Association of Foreign Banks (AFB)
Futures and Options Association (FOA)
International Capital Market Association (ICMA)
International Swaps and Derivatives Association (ISDA)
London Investment Banking Association (LIBA)
Securities Industry and Financial Markets Association (SIFMA)

Follow-up Response to FSA Consultation Paper 06/19: Reforming Conduct of Business Regulation; and Consultation Paper 06/20: Financial Promotion and Other Communications

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E-mailed to cp06_19@fsa.gov.uk, cp06_20@fsa.gov.uk
c/o Richard Stobo, MIFID Implementation Office, FSA;
Jason Pope, Retail Investment Policy Department, FSA

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Introduction

This response follows up the initial comments of AFB, FOA, ICMA, ISDA, LIBA, and SIFMA on CP06/19 and CP06/20. It should be read in conjunction with the initial response which we made on 28th November 2006, bearing in mind that in that earlier response we provided as definitive answers as possible to both FSA's 'bold' (those it identified as for comment by 28th November 2006) and 'non-bold' questions.

However, as a number of significant issues relating to NEWCOB remain outstanding, e.g. the impact of the CESR Level 3 work on best execution and the scope of NEWCOB with respect to non-MiFID business, we may wish to comment further, in the near future, on particular provisions.

Supplementary comments and answers to FSA's questions

Chapter 1: Overview

Q1. Do you have any general comments on the way in which we propose to transpose the relevant requirements of MiFID?

In our initial response we reminded FSA of the importance, as a practical matter and to avoid subjecting branches to unnecessarily complex regulation, of agreeing with other EEA regulators to apply MIFID Level 1 Article 32.7 in a way that ensures that all of the services that a branch provides within the host State, whether to clients located in that State or on a cross-border basis, are subject to the rules of, and regulated by, the branch State regulator. We have since responded to CESR's consultation on this matter, broadly supporting its proposal for practical arrangements to achieve this end, but also pointing out the need for firms to know which Member State's rules apply to their services and activities. We have included, as Annex II, a copy of the joint industry response to CESR's Passport under MIFID consultation.

Chapter 2: FSA's General Approach

Q2. Are there any additions to the list of deferred matters in Annex 5 which we should consider in the second quarter of 2007?

We do not think that FSA should consider any additions to the list of deferred matters in Annex 5.

Q3. Do you have any comments on our general approach to reforming COB regulation or our analysis of the implications for firms and consumers?

In respect of this question, we have a number of comments under the following heads:

Implementing the outcome of the CESR Level 3 work

We note, and agree with, FSA's commitment in Paragraph 1.29 of PS07/2 to consult in the usual way where it proposes any changes to its rules or guidance in order to implement the outcome of any CESR Level 3 work. This discipline will be particularly important given the number of issues on which CESR has consulted or is consulting. However, and though not directly relevant to CP06/19, we do not agree with FSA that it would not need to consult on including in the Handbook, as FSA Guidance, Level 3 CESR guidance on data consolidation, unless that guidance corresponds exactly to guidance on which FSA consulted in CP06/14. Wherever FSA has not consulted formally on aspects of CESR guidance, it should consult in the normal way.

NEWCOB Made text and transitional arrangements

As the FSA will appreciate, firms need a high degree of certainty regarding future regulatory requirements before systems changes are made. Whilst we recognise the FSA's rationale, the absence from the PS07/2 final text of a number of significant, but not MiFID implementing, NEWCOB provisions - such as the exemptions from the financial promotions regime in Annex 1 of NEWCOB Chapter 5 - is causing practical difficulties for firms. In addition, the protracted (but understandable) negotiations that are involved in trying to agree a way forward in a number of areas of Level 3 guidance (which, as the FSA acknowledges, may result in changes to the FSA implementing provisions), taken together with the need for common regulatory approaches on a pan-EU basis and the fact that regulators will have to, in part, consent to such practical approaches, mean that, in real terms, it is highly unlikely, despite the best efforts / reasonable steps of firms and their systems providers, all firms will be in a position to be in full compliance with the new requirements by November.

We, therefore, welcome the comments made by FSA speakers at recent industry events, including Dr Thomas Huertas who noted that:

> *"We fully recognise that 1 November will soon be upon us all and that there is some risk that firms will not be able to finish everything by that date. From a supervisory perspective we expect firms to have plans in place and to be making significant progress against those plans, and that is in fact what we are generally seeing."*[1]

We would, therefore, welcome further confirmation from the FSA that if firms are taking all reasonable steps to comply with MiFID, a degree of regulatory forbearance is likely to be exercised in the short term, should they be unable to come into full compliance on 1st November through no fault of their own. We also trust that a proportionate approach is exercised by all FSA divisions, including supervision and enforcement.

Principles for businesses: MiFID override

As the FSA will be aware, the joint associations believe that the Principles for Businesses should be amended so that they are consistent with MiFID and do not support the use of a MiFID override. We note, however, the FSA's response in

[1] Speech by Dr. Thomas F. Huertas, Director Wholesale Firms Division and Banking Sector Leader, FSA to the Fourth Annual Complinet Compliance Conference, 31 January 2007

Chapter 7 of PS07/2 and welcome the clarificatory amendments made to the general application provisions

NEWCOB and the FSA's move to a more principles-based approach

Our comments in relation to this question focus on the FSA's stated intention to move to a more principles-based approach to regulation ('MPBR'). The opportunities and challenges that may be presented by this approach have already been the subject of papers from a number of trade associations, including an interim paper by LIBA in July 2006 on 'Principles-based regulation – making it work for the regulation of wholesale firms.'

It seems to us that the FSA's MPBR initiative is itself two projects: one has a focus on the simplification of pre-existing rules; and the other is the implementation of 'green-field' regulatory initiatives through the use of principles alone, such as the Treating Customers Fairly ('TCF') exercise: our views are set out accordingly. We conclude with a brief comment on the implementation of EU requirements.

