

## TECHNICAL ANNEX

### INDICATIVE ELEMENTS IN RESPECT OF THE PROVISIONAL MANDATE TO CESR FOR TECHNICAL ADVICE ON POSSIBLE IMPLEMENTING MEASURES CONCERNING THE FUTURE DIRECTIVE ON FINANCIAL INSTRUMENTS MARKETS

#### **3. 1. Organisational requirements (Article 13)**

##### **3. 1. 1. Compliance obligations and treatment of personal transactions (article 13§2)**

- The establishment of a code of conduct by the investment firm as well as its minimum content.
  
- The establishment of a compliance function as well as the necessary arrangements for ensuring its independence; the tasks to be assigned to the compliance function and in particular the procedures to prevent and detect violations of the applicable rules and of the code of conduct.
  
- Which transactions and under which conditions personal transactions from employees could be admitted. In this respect, account could be taken of the different functions performed by the personnel of the investment firm in order to define the rules and conditions for each different category of employees, managers or tied agents.

##### **3.1. 2. Obligations related to internal systems, resources and procedures (article 13(4) and (5) second subparagraph)**

- How the procedures are to be formalised, the means for doing so (written, etc.) and the areas where formal administrative procedures are necessary.
  
- The duties/functions (if any) that, in principle, should be segregated in order to ensure a sound functioning of the firm. The means, procedures and arrangements put in place in the context of administrative, accounting and internal control procedures in order and to take account of the principle of segregation of duties/functions. To what extent administrative, accounting and internal control procedures should take account of the

principle of segregation of duties/functions.- The necessity to establish a segregated accounting function as well as the arrangements for ensuring its independence.

- The minimum contents of the accounting procedures of the firm. In particular and if necessary, aspects that may be considered relevant for ensuring the good functioning of the accounting function and of the accounts of the investment firm (take into account the interaction of this point with the general accounting regulation, this is without defining the content of the accounting rules which are subject to a different regulation).- Apart from the segregation of duties, determine further internal control mechanisms that an investment firm should put in place.

- The opportunity of the establishment of an internal audit function as well as the necessary arrangements for ensuring its independence. The tasks to be assigned to the audit function and in particular the procedures to ensure the correct functioning of the internal control mechanisms of the firm.

- The different risks than an investment firm faces in the exercise of its activities as well as the arrangements to put in place for dealing with them (in particular in respect of operational risk) and in particular, the opportunity for the investment firm to define a risk policy as well as to create a risk assessment function. Define the tasks that are to be assigned to the risk assessment function.

- The principles that should govern the proprietary trading of an investment firm in order to minimise the risks that this activity could cause to the firm and its clients.

- The requirements with which efficient information processing systems should comply and the arrangements and procedures that an investment firm should establish in order to guarantee the security of its information processing systems, in particular in respect of access to the systems, the data contained in them and its handling as well as in order to cope with possible failures of the systems and disaster recovery plans.

### **3. 1. 3. Obligation to avoid undue additional operational risk in case of outsourcing (Article 13§5 first subparagraph)**

- The criteria for categorising the operational functions of the firm between those that are a) critical for the provision of continuous and satisfactory service to clients; b) others.
- The different allocation of roles between the outsourcing firm and the third person carrying out the outsourced .
- The minimum criteria with which the third person carrying out the outsourced function must comply as well as the controls and rules that the outsourcing firm should impose on the person carrying out the outsourced function in order to be able to outsource to the latter part of its operational functions; examine in particular the arrangements to put in place in order to avoid outsourcing from "impair materially the quality of its internal control and the ability of the supervisor to monitor the firm's compliance with all obligations".

### **3. 1. 4. Record keeping obligation (article 13§7)**

- The minimum information that the records of the investment firm should contain (in respect of each service and/or transaction). This information should take account of the need to verify compliance by the investment firm in respect of each transaction with the obligations established under this directive.
- The procedures and arrangements for the keeping of the records, in particular those related to the security and confidentiality of the records, of the organisation of the records and those related specifically to the recording of phone conversations.

### **3. 1. 5. Protection of client's financial instruments and funds when a firm holds financial instruments and funds belonging to clients (Article 13 (8) and (9))**

- The criteria for defining what should be understood as client funds for the purposes of the Directive (for instance in the coverage of margins or settlement guarantees).

