



EUROPEAN COMMISSION

Internal Market and Services DG

Brussels, 11 July 2005

**Working document ESC/24/2005**  
**Explanatory note to working document ESC/23/2005 and to the addendum of the**  
**working document ESC/17/2005 on investment research**

**A. PRINCIPAL DIFFERENCES BETWEEN WORKING DOCUMENT ESC/23/2005 AND THE CESR ADVICE**

**1. SCOPE OF WORKING DOCUMENT ESC/20/2005**

The purpose of the working document is to prepare for future discussions on the draft Level 2 implementing legislation with respect to six major issues:

- Definition of Investment advice (Article 4 par (1) 4)
- Commodity Derivatives (Article 4 par (1) 2)
- Conduct of Business Rules (Article 19 par (1) to (8)).
- Best Execution (Articles 21).
- Order handling rules (Article 22 par (1)).
- Eligible counterparties (Article 24).

**2. DIFFERENCES BETWEEN THE COMMISSION WORKING DOCUMENT AND CESR'S ADVICE**

The draft contained in the Commission working document is largely based on the advice that the Commission received from CESR on 30 April 2005. However we have made some policy adaptations, some technical modifications as well as some drafting changes in order to transform the advice into a legislative format.

**3. OVERALL POLITICAL APPROACH**

The principal purpose of Directive 2004/39/EC provisions to which the proposed measures relate was to create a fair and efficient market where the interest of investors, especially retail investors, could be adequately protected. It is essential to respect those

guiding principles of the level 1 text while proposing regulation which is not excessively prescriptive and burdensome.

In terms of concrete policy and technical choices, our proposed approach at level 2 consists in reinforcing the fiduciary duties of the investment firms towards their clients (and especially towards retail clients). In particular, we refer to the rules we are proposing in respect of best execution and inducements: retail clients should be able to participate in a market where proper price formation is ensured (at least in respect of the retail market segment) and where investment firms are not permitted to carry on their business with an unjustified partiality that could jeopardise the interests of their clients or certain kinds of clients.

Since we proposed reinforced fiduciary duties, in formulating the information requirements as part of the conduct of business rules, we took the view that the information which firms must give to their clients should be limited to those elements that are essential for the client to understand the nature of his relationship with the firm, and the services and instruments offered by the firm. Accordingly, we have tried as far as possible to avoid overloading clients, and retail clients in particular, with information that would be of no immediate use to them.

As an alternative to traditional methods by which information is communicated, we are exploring an option for retail clients to opt for a light touch information regime. However, as a pre-condition for choosing that option, a client should demonstrate that he is sufficiently knowledgeable and has an adequate understanding of financial. To this end we propose in Article 9 an “investor aptitude test”, which would consist in setting an objective method for certifying that an investor has the necessary level of knowledge and understanding of financial business. The motivation for this “investor aptitude test” is to explore a more efficient and targeted solution that responds in a calibrated way to needs of retail investors. Nevertheless, effective investor education is a prerequisite to this approach. CESR could play a crucial role in this initiative by exploring ways of setting up the test at EU level. Alternatively, the test could be carried out in conjunction with existing investor education programmes. However the test is implemented, we consider that a harmonised content and format should be established in order to ensure an equal level of investor protection throughout the EU.

#### **4. Policy adaptations and issues for discussion**

##### Marketing Communications

After some consideration, we have concluded that we should not prescribe at level 2 the content and the characteristics of marketing communications. Our policy has been based on establishing some guiding principles in order to determine when all information is to be considered as “fair, clear and not misleading” without establishing any specific rules for marketing communications in this respect. We think that this approach will give firms and competent authorities sufficient flexibility in order to deal with marketing communications in an effective manner.

##### Client agreement

Our approach is that the client agreement should be dealt with only insofar as it forms a part of the record keeping obligations referred to in Article 19 (7) of the Directive. We agree with those aspects of CESR’s advice which provide for harmonisation of those record keeping obligations and the information requirements linked to the record keeping obligations. However, we consider that harmonising not only the content of the records

but also the contents of agreement itself or its legal form goes beyond the requirements of the level 1 text and the related level 2 powers granted to the Commission. Moreover, such an approach would have considerable implications for the civil law of Member States, and we consider that a level 2 instrument is not the appropriate place to deal with matters of that kind. Furthermore, any prescription of the content or form of client agreement might create serious problems with significant financial implications for firms which would need to redraft their contracts, and to “repaper” their clients if existing agreements were not consistent with the prescribed model.