<u>Simplification of pre-existing rules</u>

1. The FSA suggests that NEWCOB represents 'a radical simplification of the rules' and describes it as 'a flagship project for the FSA in the move towards more principles-based regulation and away from detailed and prescriptive rules.' In summary we believe that the FSA has been less radical than it could have been. We accept that the FSA has had limited ability to be truly radical in respect of those areas of NEWCOB that implement MiFID. Nevertheless, at this juncture we are not convinced that the application of MPBR to rolling back existing detailed rules is as far reaching as suggested by the FSA, and we would therefore be interested in exploring further the underlying rationale for the proposals in CP.

   Note however that even with this less radical approach to reforming the Handbook we still look forward, in the FSA's second Policy Statement on CP06/19 to a clarification of the Section 150 issues that were raised in our first response (for convenience, the relevant extract from our submission is set out below).

   In particular, in our first response we said: 'The CP does not clarify FSA's thinking about how the provisions of NEWCOB will be treated under Section 150 FSMA. The general position under that Section is that a contravention by a firm of a rule is actionable at the suit of a private person – as currently defined in SI 2001/2256 – who suffers loss as a result of the contravention (subject to the defences applying to actions for breach of statutory duty). Under Section 150(2), however, designated rules can be excluded, and FSA's Principles for Businesses have been treated in this way. There are two questions at this stage:

   (a) First, whether the "rights of action exclusion" should be applied to other new rules which are drafted at a comparable level of generality. On this, it will be important for FSA to articulate its policy for determining when the exclusion should be applied going forward, and the options should be discussed with the industry first. This is not a MIFID implementation matter as such – Section 150 FSMA is a super-equivalent provision not required by the Directive – but we have raised the matter in this response because we consider that these discussions should start sooner rather than later.

(b) The second, more pressing, point is whether there are rules due to be replaced by MIFID provisions which are currently excluded under Section 150(2): in such a case we would assume that FSA will use its powers to provide that the "replacement requirements" are excluded as well so as in practice to maintain the status quo. If this assumption is incorrect, we trust that FSA will let us know without delay.' [We would note further on this aspect that the FSA's CBA work on MiFID has not covered any changes in the Section 150 position.]

2. Notwithstanding our view that NEWCOB is not as far reaching as suggested by the FSA, any simplification of pre-existing rules requires clarity on the purpose of the reform. In particular, clarity on what is meant to be de-regulation, what is MPBR, and what is both! For firms, clearly it is important to know the cases when the FSA has decided that a particular area no longer needs to be subject to detailed regulation, however, the move to MPBR could obscure such a change unless the FSA confirms its decision in clear terms. The example below from NEWCOB sets out why such clarity is important:

   It is clear from CP06/19 that the FSA proposes to remove the excessive charges rules. Is this de-regulation – i.e. the FSA stepping away from price regulation? Or might the FSA still choose to take action on excessive charges, but under a more general requirement such as the requirement to treat customers fairly? There are very different implications for firms depending upon the answers to these questions which, pursuant to the market failure case for regulation, should rest on the FSA taking a view of whether or not the market failure of oligopolistic pricing is present: If judged to be present, the FSA could choose to pursue 'excessive charging' through the high-level requirement to treat customers fairly; if not, then neither the FSA nor compliance should have any interest in what customers are charged and pricing can be left to business areas and the forces of competition. In one case, a firm's compliance function needs to retain an interest, in the other it does not, with the determining factor being the FSA's purpose for this reform.

3. This question is closely connected with the more general issue, already raised with the FSA, namely the importance of ensuring that firms are able to make judgements with reasonable confidence about the steps that they may take in order to comply with the regulator's requirements when actions are taken (not taken): this is central to MPBR working successfully and has implications for the way FSA communicates its expectations and the approach to enforcement (as noted below).

Implementing regulatory initiatives solely through the use of principles

4. The FSA has shown itself to be willing to launch far reaching regulatory initiatives on the back of principles alone, requiring serious consideration of the wider ramifications by both the industry and the FSA. At this juncture we see two particularly important points as being a priority for further discussion and resolution with the FSA:

   - the role of regulatory forbearance[2] in creating the best environment for realising intended business and regulatory benefits of MPBR; and
   - the role of FSA's policymaking disciplines in MPBR.

5. The FSA has established an international reputation for its approach to evidence based policy making. Some of these policy disciplines are enshrined in the Financial Services and Markets Act (FSMA); others are public commitments the FSA has elected to make, such as the use of market failure analysis (although perhaps it could be argued that this is implicit in CBA). Yet, as we understand it, no aspect of the FSA's TCF project has been subject to any of these disciplines despite anecdotal evidence that the project is having a cost impact on firms, raising the perception that MPBR as applied to new regulatory initiatives could be used to circumvent the FSA's policy-making disciplines.

   The general point is the pressure on firms to take account of 'soft communications' when determining the FSA's expectations. This pressure has increased with the publication of the CP07/2: Review of the Enforcement and Decision making manuals, in particular Annex E, paragraph 2.21 EG:

   > *'Guidance is not binding on those that the Act and rules apply to, so it does not need to be followed to comply with a rule or other requirement. This means a firm cannot incur disciplinary liability merely because it has not followed guidance. Nor is there any presumption that departing from guidance is indicative of a breach of the relevant rule. Guidance (whether it takes the form of guidance in the Handbook or the form, for example, of a case study or generic letters written by the FSA to Chief Executives in particular sectors) is, however, potentially relevant to an enforcement case and is material that a decision maker may take into account in considering the matter.'*

   Some of the joint associations will be commenting separately on CP07/2 but we are concerned that the FSA does not seem to distinguish between the role of Guidance, which has been consulted on and subject to various policy disciplines, and the role of 'soft communications' such as 'Dear CEO' letters, which have not. In our view, this approach runs counter at least to the spirit of the relevant sections in FSMA and possibly to the letter depending on whether or not the substance of such communications would be seen, by Parliament for example, to be effectively 'Guidance' under FSMA. [A related issue is the

