



Response by EFFAS

CESR
Section: "Consultations"
via Email/Internet

Einsteinstrasse 5
DE - 63303 Dreieich

Contact: Claudia Stinnes
Direct number: +49 6103 5833-48
Fax number: +49 6103 / 5833-35
e-Mail: claudia.stinnes@effas.com
Internet: www.effas.com

16 March 2007

CESR/07-050b Best Execution under MiFID Public Consultation

The European Federation of Financial Analysts Societies, EFFAS, is the European umbrella organisation of national analysts societies. It comprises 24 members representing more than 14,000 investment professionals in the areas of Equity and Bond Research, Asset and Portfolio Management as well as Investment Advice.

We appreciate the opportunity to comment on the consultation paper on Best Execution under MiFID. We would like to answer the questions as follows:

Question 1: Do respondents agree with CESR's views on:

- **the main issues to be addressed in an (execution) policy? Are there any other major aspects or issues that should ordinarily be included in an (execution) policy?**
- **the execution policy being a distinct part of a firm's execution arrangements for firms covered by Article 21?**
- **the execution policy under Article 21 being a statement of the most important and / or relevant aspects of a firm's detailed execution arrangements?**

Answer: We agree

Question 2: For routine orders from retail clients, Article 44(3) requires that the best possible result be determined in terms of the "total consideration" and Recital 67 reduces the importance of the Level 1 Article 21(1) factors accordingly. In what specific circumstances do respondents consider that implicit costs are likely to be relevant for retail clients and how should those implicit costs be measured?

Answer:

The idea of the "retail investor" underlying Level 2 Article 44 (3) is of an investor making medium or long term investments in either fixed income or exchange traded equity issues. Other categories of retail investors seem to be ignored or neglected. In the ordinary course of business Best Execution for the former category might, in fact, be reduced to the factors pricing and explicit cost. For all other categories of retail investors, especially those trading in derivatives, structured products or so-called

complex instruments, price and explicit cost of an individual transaction are of importance, but have not the all dominating/pervasive role as envisaged by Article 44 (3) and the consultation paper.

For the latter category of investors, especially while trading on very volatile markets, speed of the transaction is much more important than differences in relatively low (comparing to the transaction's value) costs – implicit or explicit. This may be very important not only with derivatives, but also with shares (even for medium or long term investors), when prices start to drop rapidly and the most important factor is a possibility of closing the open position as soon as possible. Searching for the lowest costs in such cases may lead to high losses or even disasters – because when finally such a “low-cost” place is found, the price is much lower or even the whole transaction is no longer possible (e.g. when transactions are suspended).

As one can see from the explanation given above, the best possible pricing and explicit cost for each transaction is an important, but by no means the most important element in a “best execution” strategy for, or of a particular retail client.

Therefore, one should formulate typical categories or types of retail investors, categories of related financial instruments and market events, where other factors are more important than price or transaction costs.

Example: For a retail client engaging in options, the difference between out of the money, at the money or in the money and the related delta factors, and the understanding and management as well as speedy execution are of far greater importance than differences in commissions charged by executing firms.

Another factor underestimated by the regulation is the fact that an increasing number of retail investors do not play a passive role anymore and rely on their investment firms, but use trading platforms with direct access to markets. The explicit cost of using the platform is outweighed by the implicit cost and effect of the technical reliability and quality of the trading channels and tools. These retail investors assimilate more and more to professional investors without formally being classified as such. These factors must be considered by the investment service industry and regulators alike.

Question 3: Do respondents agree with CESR's views on the use of a single execution venue?

Answer: We agree

Question 4: Do respondents agree with CESR's views on the degree of differentiation of the (execution) policy?

Answer: We agree. We refer to our answer to question 2, where we have outlined some of these considerations applicable to serving retail clients as well.

Question 5: Do respondents agree that the 'appropriate' level of information disclosure for professional clients is at the discretion of investment firms, subject to the duty on firms to respond to reasonable and proportionate requests? On the basis of this duty, should firms be required to provide more information to clients, in particular professional clients, than is required to be provided under Article 46(2) of Level 2?

Answer:

To the first part of the question: We agree. The professional investors can fend for themselves, they have the expertise, if not of the markets and their mechanics, but to ask the right questions.

We think that the second part of the question is moot. If an investment firm does not respond satisfactorily to questions posed by a professional investor, the investor can and will turn to another firm that meets his information needs. The question suggests the absence of competition. Professional investors have greater bargaining power than retail investors. There is no need to regulate any and all aspects of information to professional investors.

Question 6: Do respondents agree with CESR on how "prior express consent" should be expressed? If not, how should this consent be manifested? How do firms plan to evidence such consent

Answer: We agree

Question 7: Do respondents agree with CESR's analysis of the responsibilities of investment firms involved in a chain of execution?**Answer:**

The term "chain of execution" is used as a short-hand description of the chain of services involved in carrying out a client transaction. It includes non-executing intermediaries and executing firms. It should be replaced by the term "chain of investment services".

CESR's correctly analyses the different situations according to the functions of the different services involved in a chain of investment service providers. This analysis remains, however, on a highly abstract level and can **only** provide a convergence of application in those limited cases where abstract problems of the relation of Art. 21 MIFID (Level 1) and Article 45 Implementing Directive (Level 2) are at stake. Many of those issues which portfolio managers and RTOs encounter are not explicitly addressed in this analysis.