### Best Execution

Best execution is considered the most effective means of ensuring transparency (through an effective interconnection of execution venues) and the protection of clients in a market environment where a multiplicity of different trading venues are available. It is essential that client orders (and retail client orders in particular) are routed to those venues where the best price/cost is offered. We believe that in order to strengthen enforceability of best execution obligations, a high level of clarity of the rules needs to be established at least in relation those clients. Accordingly, the proposed measures specify that price/cost should be the most important factor for determining the best possible result for retail clients. However, we do not make this price/cost principle absolute, and neither do we prevent the emergence of new business models because the Directive expressly recognises the right of clients to override that price/cost principle.

In addition, since the price/cost principle will oblige investment firms to include in their execution policies those venues that consistently offer the best prices, we consider that that principle should be reinforced by other measures that are a necessary precondition of its effective implementation. To this end we have included an obligation for execution venues (that is, regulated markets, multilateral trading facilities and systematic internalisers) to disclose their execution quality. This is a measure that has proved extremely useful in other markets (for example, the US). We think that, through transparency, the obligation will promote competition between execution venues and ensure an adequate order flow. With this information readily available, not only clients, but above all, investment firms themselves as well as regulators can be aware of the steps needed to assure best execution.

### Inducements

Our starting point is that inducements should not be subject to “one size fits all” regulation: it is conceivable that some kinds of inducements are acceptable in circumstances where other kinds are not. We think this principle is relevant irrespective of whether we take a flexible or a strict approach. In our opinion, establishing a flexible general rule (the approach taken in the CESR advice) entails the risk that it would permit the acceptance of inducements that should properly be prohibited. On the other hand, adopting a restrictive policy could result in the prohibition of inducements that are useful for the provision of the service, and which could be dealt with through disclosure of the inducements.

We consider that some more thought should be given to this issue, it would be preferable to categorise the different kinds of inducement and provide for a differentiated treatment according to each category so as to maintain the flexible policy where that is appropriate, while imposing more restrictive requirements where necessary to protect the interests of clients.

We would be particularly keen to receive feedback on this issue from all interested parties.

### Commodity Derivatives

With respect of physically delivered commodity derivatives, we interpret the Directive as requiring only those types of derivatives that raise specific concerns with respect to market stability or to investor protection to be subject to regulation. To that end we have proposed to delimit the regulatory scope of the MiFID through a test that relies mainly on determining whether those contracts, although traded OTC, are traded in a manner similar to that of other more organised venues such as RMs and MTFs (the market test).

In this sense we are in favour of a harmonised approach at EU level; we consider that additional regulation at national level or differentiated national approaches could affect the correct functioning of the single market.

Furthermore, we do not think that the Directive requires a contract by contract approach to determining whether such contracts are financial instruments. Such an approach could lead to a situation where the contracts with the same terms could be categorised differently solely on the basis of the status or the intention of the parties. Nevertheless, as we were not entirely certain of all the consequences omitting a test based on intention or probability of delivery, our proposal retains an element that might lead to such differential categorisation (Article 28.1.a).

In relation to Article 28 of the working document we have two questions:

- Is the market test that we are proposing sufficiently restrictive to include only those derivatives that, although traded OTC, are traded in a manner similar to that of other more organised venues such as RMs and MTFs?
- Should there be any “probability of delivery” test<sup>1</sup> (paragraph (1)(a) of Article 28)?

We therefore invite Member States and interested parties to indicate whether they agree with our approach, and to provide us with all the elements they consider necessary in order to establish a market test that is sufficiently restrictive.

## **4. OTHER TECHNICAL MODIFICATIONS AND DRAFTING CHANGES**

See Table in Annex.

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<sup>1</sup> This test was (in essence) included in CESR’s advice.

## **B. EXPLANATORY NOTE TO THE ADDENDUM TO WORKING DOCUMENT ESC/17/2005 ON INVESTMENT RESEARCH**

An addendum to Working Document ESC/17/2005 is also attached in order to deal with conflict of interest related to Investment Research.

The document builds on CESR's advice, but takes a simplifying approach. Rather than set out a set of prescriptive requirements specifically for investment research, it requires firms to put in place those measures set out in Article 21(4) of the working document (for general conflicts management) with the objective of safeguarding the objectivity of those research analysts.

The major change from CESR's advice is in the area of the definition of investment research. Rather than a negative labelling requirement (whereby a general recommendation would be considered investment research unless it were labelled otherwise), we prefer a positive labelling requirement (whereby material may only be labelled as research if the conflicts management standards are complied with). We believe this will safeguard the term "investment research" (and similar terms) as a "gold standard" of objective material. As an anti-avoidance mechanism, we also require firms to employ conflicts management standards if they do not label material as research but where they present it as objective or independent.