[2] By regulatory forbearance we include ,*in this context*, the willingness to accept that in a principles-based world conscientious firms can make reasonable decisions about what a requirement entails which in the event the FSA may disagree with: in such a case a firm's 'failure' to comply with the principle should be regarded as a supervision issue and not a matter for enforcement.

extent to which the FSA may now be proposing that 'non-compliance' with guidance will be relevant to determining whether a firm has contravened a rule: this would be a reversal of the current position under which …"*a firm cannot incur disciplinary liability merely because it has not followed guidance. Nor is there any presumption that departing from guidance is indicative of a breach of the relevant rule*." (Reader's Guide)

Clearly there are circumstances where the FSA will need to clarify requirements without following the full consultation requirement laid down in FSMA, particularly in a MPBR regime. But if the FSA draws upon such material when determining whether to pursue enforcement case we are concerned that firms will not accept the fairness of the process and the Tribunal may overrule FSA's decisions. Perhaps, however, these dangers can be avoided if FSA consults fully on the policy content of 'Dear CEO' letters, speeches etc in the case where this material will be relevant to its assessment of firms.

6. A central issue will be the establishing of trust and confidence on the part of firms to enable them to respond positively and without undue conservatism to the potential opportunities and challenges of MPBR. In particular, the FSA will need to make it clear that in the case of a reasonably conscientious firm, *enforcement* action will *only* be taken if a firm has not responded adequately to previous FSA notification that its compliance with one or more principles is insufficient.

<u>Implementing EU requirements</u>

7. The implementation of EU Directives presents a number of challenges to the FSA's agenda on MPBR. The FSA's 'intelligent' copy out approach to implementing Directives could be presented as the FSA making the best attempt to avoid an unnecessary detailed implementation of EU requirements except for the use of interpretative text on any 'grey areas' of EU requirements. However, the weaknesses of copy out must be recognised where the underlying EU message is opaque. In those areas, according to firms' needs, the FSA can help by explaining the purpose of a provision – a firm is much better placed to decide how to meet a requirement when its purpose is understood.

8. Going forward, we think the FSA could do more to align the implementation of EU requirements with its approach both to MPBR and the use of industry guidance, particularly in respect of avoiding an assumption that the FSA will always be best placed to provide clarification on 'grey areas'. In particular, it might sometimes be the case that 'grey areas' could be left to industry guidance (such as that being produced by MiFID Connect) and/or firms to sort out. It must be recognised though that given the variety of firms' business, there can still be grey areas even when industry guidance has been developed.

Chapter 6: COB obligations

Inducements

CESR's December 2006 consultation on inducements under MIFID prompts us to reiterate and stress the points that we made on this issue in our initial response to CP06/19. As we explained in the joint industry response to CESR's consultation, a copy of which forms Annex III to this response, it would be inconsistent with MIFID to interpret Level 2 Directive Article 26 as applying to a broader range of payments than current FSA inducement rules, or implying a significant change to the existing rules. We think that in its consultation CESR has drawn the wrong conclusions from its analysis of the inducement provisions about the range of payments that fall within the Article 26(b) constraints.

Customers introduced to clearing firms by introducing firms and overseas introducing brokers

Q14. Do firms agree with our approach to dealing with scenarios currently covered by COB 5.8? Do any additional risks or concerns for firms or investors arise under this proposal?

Opinion is divided on this question. On one hand, some firms argue that given the uncertainties than can arise in such relations, the guidance, although it may be in need of redrafting, should remain, particularly as the application of the Principles may be cloudy in such non-standard arrangements. Conversely, other firms believe that, because of the uncertainties that surround such relationships, it is important to review each introducing arrangement separately and the guidance in COB 5.8 is not helpful in this particular regard.

Whilst, however, we tend to agree with the FSA's analysis in paragraph 6.53 of CP06/19 and recognise the limitations of the current COB 5.8 guidance, we do not believe that the other Handbook provisions are sufficient to cover the particular nature of the arrangement that the guidance at COB 5.8 envisages. The key issue, and the reason why this guidance is significant, is not that it reinforces Principle 6 on the obligations of firms to their customers but that it documents the respective responsibilities of the clearer and the introducing broker (indeed, as we understand it, some firms may use very similar wording in their agreements with clients and introducing brokers). In this way, there should be less scope for misunderstanding by either the firms involved or, because of the requirement for clarity to the customer, the customer itself to whom the various services are being provided. The joint associations would, therefore, be interested in discussing this question with the FSA in more detail.

<u>Chapter 8/ CP06/20: Communications to clients</u>

4MQ1. Do you agree with our proposals relating to all information in NEWCOB 4 for non-MiFID scope business?

We remind FSA of the comments in our initial response, that FSA should retain the 'reasonable steps' standard, for both MIFID and non-MIFID business. We agree with the City of London Law Society's argumentation on this point. We note that in PS07/2, FSA states it does "not anticipate the change in wording will alter the standards we expect of firms…". However, whilst this may be the FSA's practice going forward, notwithstanding, there is an important distinction in law between a 'reasonable steps' standard and, the much higher, absolute standard. The change will, therefore, significantly increase firms' legal risk in this area; particularly given that consumer' rights of action under 150 of FSMA will arise in the event of a breach, by a firm, of the absolute standard.

Furthermore, we do not think that FSA is justified in concluding that change to an absolute standard would make little cost-benefit difference on the grounds that 'firms already act as if the requirement were absolute'. As a more general point, FSA should consider carefully, case by case, whether it is appropriate and justified to apply MIFID rules to non-MIFID business, and ensure that it applies cost-benefit disciplines. Unless these statutory disciplines had been observed, FSA would need to be prepared to give firms a waiver from MIFID requirements in relation to the relevant non-MIFID business. The joint associations will consider this issue further in connection with the FSA's forthcoming '*Non scope deferred COB review'* consultation.

<u>Chapter 9/ CP06/20: Financial promotion</u>

4MQ5. Do you have any other comments on issues raised by this CP?

