it comes to issues concerning investor protection and the draft text may therefore be more stringent than the CESR advice in some areas.
- (2) Reliance on clear principles – in order to avoid legislation that is too prescriptive, we tried to follow an approach that is demanding yet flexible in allowing firms to organize their business in a manner they consider

appropriate as long as the underlying regulatory objectives are met and as investor protection is not undermined.

- (3) Establishment of a Single market – in certain areas (e.g. record keeping) the draft text goes further than CESR proposal in promoting common standards for all firms, valid throughout the EU as well as in reducing red tape and avoiding regulatory duplications for firms operating in several jurisdictions.

3.1. Policy adaptations

- Compliance, Risk Management and Internal Audit Function;

The CESR advice consisted in a formal separation of different functions within the Investment Firm. This regulation of discrete functions, although useful in respect of certain activities, is restrictive in its approach since it as it does not allow a focus on the general organisation of the Investment Firm and the ability of that organisation to meet the relevant requirements in a global manner.

In order to improve the understanding of the way organisational requirements are regulated and to avoid practical problems concerning the scope of the different organisational principles that are dealt with separately in the CESR advice, we have considered it useful to establish, in article 3, a set of high level principles that are common to the different functions identified by CESR, and will be applicable to the overall organisation of investment firms.

In addition to those general principles, we have singled out three specific objectives that, because of their importance, we consider should be subject to further regulation. These objectives are compliance, internal audit and risk management.

In respect of compliance we have followed CESR advice and differentiated between the general compliance objectives and policies on the one hand, and the requirement for formal compliance arrangements or a compliance department on the other. We have adopted CESR's recommendation that all investment firms should establish a compliance function because of the important regulatory considerations that are at stake. The same functional approach has also been followed in respect of internal audit.

However, we have departed from CESR's functional approach in respect of risk management. We propose that the Regulation will require investment firms only to establish adequate arrangements to identify and manage its risks as well as to monitor them, without obliging them to establish a formal risk management function. **Our decision reflects our view that, where possible and where it does not compromise investor protection, regulation should be sufficiently flexible to allow the investment firms to achieve the regulatory objectives through the means they consider most appropriate to their size and structure and the nature of their business.**

Certain elements of CESR's advice – in particular those dealing with accounting specificities and the Code of Conduct - are not included in our Working Paper. We consider that these issues are more appropriate for Level 3 guidance, and can be dealt with adequately and comprehensively by CESR at that Level.

- Outsourcing of Investment Services and Activities;

Contrary to CESR's recommendation, we do not think that there should be any specific limitation on firms' ability to outsource Investment Services or Activities to non-authorised entities in cases when the service or the activity is not subject to authorisation in the jurisdiction of the service provider.

We consider that the obligation on investment firms to select an adequate service provider and to monitor closely its activities, together with the power conferred on competent authorities by the Directive to analyse the outsourcing arrangements of investment firms and to oppose any arrangement that could be detrimental to the stability of the firm (see article 12 of the Working Document) are sufficient to achieve the regulatory objectives related the sound management of the investment firm as well as investor protection. Therefore, any additional limitation to the firm's freedom to organise its activities is not, in our opinion, justifiable.

- Record keeping – Telephone orders;

We agree with CESR that, for reasons of investor protection and for facilitating the supervision of the activities of investment firms, telephone conversations whereby orders are given must be recorded. We do not agree, however, that there should be a mechanism for waiving that obligation as CESR proposes.

Our preliminary research indicates that a great variety of systems for recording telephone conversations are readily available and that maintaining this type of arrangement is not necessarily expensive. Prices for telephone recording systems range from under one hundred euros to hundreds of thousands of euros, depending on the level of sophistication of the system. We believe that even the cheapest types of the system could, possibly in combination with other arrangements, comply with the obligations of the draft text.

In the absence of any overriding reason relating to excessive costs to firms or the material impossibility of compliance with the obligation, we take the view that considerations of client protection and the fair and orderly functioning of the market should prevail.