- The different arrangements and internal controls that an investment firm should use in order to protect its client's assets. In particular the specific rules with which an investment firms should comply when selecting a third party as custodian of the financial instruments of its clients and the possible rules to be established relating to the use of omnibus accounts, margin segregation in respect of derivatives and stock lending.

- The minimum content of the information that an investment firm should give to their clients in respect of how the arrangements that the firm has established in order to protect its client's assets and moneys, in particular when using the services of third parties. This request should be dealt with together with the requests formulated in the context of Article 19.

- The procedures and the information to be given to the client for obtaining its consent to use its financial instruments.

### **3.2. Conflicts of interest (Art. 18 and 13(3))**

- The appropriate criteria for identifying conflicts of interests whose existence may damage the interest of the clients or potential clients: a) between the firm and its clients, in particular when the firm combines different investment services or activities b) between the managers, employees or tied agents and the clients c) between any person directly or indirectly linked by control to the investment firm and the clients d) between clients.

In establishing these categories, particular attention should be paid to the types of conflicts of interest that can result from certain practices such as: a) payment for order flow b) the transmission of clients' orders received to other investment firms for their execution and c) the distribution of units in collective investment undertakings d) soft Commissions. Address conflicts that arise from any inducement that is received or self-interest that arises in connection with the performance of an investment service which may compromise the quality or fairness of a related investment service that is performed on behalf of or provided to a client.

- The arrangements that the investment firm has to put in place in order to a) identify the different conflict of interests in which it could be involved b) manage the conflicts of interest so as to prevent them from affecting the interests of its clients c) disclose the conflicts of interests (where, how and when) so as to ensure the awareness of the client
- Under which conditions organisational arrangements taken by an investment firm could be considered as effective or non-sufficient to ensure that risks of damage to client interests will be prevented.
- Particular attention should be paid to the frequency of conflicts of interest (whether they occur regularly or in limited individual cases) in different types of investment firms as well as that there is an appropriate mix of prevention, management and disclosure

### **3. 3. Conduct of Business Obligations when providing investment services to clients (Article 19)**

#### **3. 3. 1. Publicity and marketing communications (article 19§2)**

- Types of marketing communications and its distinction from a personal recommendation.
- Criteria for assessing the minimum content of marketing communications or aspects that should necessarily be disclosed in respect of marketing communications so as to avoid that they are misleading or unfair (i.e. name of the person that has done the advertisement- identification of sources).
- Analyse rules regarding specific issues included in marketing communications (Rules regarding promises or specific results, special offers, treatment of comparisons).
- Criteria for considering when an information should be considered as misleading (context of the information, the audience to which it is directed, its overall clarity, etc.).

#### **3. 3. 2. Appropriate information to be provided to the clients or potential clients (article 19 (3))**

- Categorisation of financial instruments: Establish the different elements for categorising financial instruments for the purposes of this implementing measure (i.e. by risk, by legal characteristics, complexity, investors that have access to the instrument, etc.).
- Categorisation of investment strategies.- Identification of the risks inherent to specific financial instruments and strategies and determine the minimum content of the adequate warning in respect of those instruments and strategies.
- Means for making those warnings acknowledgeable to the clients or potential clients.
- CESR, in order to determine the appropriateness of the information might take account of the complexity of the investment services and financial instruments proposed.
- CESR should analyse how the obligation to inform about the execution venues might apply to potential clients.

### **3. 3. 3. Client Records (article 19(7))**

- The content of the records that each investment firm has to have in respect of each client: documents, agreements, etc.
- The minimum content of the documents agreed between the firm and its client: In particular those that set out the rights and obligations.
- The arrangements to keep the records (take account of organisational measures in article 13).
- Period to keep the record. Examine the possibility to differentiate on the basis of the different type of documents that have to be part of the records.

### **3. 3. 4. Reports from the firm to its clients (article 19 (8))**

- Events that give rise to a reporting obligation and its periodicity.
- Minimum content of the reports.
- Valid arrangements for delivering the reports to the clients.

### **3.4. Best execution obligation (Art. 21)**

#### **3.4.1 Criteria for determining the relative importance of the different factors to be taken into account for best execution (21.1)**

The content of the different elements that are to be taken into account in order to evaluate the execution of the client's orders: a) Price, for each financial instrument; b) Costs: the different costs that need to be considered c) Likelihood of execution: how to assess it; d) Nature of the orders e) Other relevant considerations, in particular taking into account the characteristics of the market for that financial instrument.

