



The Good, the Bad and the Unfinished

The final stage of the Financial Services Action
Plan and the Lamfalussy Process

**the Association of
Private Client Investment Managers
and Stockbrokers**

January 2004

Foreword

APCIMS is the association which represents all stockbroking firms and investment management firms in the UK which act for the private investor. In addition, we have a number of private banks and the larger solicitor investment management firms as our members, plus an increasing number of firms which are quartered in Ireland, the Channel Isles and continental Europe. Our 221 members operate on more than 400 sites, undertake more than 50 per cent of agency trades in UK equities on the London Stock Exchange and have £240 billion under management for the private investor.

The following paper addresses a number of the issues with respect to the Lamfalussy process and principles of assessment that should guide the Committee of European Securities Regulators (CESR), the Financial Services Authority (FSA) and practitioners when considering the conduct of business requirements that flow from the Directive on Markets in Financial Instruments (formerly known as the Investment Services Directive and referred to in this paper as the ISD). The concluding pages address in some detail aspects of conduct of business that are relevant to our member firms.

Does the Lamfalussy process work?

Quality versus speed

One of the most important criteria for assessing the success of the new process was to ensure that the quality of legislation was not sacrificed at the cost of achieving speed. We have to note that we do not believe that there has been significant progress towards achieving faster progress for EU legislation. Nor in our view have the legislators succeeded in creating “framework” legislation at a truly strategic level. And we believe it is too early to assess whether the process can be sufficiently flexible to keep pace with market developments.

Cost benefit analysis

Our view is that there has been a slight improvement in the use of consultation processes, but there remains a very substantial amount of progress still to be achieved, especially with regard to cost-benefit analysis. The whole question of cost-benefit analysis has been virtually ignored by both the EU Commission and CESR and this is simply not acceptable.

We believe it is important to remember that there is a cost to any new proposals. We recommend that a cost benefit analysis should always be carried out at each stage as proposals get more developed and their impact on different sectors – or different types of firms – are better understood. Early cost benefit analysis should also be undertaken by national regulators in order that the issues are fully understood both by firms and to help inform the Commission.

Open and transparent procedures

In recognising that there has been an improvement in consultation processes, we believe that there remains much more to be done. For example, the EU Commission now publishes each individual response to its Communications,

but it does not provide any assessment of the issues and points raised, and why these are judged to be valid or not valid. Opportunities to feed in views to the Commission and to CESR have improved, but there has been little discernible improvement in the regulators actually listening to industry and shaping their proposals according to informed industry contributions.

We also believe that while there have been improvements in the transparency of the decisions reached by the EU Commission and by CESR (though more could be done by each of these bodies) the working of the European Securities Committee (ESC) in both of its roles (i.e. regulatory and advisory) fall well short of being sufficiently transparent.

We believe that there is a substantial risk of rushing through the Financial Services Action Plan merely to achieve the political timetable rather than to ensure that the legislation is well constructed and will result in clear benefits to all those in the Single Market. We strongly support CESR in its desire to agree upon harmonised rules, but CESR is largely bound by timetables outwith its control. There is therefore a real danger of CESR rushing through, for example, the implementing measures on the Market Abuse Directive and there is a risk that, in rushing, CESR will not achieve the best end rules. Consultations must not be condensed because the quality of end output could be adversely affected.

Is the process sufficiently democratic?

While the early reservations of the European Parliament about the Lamfalussy process and whether it was intrinsically undemocratic are not proven to date, we believe that there is scope for improvement. There is evidence of practices which are falling short of being sufficiently democratic and examples include the insertion of Article 27 into the Directive on Markets in Financial Instruments (formerly the Investment Services Directive and referred to in this document as the ISD) with no prior consultation whatsoever by the EU Commission. Furthermore, we have doubts that the Economic and Monetary Affairs Committee (EMAC) report and work on this Directive is being

sufficiently taken into account and considered by the other relevant institutions.

But the single most serious obstacle hampering the democratic processes is the absence of a common political understanding on what are the desired outcomes. This might be due to protectionist endeavours or it may just be a reflection of different mind-sets among political delegations.

Flexibility and harmonisation

As already noted we believe it is too early to comment on whether the new process will be sufficiently flexible although we do believe that this is critical to the success of the entire process. It is vital that there must be flexibility in the arrangements for reviewing and changing rules that do not work. The key issue is that if it is not essential to harmonise, then it should not be harmonised. Furthermore harmonisation means equivalence and not necessarily uniformity which will often be impossible to achieve given differences in national laws, far less market cultures.