We have consulted firms again on the position that we took in our initial response, and they confirm the view that FSA's proposed approach is too complex. Particular problems identified include difficulties in interpretation (particularly the application provisions) and issues of coherence between different rules and between Chapter 5 and, for example, the requirements for UCITS funds. We welcome, therefore, the FSA's commitment, in PS07/2, to restructuring "the layout and presentation of the Handbook text consulted on in CP06/20 and to "making the application provisions clearer and the rules more user friendly…" but believe that a more comprehensive review and redraft is required that considers structure and not just layout. We would, of course, be pleased to provide the FSA with further and better particulars of our concerns.

Chapter 14: Suitability

Summary

We welcome FSA's statements in paragraph 5.4 of PS07/2 that firms can provide information and opinions without providing advice, that a disclaimer that communications are not presented as personal recommendations will reinforce a presumption that advice is not given, and that where suitability does apply in wholesale markets, the obligation to obtain information is qualified for professionals in several ways. We note that FSA intends to work with stakeholders to consider the position of wholesale markets in more depth, and we set out below the principal considerations that we think that FSA should take into account.

One of the principal challenges of MIFID for firms and FSA will be to ensure implementation of, and compliance with, MIFID's requirements in a manner that supports existing good practice in firms. Record keeping has a part to play but it must be viewed in context and be interpreted and implemented in a proportionate manner that supports rather than undermines those objectives. A more principle-based approach to regulation should mean that FSA's record-keeping rules should not extend beyond the high level requirements of Article 13(6) of Level 1. The proposed COBS 10.5.1R, set out in paragraph 5.8 of PS07/2, goes some way beyond the high-level requirements of Article 13.6 of Level 1, and would thereby impose a degree of prescription that would be inconsistent with this regulatory approach. FSA's rules should instead be based exclusively on Article 13.6 of Level 1 so that firms have the maximum degree of flexibility and are able to adopt a proportionate approach to demonstrating compliance with the suitability requirements of MIFID.

In wholesale markets, there are a number of checks and balances already in place which ensure that any advice given is suitable. One of the principal checks is professional clients themselves, who by definition are sophisticated investors. MIFID acknowledges this by allowing firms to assume that professional clients have the requisite knowledge and experience and (in the case of per se professionals) the necessary financial means. As FSA is aware, professional clients will often canvass many wholesale firms for their recommendations before formulating their own views as to how they should proceed. If poor advice is given, the client may complain, withdraw its business and may even seek legal redress.

MIFID's rules on suitability are new and designed to ensure the suitability of personal recommendations. The objective should be to implement MIFID provisions in a manner that maintains the existing processes to ensure that clients continue to receive the information they need and receive at present, and that where advice is given, it is suitable.

Investment Advice

For a communication to constitute investment advice it must contain all of the constituent elements of the definition. It must be a recommendation to a person in his capacity as a (potential) investor to buy, sell etc a specific financial instrument(s) and it must have been presented to them as being suitable for or based upon a consideration of their particular circumstances. Thus opinions expressed by firms (e.g. "our view of this transaction is X") do not constitute personal recommendations and neither do descriptions or explanations of products (e.g. the pros and cons of a particular product). Conversations involving the expression of opinions or explanations of products could become personal recommendations depending upon how the conversations progress and how the views are expressed and presented to recipients. All factors will be relevant in determining whether investment advice is given. Disclaimers in terms of business and/or in the relevant communication will be such factors (and we welcome the indications that FSA has given that they will be strongly indicative factors), even though they may not be determinative.

Suitability

When a personal recommendation is given to a professional client, the MIFID suitability requirements come into play. In the context of professional clients, firms must obtain such information on the client's investment objectives (and financial situation for those opted-up) as is necessary to enable the firm to ensure the personal recommendation is suitable. The nature and extent of the information required will vary considerably as a consequence of the range of client types, product types and recommendations that will arise in practice. This is particularly the case in wholesale markets where the range of scenarios in which a personal recommendation may be made is extremely broad. It will be a matter of judgment in each case to determine what information is necessary and indeed whether the recommendation in question is suitable by reference to all the surrounding circumstances.

It is firms' responsibility to ensure that they comply with these requirements. Many firms would argue strongly that they already comply with these requirements as a result of the commercial factors and existing procedures already in place. It will be up to each firm to determine whether its existing processes and procedures are adequate. Some may feel that a new or revised policy or procedures are desirable, backed up by training and supervision, which makes it clear to staff what their responsibilities are should they make a personal recommendation to a professional client.

Record Keeping

Record keeping has a role in the suitability process. However, if it is not viewed in context and implemented in a proportionate manner, there is considerable risk that record-keeping requirements would result in significant cost to the industry that will result in a diminished quality of service to clients and detract from rather than enhance firms' ability to comply with the MIFID suitability requirements. Contrary to the intention of MIFID, in these circumstances firms would be likely to seek to avoid giving personal recommendations (or other information) to clients, not because it was undesirable from a commercial perspective and, critically, not because they were unable to comply with the requirement to ensure information was obtained and personal recommendations were suitable, but because the interpretation of the record keeping requirements would make it impractical for firms to comply. It is important for FSA to avoid a prescriptive requirement or expectation that firms maintain individual written records of information on clients' investment objectives in all situations. Such an approach is not necessary, desirable or supported by MIFID, and would be inconsistent with a more principle-based approach to regulation.

MIFID contains no specific record keeping requirements relating to suitability, but only the general high level record keeping requirement in Article 13(6) of Level 1. The maintenance of records is not a primary but a secondary obligation. Records are a tool whose purpose is to help ensure that the primary requirements - in this case the suitability provisions - are met. Record keeping is therefore not an end in itself but rather a means to ensure compliance with the primary obligations. As such it must be interpreted and implemented in a manner that supports and increases the likelihood of compliance with the primary objectives.