#### **3.4.2. Trading venues to be included in the order execution policy (21.2).**

- The different execution methods and the price availability: regulated markets, MTFs, systematic internalisation systems, crossing systems, broker that arranges transactions, etc.
- The criteria for determining when an execution venue is offering the best results on a consistent basis. Specify what could be considered "consistent basis".
- The conditions of the order and the conditions prevailing in the marketplace.

#### **3.4.3 Information to the clients on the execution policy of the firm (21.2)**

- the minimum information that investment firms have to provide to their client on their order execution policy, in respect of each class of instruments, such as the different venues where the investment firms execute their clients orders indicating whether they access directly or indirectly through another firm and the factors affecting the choice of execution venue;
- the way and timing this information has to be provided;
- the information that has to be given to the clients when the firm changes its execution policy;
- CESR may wish to take into account the retail or professional nature of the client

#### **3.4.4. Obligation to monitor and update the order execution policy (21.3)**

- Periodical revision and monitoring of the execution policy. The arrangements that the investment firm has to put in place in order to revise and monitor the order execution policy of the firm.
- Availability of comparative information for making the revision effective.

#### **3.5. Client order handling rules (Art. 22)**

- The general handling conditions that investment firms should apply to its client's orders and the minimum content of the handling policy of the firm. In particular the following aspects should be examined: a) Minimum content that should be contained in the order; b) Registration (documents) and record-keeping of the orders; c) Allocation and distribution rules; d) Aggregation of orders; e) Policy in respect of cancellations; f) Management of the order log; g) crossing of client's orders h) Conditions under which and reasons why the prompt execution principle could be overruled.
- Analysis of the different types of orders.
- Criteria, in respect of each different type of order, for determining what could be considered a prompt, fair and expeditious execution. In analysing this aspect account should be taken of following issues: a) the conflict of interest (dealing on own account, underwriting, placement, etc.), (Art 18) b) best execution (Art 21)

#### **3.6. Reporting of transactions (Art. 25 (3), (4), (5) and (6))**

- The criteria for determining when the arrangements put in place by a regulated market, an MTF or a trade matching and reporting system are sufficient to allow the waiver of the obligation to report directly by investment firms.

- The conditions with which all the reporting methods and arrangements have to comply in order to be considered valid. A common standard or format should be defined for the reports to facilitate its exchange between competent authorities.

- The criteria in order to determine liquidity: a) the market to be considered; b) the mechanisms for analysing and checking liquidity; c) the revision procedures; etc. -

- In respect of the harmonised content of the reports: a) the content of the information related to quantity in respect of each type of financial instrument: volume of instruments, monetary amount, etc. b) the content of the information in respect of prices in respect of each financial instrument; c) the methods for reporting the time and date of the transaction; d) the means for identifying the investment firms concerned; e) The means for identifying the instruments bought or sold (security codes).

- Any other aspects that are necessary in order for the reporting to be useful in respect of supervisory issues – such as the identification of the markets where the transaction has been executed, whether the transaction is executed as agent or as principal, etc.

### **3. 7. Transparency obligations (Articles 28, 29, 30, 43 and 44)**

#### **3. 7. 1. Pre-trade Transparency requirements for Regulated Markets (Article 43) and MTFs (Article 29)**

- When and how the information is considered to be made public:

- differentiate between the information accessible to the members of the market and that accessible to the investors.
- The conditions under which the information may considered as accessible to the investors and the arrangements that a Regulated Market has to put in place, directly or indirectly, in order to fulfil its obligation to make public the information.
- In case that the information is disclosed indirectly: the minimum arrangements that the systems used by the regulated market or the market operator have to put

in place in order that the regulated market or the MTF can ensure compliance with the obligation contained in articles 43 and 29.

- The content of the terms "bid" and "offer" for quote and for order driven systems.
- What is to be considered as "depth of trading interests" for quote and for order driven systems.
- The range of the information that should be made available (i.e. all the order book, only part of it, all the quotes from market makers, only the best ones, etc.). Examine whether some criteria in respect of the form in which the information is presented are necessary (i.e. aggregated for the same price, etc.). In respect of the range of the information examine whether the same range should be available both to members of the market and to investors or if there might be some reasons for limiting the amount of information available to the latter.
- The general criteria for determining when a type of order also quotes and other indications of interest) may be exempted from the obligation to be made public. In this respect it might be useful to establish an open list with the different types of orders that are expressly eligible for the waiver.
- For those types of orders, the conditions under which the pre-trade transparency obligation may be waived.
- In respect of Block orders: a) criteria for grouping shares into types, in particular their liquidity; b) what is to be considered a normal market size; c) What is to be considered as large in scale compared to the normal market size.- The general criteria for determining when a market model may be exempted from the obligation to make public pre-trade information. In this respect it might be useful to establish criteria to define the different types of market models that are expressly eligible for the waiver.