Choice of Instruments at Level 2

The Commission has proposed a mixture of Commission Regulations and Commission Directives for the first measures to follow the Lamfalussy process i.e. the Directives on Prospectuses and on Market Abuse (a total to date of two Commission Regulations and three Commission Directives). The actual Lamfalussy process does not favour either legislative instrument. What is important is not the choice of either Regulation or Directive, but how best to avoid delays in implementation and divergences in interpretation of policy. Therefore, we firmly believe that more work needs to be done at all stages of the legislative process to identify different practices in the main conduct of business areas in the EU.

Directive on Markets in Financial Instruments (ISD) conduct of business issues

Introduction

There are four fundamental principles which should guide CESR, the FSA and practitioners when considering the conduct of business issues that flow from the ISD. There are many issues surrounding the detail of CESR's work on conduct of business rules and again we have identified four areas likely to have a significant impact.

The fundamental principles are:

- i) the need to identify the differences in basic practices in the various countries;
- ii) allowing sufficient time for open consultation practices;
- iii) focussing on achieving equivalent end results rather than identical detail; and
- iv) implementing new rules in a sensible and not continuous manner.

The five detailed conduct of business issues are:

- i. execution-only services and suitability requirements
- ii. client notifications
- iii. best-execution
- iv. trading venues in execution policy
- v. RSPs and Article 27

Principles

1. Information about the basic practices in the various countries

There are many differences between countries with their current business practices which need to be understood if CESR level 2 measures are to be

appropriate. For example, although advisory and discretionary portfolio management are common alternatives in the UK, it is our understanding that this is not the case in other European countries.

A second example is related to execution only business and the ISD. The ISD specifically states that derivatives should not be sold on an execution only basis. Our understanding is that in some countries as long as parameters are set for an individual at the outset of a relationship, that individual will then be able to deal without advice in derivatives provided he or she does not exceed the parameters. In other countries (such as in the UK) this would not be acceptable as execution only business.

These two examples underline the need for information about financial practices to be understood prior to final decisions being made by CESR, if the rules are not to have an unintended differential impact in some countries or to have net different results.

2. Consultative Process

It is essential that sufficient time is given to the consultative process so that the industry can respond, CESR can take the responses into account and reissue the document for further consultation with the changes included. Without such consultation practices it will not be possible to ensure that quality regulation results. In addition, and as transparency is key to achieving harmonised implementation of the FSAP, CESR should publish the responses it receives and then the reasons why it does or does not adopt the proposals put forward by the industry during the consultative process.

3. Harmonisation is about reaching equivalent results

CESR and home state regulators should be concentrating on achieving equivalent end results in each of the EU countries rather than attempting to make every country operate in exactly the same way. The different legal frameworks make it impossible, or near impossible, for every country to undertake every practice in exactly the same way. In addition as long as the

effective result is the same, then current practices that are acceptable should be allowed to continue and not be subject to detailed change.

There are already (and no doubt there will continue to be) aspects of the directives that are subject to interpretation. A current example is with the Distance Marketing Directive where the FSA has consulted the industry about the various changes that it proposes to make, including incorporating portfolio management services into a cooling off period. To date however we are unable to find any other European country that proposes to make a similar set of changes. Rather we are told that as current practices are broadly in keeping with the spirit of the Distance Marketing Directive, then no industry changes are proposed. It is in the interest of the industry as well as comparability across EU states that where there are issues of interpretation, a common agreement is reached.

4. Timing of implementation of the changes

Continuous change is more costly and disruptive than change that can be planned and implemented in one go. There is increasing pressure from business in the UK for two set implementation dates each year, for example 1 January and 1 June. Considering the extensive number of changes embodied within the Financial Services Action Plan and the fact that many firms will be subject to most of these changes, consideration needs to be given to time the implementation, even though this might mean that some changes are subject to a six-month delay. Lamfalussy mentions the need to minimise the cost to the industry of the FSAP changes.

Conduct of business issues in detail

There is considerable detail in the draft mandate to CESR for its work on the ISD, yet both CESR and the industry have already carried out much relevant study and detailed analysis in response to the CESR Working Party on Harmonised Rules for Investor Protection which published its “Final” Rules in 2002. We hope that CESR can draw upon the experience of this Working

Party and especially to identify the different basic business practices of the different countries.