The determination of the extent to which records are to be maintained should be governed by whether or not the records assist in demonstrating firms' compliance with the primary obligation. FSA should not expect firms to maintain a written record of the information obtained from clients, or a record of the advice given or suitability assessment made. Once one accepts that there is no need to maintain physical records of such information, logically there should be no automatic need to treat the recording of investment objectives differently. The records made should be proportionate to the circumstances. In the same way that the primary requirement varies according to the vast range of client types, products and recommendations as discussed above, so should the record keeping requirements. A more significant body of evidence might be feasible and appropriate in relation to advice given in the context of highly complex (structured/bespoke) products recommended to professional clients than ad hoc recommendations relating to vanilla products. The maintenance of written records of clients' investment objectives in the latter situation for example would not be proportionate or practical, or enhance the overall objective of ensuring that investment advice is suitable.

In addition an interpretation of "record keeping" that was confined to physical written records would be overly narrow. Evidence for example of a policy backed up by staff training and supervision, and perhaps retrospective review and monitoring of completed transactions, would constitute a "record" that demonstrates a firm's compliance with the primary requirements to obtain necessary information and perform the appropriate suitability assessment. For the reasons given above, such an approach may not always be appropriate in all cases but it should be more than sufficient in the vast majority of sales/trading discussions in the wholesale market for example.

In sum, the objective is to ensure that necessary information is obtained and suitable advice is given. It is up to firms then to determine the means by which that end is best achieved, and how appropriately to document it. In light of this, we welcome FSA’s recognition of the problems inherent in the specific prescriptive language in its original draft of NEWCOB 10.5.1.R. However, we are concerned that the alternative wording of COBS 10.5.1R that FSA proposed in paragraph 5.8 of PS07/2 is

(a) too prescriptive;
(b) super-equivalent to what is required under MIFID;
(c) contrary to a principle-based approach to regulation; and
(d) may still require firms to keep a record of the client suitability information they obtain, and would thereby fail to address the problems that we identify.

We welcome FSA's recognition of the need for further consideration of the position in wholesale markets, and we would urge FSA to adopt a principle-based rule based on Article 13.6 of Level 1. This should ensure that firms have the maximum degree of flexibility and are able to adopt a proportionate approach to demonstrating compliance with the suitability requirements of MIFID. We think that FSA should at most not retain COBS 10.5.1 as anything other than Guidance applying to retail clients.

Chapter 16: Dealing and managing

Best execution

There are a number of important developments which have affected the implementation, by firms, of the MiFID provisions on best execution since our initial response to CP06/19 on 28 November.

(a) Scope of the best execution obligation

We understand that the European Commission will shortly be replying to CESR's questions on the scope of the best execution obligation. The joint industry position on scope, which is supported by both the buy side and the sell side, is set out in our submission to the Commission dated 7 February. This is attached at Annex I to this response.

Once the European Commission's legal interpretation on scope has been sent to CESR, we would be grateful if the FSA would clarify for the industry as soon as possible how this will affect the FSA's previous public statements on scope (e.g. in CP06/19), including the FSA General Counsel Division's legal advice on *Best execution: orders*, published in October, and whether there are any implications for the Handbook.

(b) Issues relating to best execution other than scope

We are currently considering our response to CESR's Consultation Paper published on 2 February on *Best Execution under MiFID.* We will be responding by the deadline of 16 March. We will send the FSA a copy of our response.

Once CESR has evaluated responses to the CP and published any guidance on best execution, we would be grateful if the FSA would clarify for the industry how CESR's proposals will affect the FSA's previous public statements on best execution other than scope, including the views expressed in CP06/19.

(c) FSA guidance on best execution

We note that, in paragraph 7.4 (on page 94) of PS07/2 on 26 January, the FSA states that it intends to consider our requests for additional guidance on best execution at a later stage of the MiFID implementation process. We reiterate in particular the following points made in our initial response to CP06/19:

16.43 and Q42: We agree with the FSA's proposal to add guidance on the role of price in best execution, and we note (in 7.4 of PS07/2) that the FSA is "minded to confirm the provision of that guidance".

16.46: We agree with the FSA proposal not to provide guidance on benchmarking.

16.47-16.49: We agree with the FSA's statement that firms can use internal models that take account of the firm's own book and the like, but which refers to Level 2 Directive Recital 69.

Q43: Which of the three options in relation to Best Execution for UCITS portfolio managers creates the most appropriate and proportionate regulatory regime? Why?

We do not have any further comments on the FSA's question on UCITS.

(d) Implications for the timetable

It was originally intended that firms should be given nine months to complete their preparations for implementing MiFID by the due date of 1 November after it became clear exactly what they needed to do to comply. However, as a result of the new developments discussed above, there is still uncertainty over what firms need to do to implement the best execution provisions of MiFID. This affects firms' ability to complete their preparations by the due date. In addition, we note that CESR has stated in its CP (paragraph 12) that it "will consult market participants on [scope] and related aspects after having received the response from the Commission." Given that implementation of the MiFID provisions on best execution is a high priority, we are concerned about the shortage of time that will be available for firms prior to the implementation date once outstanding issues are resolved in CESR, and we would therefore like to know how the FSA is proposing to help firms address this problem.

<u>Personal transactions</u>

Q50. Do you agree with our proposal to copy out the MiFID personal transaction requirements and to apply them to non-MiFID business?

See our general comment under 4MQ1 above. There is no reason why firms should be burdened with requirements in relation to non-MIFID business, which are not necessary to implement MIFID. In this instance, particular problems would arise as regards the application of MIFID requirements to outsourced services.

Chapter 17: Investment research

We are pleased to note from PS07/2 that the FSA intends to use the "current defined Handbook term research recommendation' to achieve consistency in the definition of non-independent research.

Q53. Do you agree with our proposed approach to implementing the MiFID requirements on research?

We wish to remind the FSA of our concerns, as set out in our first response to CP06/19, regarding the guidance in NEWCOB 13.3.4G; namely that the guidance at NEWCOB 13.3.4G(1) and 13.3.4G(2) is super-equivalent and should either be amended or deleted.