- Record Keeping – the list of records;

We consider that the Mifid and its implementing legislation should serve two important objectives in respect of the records that investment firms are obliged to maintain. The first is that firms should be certain as to which records they are required to keep, and the second is that there should be some rationale as to which records are required.

We think that neither of these objectives would be met if the Level 2 measures were based on CESR's advice, which consists of a list detailing the records which, as a minimum, the firms will be required to keep. We are not convinced that establishing a minimum list of records would result in any real benefit either for investment firms or for competent authorities. Neither do we believe that a measure of this kind would substantially contribute to the creation of the single market.

Therefore we are proposing a different system that consists in:

- o Clearly limiting the records that firms must keep (for the purposes of the Mifid) to those required by the Mifid and its implementing legislation;

- Obliging CESR to draw a harmonised list with all those records including the practical details in respect of their form and content.
- Allowing competent authorities to oblige firms to keep additional records (to those in CESR's list) only if that is necessary for reasons specific to the national market or the financial instrument and the objective of that obligation is not already met by community legislation;
- Obliging competent authorities to make available to firms the list of records that they must keep (consisting of those required by the Mifid and its implementing legislation as detailed in CESR's list and any additional records required by the national competent authorities).

We consider our approach to be important from the industry's point of view as one of the most common complaints is that investment firms are never certain as to what records they should keep in each Member State.

A revision clause is included in order to evaluate the functioning of the system described above by 2010.

- Safeguarding of Client Assets:

We consider that the level 1 Directive is based on the principle that client assets have to be protected, and for that purpose the Directive provides that "adequate" arrangements must be put in place. In order to be adequate, such arrangements must take into account, where applicable, the different legal regimes that could affect the protection of the client's rights, and their rights to property in particular. We think that although CESR's advice is on its face consistent with the Level 1 Directive, it might nevertheless undermine that balance between the Community requirement and national law in so far as it proposes that the principle of protecting clients' assets should be subject to any limitations on property rights etc. under the national law of the States in which the assets are deposited.

We have chosen to avoid any possibility of confusion, and have therefore focussed on the nature of arrangements themselves and avoided references to the general principle. This approach is also consistent with the scheme of the Directive, which envisages that the arrangements will be the object of Level 2 measures.

This does not mean that the arrangements themselves should not be adapted to national law. We intend that the proposed measure should retain the flexibility for firms to take into account the systems of law applicable to the arrangements by which client assets are held, and proportionate nature of the arrangements adopted; but only provided that the general principle of protection remains untouched.

We have also added a provision designed to encourage the use of jurisdictions that regulate the depositing of client financial instruments and funds, and to limit the use of jurisdictions where that activity is not regulated to those cases where it is necessary to the provision of the service. We consider that this provision will enhance the protection of client financial instruments and funds.

- Conflicts of Interest:

We have tried to ensure that the implementing measures do not go beyond the limits of the Level 1 text. The Directive imposes the objective of ensuring that firms and their personnel can identify with sufficient certainty those situations that might give rise to a conflict of interest. In this respect, we consider that the CESR recommendation is too open and that it does not give a clear answer to the issues that the Directive envisages should be resolved. In particular, we do not consider that it deals adequately with the means of determining the types of conflicts of interest to which the Directive refers.

For these reasons we have included a clear, although open, list of the generic situations that should be treated, where they arise, as conflicts of interest detrimental to the client for the purposes of the Mifid. We think that this approach is preferable to that recommended by CESR, which presented those situations as illustrative *examples*.

On the other hand, in respect of the list of organisational measures for managing conflicts of interest which was proposed by CESR we have decided to make it mandatory if those measures are appropriate in light of the type of conflicts to which the firm is subject. We share CESR's opinion that the application of these measures will adequately deal with the vast majority of conflicts of interest. For this reason and for reasons of investor protection we have reformulated the way in which these obligations apply. Some flexibility is needed in cases where such measures will not be appropriate or sufficient and this is the reason why we allow firms to apply additional or alternative measures.

Inducements

The issue of inducements will be dealt with in one of the subsequent draft texts.

4. OTHER TECHNICAL MODIFICATIONS AND DRAFTING CHANGES

See Table in annex.