There are many issues arising from the mandates on the conduct of business rules for investment firms and we highlight five which are likely to have major impacts:

1. execution-only services and suitability requirements
2. client notifications
3. best-execution
4. trading venues in execution policy
5. Retail Service Providers (RSPs) and Article 27

1. Execution-only businesses/suitability test/appropriateness test (Article 19.4-6)

Debate is continuing about the precise wording in the Directive and whether execution-only services should be provided only “at the initiative of the client”. We note that the mandate asks for criteria to be defined for assessing the minimum level of information that should be obtained from the client regarding his knowledge and experience in the investment field, and to determine the criteria for assessing on the basis of the information received, the appropriateness for the client of the investment service or product envisaged as well as the content of the related warnings. The mandate also asks for technical advice on what is to be considered a non-complex instrument for the purposes of this rule.

We have provided a large amount of advice to CESR on the extent of information gathered by investment firms for their no-advice or ‘execution-only’ customers and on the information given by investment firms to their clients when this type of service account is opened. We have also commented at some length on what we believe are subjective judgements if firms are required to assess a client’s knowledge and experience in the investment field. We find it difficult to move from our view that any assessment by a firm of a client’s knowledge will be a subjective judgement.

2. Reports from the firm to its clients (Article 19.8)

We note that the mandate is for CESR to provide advice on the criteria for determining when and in which manner the investment firm should report to its clients, and take into consideration events which give rise to a reporting obligation and the frequency of reporting, and the minimum content of the reports. The experience from APCIMS firms is that firms already have to provide a large number of reports on a range of matters and that with the exception of changes to customers' Terms of Business, periodic statements and contract notes, such reports are generally deemed to be of no value.

We would also comment on the practical difficulties of two-way notifications to clients. Experience has indicated that such notifications are a huge cost to firms, have little or no benefit to customers and in over 60 per cent of cases are unreturned by customers after one mailing. There is a substantial body of evidence showing that customers are puzzled and irked by the volume of material received from firms.

In this context it is vital that where there are to be major changes such as the introduction of the requirement to notify clients of execution policy, that current practices are allowed to be "grandfathered" into the new regime, and thereafter that any changes are notified to clients as soon as is practicable. It is important that this is not subject to a "two way notification" (i.e. requiring the client's consent) as the best execution requirements do, in any case, place an obligation on the firm to obtain the best possible outcome for the client.

3. Best Execution (Article 21)

We note that CESR is asked to bear in mind that there is "a need for a comprehensible set of criteria to be put in place to allow firms to determine whether they are complying with the obligations as well as to allow clients to understand execution policies". It is difficult to comprehend how firms will be able to judge whether or not clients understand execution policies.

The requirement for firms to inform their clients about their order execution policies and to obtain the prior consent to these from clients is a new requirement. It is hard to assess the possible benefits to clients and whether

they will be able to understand execution policy when the majority of clients simply ask for a transaction to be carried out simply, quickly and at a reasonable cost.

4. Trading venues to be included in the order execution policy (Article 21.2)

CESR has been asked to carry out a range of different work in this area including “the criteria for determining the venues that enable investment firms to obtain on a consistent basis the best possible result for executing the client orders” . CESR is asked to take into account the different execution methods and the price availability, the criteria for determining when an execution venue is offering the best results on a consistent basis, and to specify what could be considered “consistent basis”.

We hope that the work on this area can be kept at as simple a level as possible and that CESR’s advice is not unduly detailed or complicated. We believe that the different trading venues, MTFs, execution centres and crossing systems are simply not of interest to retail clients and information on such venues will not be understood. What is important to clients is the overall level of service provided by professional investment firms and an effective means of redress in the event of grievance or error.

5. Retail Service Providers (RSPs) and Article 27

The mandate on Article 27 ‘Obligation for investment firms to make public firm quotes’ is likely to have significant implications for our members, the way they carry out their business and the overall structure of retail trading through the RSPs in the UK. The RSP structure is unique to the UK and a unique solution must be found to the issues arising. It is at present uncertain how they will be classified – the possibilities include:

- on-exchange – outside the scope of Article 27 and pre-trade transparency

- off-exchange – subject to Article 27 and pre-trade transparency requirements,
- Multilateral Trading Facility (MTF) – would involve new status and pre-trade transparency requirements
- systematic internaliser – no price improvement and transparency requirements.

If the RSPs are to count as systematic internalisers, then clearly we would like “standard retail size” to be defined at the lowest possible size. Clearly, there are requirements on APCIMS firms to obtain best-execution for their private clients. And this will continue. But to deny RSPs the potential to improve their prices with APCIMS firms with whom they deal in a professional capacity would seem to us to be a unwise avenue which would have the effect of substantially increasing costs to private clients by denying them the best possible price, at no benefit whatsoever.