Chapter 21: Reporting information to clients

Confirmations for professional clients

We wish to remind the FSA of the comments made in our first response regarding, inter alia, the interpretation of NEWCOB 17.1.1 with respect to professional clients and would find it helpful to discuss these issues with the FSA in more detail.

Venue identification (NEWCOB 17 Ann 1 R, Item 6)

MIFID Rules give no indication as to what should appear on retail clients' trade confirmations if the client order is dealt in a series of tranches at different venues, with averaged prices. Under current rules there is no requirement to state the venue on confirmations (wholesale or retail). It is rare that an order is executed on one venue, especially in cash equities. Firms typically use multiple sources of liquidity to achieve best execution for clients. There is no guidance as to how an allocation to clients that results from multiple market side transactions on different venues should be represented.

We understand that FSA has suggested in meetings with APCIMS that the contract note should show the venue for each tranche. Technically this would be very costly to produce since in effect every tranche of the order would have to be displayed on the contract note with the detail of each venue. This could be especially difficult for systems whose fields can accommodate only prescribed values.

FSA has alternatively suggested that separate contract notes should be produced for each tranche executed at a different venue. However, where tranches were reported by means of separate contract notes the transaction reports could be corrupted. Firms' systems typically process an order with the transaction report and transaction confirmation being part of the output arising from the completion of the order process. The data to produce the transaction report and transaction confirmation are essentially the same data set, so if contract notes were produced for each tranche the transaction report would also be at tranche level rather than at order level. Separate confirmations would also deluge private banking clients in paper or emails (larger orders are more likely to be tranched).

The systems costs to follow either of the approaches suggested by FSA are likely to be very high, and there could be major difficulties making system changes in time to meet the November 2007 MIFID implementation deadline. Firms will be forced to make pragmatic decisions in this area. Many firms may decide that simply marking client side transaction reports as ‘OTC’, and simply stating in the confirmation that there are multiple venues, and that further information on those venues is available on request, is the only practical way forward.

Time of execution (NEWCOB 17 Ann 1 R, Item 4)

Under FSA’s approach, a similar issue would arise because of the new MIFID requirement to show time of execution on retail confirmations. If the tranches had to be reported to clients separately, the confirmations would have to show multiple times. Under current rules there is no requirement to state time of execution on confirms: the firm can state that the time of execution will be available on request.

Currently, many firms retain trade time information in their front office systems, which defaults to the time the trade ticket is opened by a trader or the time of execution on an order book. In order for this information to make its way onto a trade confirmation, it would need to be channelled into the back office system. This is already in train for transaction reporting purposes. However, it would be a new and separate IT/infrastructure/operational expense to enable that information to be taken from the back office and into the confirmation. Experience suggests that clients would not regard this as valuable information.

Clearly this is a retail issue as the detailed content requirements apply only to confirmations for private clients. But the difficulty of putting multiple venues or multiple execution times on the same confirmation would be a significant nuisance for any firm with a significant private client business. It could also be a problem for any firm that decides that it cannot classify all of its wholesale counterparties as professionals while continuing to deal for them. It could also be a problem for firms that decided that they needed to accommodate the relevant information in their systems for all clients because it would be too complex to operate a separate trade confirmation system for retail and professional clients.

It appears that the FSA has underestimated the complexity and cost of these additional requirements as a result of an oversimplified view of how client orders are executed, and trades allocated to clients. It appears that significant rebuild of systems would be needed to enable firms to record the relevant information as a preliminary to printing it on the contract note. Some years ago a typical large firm undertook a similar exercise with regard to execution capacity, i.e. principal/agency with multiple executions resulting in allocations of "mixed"/"hybrid" execution capacity: this project took three years to complete.

There is also a question as to how a retail broker should describe the venue of execution to its underlying clients: it should not be required to capture a venue code from all brokers to whom it has routed orders and pass this through to its underlying clients, but should be able merely define all its trades with these brokers as executed OTC.

Other items in NEWCOB 17 Ann 1 R which could necessitate new system development, but which are specified by MIFID in a way that may provide less flexibility that clearly exists regarding venues and timing for multiple-tranche transactions, are the following. FSA should consider what scope there is to enable firms to make use of the 'where relevant' language in NEWCOB 17 Ann 1 R to enable firms not to include this information specifically in contract notes where it is not needed by the client or can be provided by other means where the client does need it:

- **Item 5 - Type of Order**: The great majority of business in institutional markets is quote driven (FI bond business, OTC derivatives and Commodity / FX derivatives) - there is no order, so this field will be blank. However, type of order information (where it exists) would be located in front office systems. It would be necessary to develop systems to transmit it to the back office for entry into confirmations.
- **Item 9 - Nature of the order other than buy/sell**: Swaps or loans are always subject to specific (manually produced) agreements (e.g. ISDA confirms, LMA/LSTA confirms). It would be important to be clear that there was no need to amend automated systems for other products.
- **Item 18 - if client's counterparty was the firm, affiliate thereof or another client of the firm, that fact:** costly system development would be needed to capture this information in confirmations.

We recognise that FSA is constrained by the need to implement MIFID. However, within the 'intelligent copy-out' approach, FSA should follow a more practical approach, bearing in mind that:

- FSA said in CP06/19 that there is broadly no change in this area.
- FSA's November 2006 'Impact of MiFID' document also did not see any substantive costs arising out of new requirements on trade confirmations.
- It would not be consistent with better regulation principles or FSA's commitment to cost-beneficial regulation to require firms to develop complex and costly systems to capture and report information which is of little or no value to clients
- An approach under which a multi-venue execution contract note carried a note saying "Multi-centre, breakdown details of execution available on request" would be consistent with 'intelligent copy-out' of MIFID, enable firms to tell clients the make-up of transactions executed in tranches on the basis of an audit of a bargain screen dump.

Chapter 26: Transitional provisions and waivers

Q81. Are there any areas, other than those mentioned in paragraph 26.10, where you think it would be helpful to make transitional provisions?