In analysing those different elements CESR should take account of the differences as expressed in the mandate between different types of market models and in particular between order and quote driven systems. CESR should be particularly careful, in order

not to stifle competition, in considering the special characteristics of quote driven systems and, in particular the risks incurred by market makers.

In analysing the feasibility of a single and simple model for block orders CESR might wish to take account of the experiences of other non-european jurisdictions.

- For those types of market models, the conditions under which (for instance minimum information about the model that should be given to the members, conditions for its functioning, etc.) the pre-trade transparency obligation may be waived.

### **3. 7. 2. Post-trade Transparency requirements for Regulated Markets (Article 44) and MTFs (Article 30)**

- When and how the information is considered to be made public. In particular differentiate between the information accessible to the members of the market and that accessible to the investors. Conditions under which the information may be considered as accessible to the investors and the arrangements that a Regulated Market has to put in place, directly or indirectly, in order to fulfil its obligation to make public the information. In this respect establish also the criteria for determining what can be considered as "reasonable commercial basis". In case that the information is disclosed indirectly the minimum arrangements that the systems used by the regulated market or the market operator have to put in place in respect of the disclosure of post-trade information, in order that the regulated market or the MTF can ensure compliance with the content of articles 44 and 30.

- The exact content of the information that has to be made public as well as the different forms in which it can be presented: i.e. in an aggregated manner, trade by trade, etc. Differentiate between the information that has to be made public during the trading session and that that has to be disclosed at the end of the trading session. In respect of the latest take into account the current level of information as mandated by Directive 93/22.

- On the basis of the information disclosed and the recipients of the information the different criteria for assessing whether the information has been disclosed "as close to real time as possible" and how it could be made possible across the EU.

- The criteria for deciding the transactions for which deferred publication is allowed. In this respect it might be useful to establish an open list with the different types of transactions that are expressly eligible for deferred publication.

- Taking into account the conditions established in respect of the mandate of article 41 the criteria for determining the size for which transactions could be eligible for deferred publication.

- For the specific types of transactions, the conditions and the limits for the deferred publication of transactions.

- How the arrangements for deferred publication are to be disclosed to the market as well as the content of the arrangements that has to be disclosed to the market.

### **3. 7. 3. Post-trade Transparency requirements for Investment Firms (Article 28)**

- The arrangements that the investment firm have to put in place as well as the conditions with which those arrangements have to comply in order that the investment firm can ensure compliance with its obligation under article 28.

In case that the investment firm decides to disclose post-trade information through the offices of third parties, the minimum arrangements that the third party systems used by the investment firm have to put in place in respect of the disclosure of post-trade information, in order that the investment firm can ensure compliance with the content of article 28.

- the types of transactions for which the exchange of shares could be considered as determined by factors other than price (take account of the cases specifically covered by article 28, collateral and lending) and to other transactions that contain little or no useful price information

- How, if necessary, the obligation applies to those types of transactions. In particular examine the case of (lending of shares for covering short positions) short selling.

### **3. 8. Admission of financial instruments to trading (Art. 39)**

- In order to define the conditions under which a financial instrument can be traded on a fair, orderly and efficient manner, and taking into account the current developments in Community Legislation, the following elements should be analysed a) the different aspects related to the issuer of the securities; b) the different aspects related to the instrument itself; specific rules with respect to derivatives; c) the different aspects related to the market for that particular instrument.; take account of the different types of market structures and of investors that have access to the market;
- Whether the regulated market should establish formal separations or segments in respect of the different characteristics of the same type of instruments; define those characteristics.
- With respect to the obligation imposed upon regulated markets to make information accessible to their members or participants analyse the case of "parallel trading".

### **3. 10. Exchange of information (Art. 58)**

- Define the way requests for information should be made and executed, taking into account the need to foresee a plan for urgent cases.
- Establish the criteria to identify those particular cases where the information should be immediately supplied to other competent authorities without mediating any request. Particular attention should be paid to the transmission of information on the transactions in financial instruments to the competent authority of the most relevant market in terms of liquidity.
- Identify the provisions of the Directive which implementation will require the exchange of information between competent authorities.