Some issues are:

- Contractual duties in a principal – agent relationship
- On whose initiative or responsibility was the chain of investment service providers formed
- Categories of financial instruments.
- Conflicting objectives

1. Contractual relations:

It is not clear whether in cases of RTOs introducing and serving retail clients on the first tier, a pure one-side agency contract between another executing or intermediary firm as principal on the second tier is still permitted under the MiFID provisions. MiFID (Level 1 Art. 19 par. 7 and Level 2 Art 39 require a basic agreement between the investment firm and the retail client. Nonetheless, there will be cases in which RTOs have one or more exclusive agency agreements with second tier investment firms introducing investment products or services to retail clients without being tied agents. The RTO owes the principal firm(s) fiduciary duties in promoting their products. The agency contract precludes that the RTO introduce clients for the products or services covered by the exclusivity to other execution or intermediary firms. The "best execution" owed by the RTO to the client cannot be the best price including the remuneration of the second tier firm, but rather that such a second tier firm meet its own "best execution" obligations in selecting the best venue for executing or carrying out the retail client's order.

The first tier RTO agent has no possibility to influence the amount of remuneration charged by the second tier firm. The RTO should at most monitor and object to a discriminatory commission policy of the second tier firm relating to different execution venues. Our interpretation of such cases of duties of exclusive agency owed by an RTO is that the best execution ought to be the best price obtainable for a retail client on the doorstep of the second tier principal firm. In this respect, the RTO is in a position similar to a tied agent.

2. Initiative for the chain

2.1 Chain formed upon the firm's recommendation

The chain may be formed upon the initiative and the advice of the RTO or the portfolio manager recommending that a certain bank or broker carry the retail client's account and execute the orders. The relationship is set up at the outset before any transaction is executed. Since level 2 Article 45 NR. 4 in combination with Article 44 NR. 3 requires a best price policy including all items up to the doorstep of the RTO or portfolio manager. Does a best execution policy require the RTO or portfolio manager only to recommend execution firms with lower cost or advisory firms with higher cost?

Firms recommended to a retail client by an RTO or portfolio manager might later on increase their fees or commissions relative to their competitors' charges. Is the RTO or portfolio manager obliged under a "best execution" policy to advise the client to switch the account carrying and executing firm although the client might be used to and happy with this second tier relationship? Considering the complicated regulatory requirements for establishing a new service relationship, in particular opening a new account, such changes entail efforts and inconveniences (opportunity costs) which might deter the retail client from the introducing RTO or portfolio manager recommending such changes.

A similar problem arises when a portfolio manager recommends to a client a specific account carrying and execution firm with a mixed record of remuneration amounts for different transactions. To use a phrase out of another context, this policy to use one firm with this mixed bag for a retail client, instead of confusing the client with a multitude of accounts and complicate the management by placing orders with different firms, might be designed to enhance the overall quality of the service. Is this a valid argument in mitigation the best pricing requirement for each and every transaction?

2.2. The chain is formed upon the retail client's own decision and initiative.

In many cases, the RTO is only concerned with introducing a particular financial product or the portfolio manager in managing a portfolio which has been established at an account carrying and executing firm chosen by the client, possibly long before the relationship with the RTO or portfolio manager was established. We think that this choice amounts to a specific instruction given by the retail client to use this firm for execution which discharges the RTO or portfolio manager according to Level 1 Article 21 (1) and Level 2 Article 45 (4) par. 2.

3. Categories of instruments

Especially in derivatives, fast markets may have an impact even on retail clients' positions, where efficient access to the markets through executing firms might be, in an overall consideration, much more important for a successful trading of a client than savings on fees and commission through another firm which might reasonably perform in regular or quiet markets, but is unable to deliver the best service in such crucial situations. We refer to our above prime objective to prevent disaster. Do considerations of this nature allow an approach of recommending executing firms who on paper do not have the lowest fees and commissions?

4. Conflicting objectives

An example may be a RTO introducing a retail client to a portfolio manager. The portfolio managers in question have remuneration structures in which part of the remuneration charged to the retail client is a transaction- (volume-) based commission. In practice, there exists a different level of conflict of interests for portfolio managers charging those transaction fees. Portfolio managers with lower transaction fees have a higher incentive to increase the volume of business than those portfolio managers charging a higher fee per transaction. In plain market language, the risk of a client being churned is greater in the case of the cheaper portfolio manager. Is the RTO permitted to take these considerations into account when introducing the client to a portfolio manager?

These and certainly other practical issues regarding best execution are encountered in a chain of investment firms serving retail clients. Basically, other aspects of best execution besides the mere pricing of a transaction in many instances play a greater role also for the service to retail clients. Guidance as to the treatment of typical cases would be helpful to the industry.

Question 8: What core information and/or other variables do respondents consider would be relevant to evaluating execution quality for the purposes of best execution?

Answer:

To ensure the execution quality information about the following facts are needed:

- Does the price of the financial instrument correspond with the market standard
- Speed and method of order execution
- Probability of order execution
- market access
- concerning shares of investment funds, the appropriate price fixing depending on the execution type would still have to be evaluated.

Yours sincerely,



Fritz H. Rau
Chairman of EFFAS



Giampaolo Trasi
Chairman of the EFFAS MSC