There is a need for more clarity about the transitional status of record-keeping requirements. Where records are currently required to be maintained for three years, but the three-year period runs over 31.10.2007, the required period should continue to be three years for records that do not change as a result of MIFID requirements. The five year period should apply only to new records or those that change as a result of MIFID requirements.

Q82. In which areas, if any, do you think it possible that you may need to apply for waivers?

We have not yet identified any areas where waivers will definitely needed, but believe this might be due to firms' unfamiliarity with NEWCOB and the uncertainties pertaining to a number of key provisions. In the event that areas are identified subsequently, we will bring them to FSA's attention.

ANNEX I

Joint industry submission to the Commission

Proposals for interpreting best execution in MiFID
7 February 2007

Best execution is owed under MiFID when a firm executes an order on behalf of a client. The principle governing whether best execution is owed should be that best execution will be owed where there is a client relationship and the firm providing services has taken on an obligation to act on the client's behalf. When there is a client relationship, but best execution is not owed, other client protections, such as conflicts of interest and client assets protection will still apply. For the purposes of determining whether best execution applies, it is not therefore necessary to distinguish between investment services and activities under MiFID.

Client status in dealer markets

For the purposes of clarity, it is worth considering the circumstances in which a client relationship exists under MiFID. MiFID states that a client is someone to whom investment and/or ancillary services are provided. The list of MiFID investment services and activities set out in Annex 1 to the Level 1 Directive does not distinguish between investment activities and services. The key factor is, therefore, whether a client relationship exists: if it does, then a service will be provided.

In dealer markets, the two relevant services for these purposes are 'dealing on own account' and 'execution of orders on behalf of clients'. It is axiomatic that the latter is a service. By contrast dealing on own account can be both an activity and a service. Providing an investment service is not confined to when a firm has taken on an obligation to act on behalf of a client. Other factors may also indicate that an investment service is being provided[3]. For example, these would include the terms of business agreed between the parties (although a statement that there is no client relationship will not be conclusive if it is not consistent with the overall nature of the relationship between the parties), communications between the parties, where a client relationship is implied by the course of business between the parties, and the intentions of the parties.

By reference to such factors, it is clear that when a dealer deals on own account with an investment manager he will be providing an investment service to his client. As has been noted, however, the principle governing whether best execution is owed should be that best execution will be owed whenever one party has taken on an obligation to act on another's behalf. What follows is a non-exhaustive series of examples illustrating how this principle will apply across different dealer markets.

[3]Note also that there are services in MiFID that are not defined. Specifically, Article 25 makes it clear that the facility to execute transactions exists and that it does not have to be the same as the execution of a client order, although it could overlap.

Cash fixed income

The cash fixed income markets have for decades operated as dealer markets. The dominant model, in the wholesale market, is that of dealer liquidity made available in size to institutional and other market participants (but not direct retail participants, by virtue of the sizes traded). In a small proportion of cases dealers may take on an obligation to act on behalf of the client by, for example, searching the market for a particular security. This may, for instance, take place when the security is hard to locate and the dealer holds none on his own book. Although of regular occurrence, this is atypical in terms of the volumes traded across the market.

Although the market lacks formal transparency, wholesale participants are reasonably well placed to infer what is going on.

The market model is commonly described as 'request for quote'. This refers to the practice whereby the client contacts one or more dealers and asks that each provide a quote to him for a given security. The client may or may not indicate whether he is buying or selling. Because there is no formal market mechanism, such as that imposed by exchange rules, the dealer is not bound to give his best quote or indeed any quote at all. The dealer does not take on any obligation to act on the client's behalf. What will drive him to provide a reasonable quote are commercial considerations, in particular the need to service and retain his client in a competitive environment?

In these circumstances, i.e. where the client approaches one or more dealers for a quote, it is clear that the client is responsible for:

- selecting the counterparties in the group which he has approached; and
- Selecting the chosen dealer from amongst the group, with whom he concludes the transaction.

This is the basis on which investment managers would agree that the best execution obligation does not currently apply to the dealer in a 'request for quote' market.

When a client approaches only one dealer, this may be because although he is operating under a request for quote model, there is only one dealer in that security, or the client may believe that the dealer in question is the only one holding the relevant securities, or because the client may wish to undertake a particularly large trade and does not want information about the trade to leak into the market. Accordingly, the client may feel that only approaching one dealer for a quote is the best way to meet his own obligation to act in accordance with the best interests of his own clients. In such circumstances, the dealer has not taken on any obligation to act on behalf of the client and does not owe best execution. However, in other circumstances, the client may wish to agree terms for conducting a particular trade with a dealer, for example because the client may wish to trade in a security that is in some way difficult to trade, or illiquid, and may wish to negotiate the best way of selling or acquiring the security. What obligations the dealer will owe the client will depend on what exactly is agreed between the parties, but where the dealer agrees to act on the client's behalf in conducting the trade, best execution will be owed.

How does this fit into MiFID?

The way in which this should be read as fitting into MiFID is as follows.

The dealer, by virtue of operating on a 'request for quote' basis, does not provide the service of executing orders on behalf of clients. This analysis is based on the premise that although the dealer may execute the transaction, and has acted to conclude an agreement to buy or sell one or more financial instruments, and has done so with his client, he has not done so on behalf of his client. Thus not every part of the definition can be fulfilled that would indicate that the dealer is executing client orders.

In these circumstances the dealer is still providing the investment service to the client of dealing on own account.

The position of the dealer

Accordingly, the position, in terms of the regulatory requirements to be met by the dealer when operating on a request for quote basis, is as follows:

- The dealer will be obliged to manage his conflicts of interest in accordance with Article 18 and Article 13 and will additionally be obliged to act '*in accordance with the best interests of [his] clients*' under Article 19(1) of the Directive;
- The dealer will not be obliged to comply with the terms of Article 21.

However, nothing in this analysis prevents the client from seeking the protection of the best execution rule as a matter of contract from the dealer. Where the dealer does agree to search the market for a particular security on behalf of the client, best execution will be owed.

Cash equity markets

Most if not all equity markets revolve around a centralized and reasonably transparent exchange or exchanges. In some countries there is little available to trade outside the exchange model. In the UK, however, the equity market is multi-layered. From a pricing perspective much still revolves around the central exchange, but from the liquidity perspective there is substantial reliance on the large liquidity providers. MiFID may change the way the market is structured but it is unlikely, in the short term, to change these two constants.

Clients may approach the market in a number of ways. Typically these will range from the client selecting one or more agency brokers to undertake all of their trading, through to the sophisticated dealing desks at the large institutional clients who will wish to control the flow of orders through to the market. This client group will tend to use the big liquidity providers rather than the agency brokers, to permit them to trade the market in the required volumes. However, the arrangements will be very variable.

- The client may seek liquidity from the dealer and take a price for his trade.

- The client may use Direct Market Access to the exchange via the dealer (in which case the client will be subject to protocols imposed by the dealer for submitting the order, but will clearly have selected the venue for the order).

- The client may ask the dealer to work the order in some way. For example he may seek liquidity in the form of a portfolio (basket) trade[4] or by asking the dealer to work the order over the course of the day by benchmarking against VWAP or some other measure.

- The client may ask the dealer to buy or sell the security on his behalf without giving any specific instructions as to how it should be done.

In the first circumstance much the same analysis applies as to 'request for quote' markets. However, it should be noted that the client may nonetheless ask the dealer to provide 'best execution' under the current regulatory regime.

In the second circumstance the client as a matter of fact takes responsibility for best execution, selecting the venue and timing for his trades. Again, however, in current markets the client may still ask the dealer to provide best execution.

In the third and fourth examples the client will commonly obtain best execution now and would expect to continue to obtain best execution under MiFID[5]. In both examples, the dealer has discretion as to how the trade should actually be executed (albeit that that discretion is limited by specific instructions provided in the third scenario) and it is up to the dealer to judge how the trade is actually laid off (for instance whether he crosses the trade against another client trade, matches it through the exchange order book, place it in his automated client trading engine, or trades against his own book). In both scenarios the dealer is taking on the obligation to act on the client's behalf and so best execution should be owed, albeit that, in the third example, he will need to execute the order following the specific instructions provided by the client.

The position of the dealer

First

In the circumstance in which the client takes a price from the dealer, the same analysis applies as in cash fixed income markets. The dealer will not be executing a client order, accordingly:

- The dealer will be obliged to manage his conflicts of interest in accordance with Article 18 and Article 13 and will additionally be obliged to act '*in accordance with the best interests of [his] clients*' under Article 19(1) of the Directive
- The dealer will not be obliged to comply with the terms of Article 21.

[4] This may be a risk trade or an agency trade

[5] Note that in this market model the dealer trades as principal, but this is a matter of legal construct. In terms of the client relationship, the dealer will in most circumstances, as described, act on behalf of the client. This is the basis on which the current market works and on which the client asserts, and the dealer accepts, that best execution is owed.

However nothing in this analysis prevents the client from seeking the protection of the best execution rule as a matter of contract from the dealer.

Second

In circumstances where the client chooses to use DMA, such that he selects the counterparty, the venue, the timing and size of trade, the dealer while acting on the client's behalf in providing the DMA service will be treated as having satisfied its duty of best execution as the client has given specific instructions.

Third

In circumstances where a client asks a dealer to work an order in some way and the dealer agrees to act on the client's behalf by taking on those obligations to the client, the dealer will be executing a client order and therefore the best execution obligation will apply, albeit within the bounds of any specific instruction provided by the client[6].

Fourth

In circumstances where a client asks a dealer to buy or sell a security for him without giving any instructions as to how it should be done and the dealer takes on an obligation to act on the client's behalf, best execution will apply.

OTC derivatives markets

OTC derivatives are unique bilateral contracts for transferring risk. They cannot be traded in the sense that they are not standardised or freely transferable instruments.[7]

Currently when a client approaches a dealer to obtain an OTC derivative product the dealer will not provide best execution to the client. The client, if he is an investment manager, will assess the result in several ways:

- Does it meet his investment needs (e.g. to hedge or gain exposure to the underlying, or implement a strategy to switch assets)?

- Was the cost reasonable (e.g. when compared to his own model, or when compared to other counterparties who have written other instruments for him)?

The entry into an OTC derivative instrument creates a very different set of circumstances than those for trading in commoditised (or standardised) products.

- The product will have many facets, including: underlying asset; counterparty risk; asset risk (e.g. interest rate risk); time period; restrictions on trading and/or settlement; potentially currency risk. The product will almost certainly not be fungible.

[6] Note that this will not apply when a portfolio trade is traded on a risk basis

[7] The analysis in this paper focuses on structured OTC derivatives. At the more commoditised end of this market it should be possible to apply the request for quote analysis that appears elsewhere in this paper, where market practices are comparable.

- The contract is formed when the proposal put forward by the dealer to meet the client's investment needs are accepted by the client and executed.

Although the client provides instructions on his investment needs to the dealer, these are directed at the content of the contract, not at the factors comprising best execution. The contract that the client receives from the dealer takes into account the client's instructions, but is also a discrete product. It is therefore important to the client that the dealer should, in packaging together his instructions, offer a result that is the best the dealer can provide. This is not a matter of the dealer acting on the client's behalf but the dealer will be under commercial pressure to service his client's needs well. To that extent, the regulatory protections of most importance to the client are those provided by Article 18 and Article 19 of the Directive.

<u>How does this fit into MiFID?</u>

In OTC derivatives products the dealer is not agreeing to act on the client's behalf. This means that Article 21 will not apply. However, Articles 18 and 19 will apply in these circumstances.

<u>The position of the dealer</u>

Accordingly, when a client has asked a dealer to write a customised OTC derivative the following will apply:

- The dealer will be obliged to manage his conflicts of interest in accordance with Article 18 and Article 13 and will additionally be obliged to act in accordance with Article 19 of the Directive;
- The dealer is not acting on behalf of the client, and so the terms of Article 21 will not apply to the dealer.