CJ/SJ/ n°2213/Div.

Mr Fabrice Demarigny
Secretary General
Committee of European Securities Regulators (CESR)
11-13, Avenue de Friedland
75008 Paris

Paris, March 16, 2007

AFG RESPONSE TO CESR CONSULTATION ON BEST EXECUTION UNDER MIFID.

Dear Mr Demarigny,

The Association Française de la Gestion financière (AFG)[1] welcomes CESR consultation on Best execution under MiFID, a question that is of utmost importance for the asset management industry.

[1] The Association Française de la Gestion financière (AFG)[1] represents the France-based investment management industry, both for collective and discretionary individual portfolio managements. Our members include almost 400 management companies and more than 700 investment companies.

They are entrepreneurial or belong to French or foreign banking, insurance or asset management groups. AFG members are managing more than 2500 billion euros in the field of investment management, making in particular the French industry the leader in Europe in terms of financial management location for collective investments (with nearly 1500 billion euros managed, i.e. 22% of all EU investment funds assets under management, wherever the funds are domiciled in the EU) and the second at worldwide level. In the field of collective investment, our industry includes – beside UCITS – the employee savings schemes funds and products such as regulated hedge funds/funds of hedge funds and a significant part of private equity funds. AFG is of course an active member of the European Fund and Asset Management Association (EFAMA) and of the International Investment Funds Association (IIFA).

For several years now, AFG has been actively contributing to European discussions and consultations relating to the Markets in Financial Instruments Directive (MiFID), either directly or through the European Fund and Asset Management Association (EFAMA).

GENERAL COMMENTS:

1. *Best execution obligations on OTC Markets:*

In its consultation paper, CESR does not address the issue of the OTC Markets (e.g. dealers' markets) in the context of the best execution obligation applicable to portfolio managers. OTC Markets are **de facto markets** where the first circle players are intermediaries (generally banks), which offer prices on the market. Portfolio managers are part of a second circle, asking the players of the first circle (such as dealers) for buying or selling financial instruments on such markets. Therefore portfolio managers are clients of such intermediaries. On these OTC Markets, intermediaries have to comply with the general principle of best execution (applicable to any financial instrument according to Art. 21 Level 1 MiFID)[2]. However, this general obligation required by Art. 21 has obviously to take into account the *specific features* of the relevant instrument and markets: for instance, for instruments other than shares, there is no requirement of transparency (as opposed to shares); and for OTC markets, there is no centralised pricing. Therefore this general obligation of best execution must be adapted to the features of the relevant instrument and market, which could justify a lighter implementation in practice of the best execution principle for bonds for instance as compared to the implementation of the same principle for shares. In any case, portfolio managers acknowledge their duty to comply with the obligation of Article 45 Level 2/Article 19 Level 1 - but not with Article 21 Level 1 when they do not belong to the first circle of players on markets (which is usually the case).

We don't understand why CESR, though composed of market practioners, did not tackle such a crucial issue of clarifying the respective obligations of best execution on OTC markets and the relevant financial instruments, and instead asked the European Commission to interpret the MiFID in such a case.

First, as you know, *the European Commission has not any powers to interpret European legislative texts officially*: only the European Court of Justice (ECJ) can provide for an official interpretation of European legislative texts. Indeed, we wrote letters to the European Commission services last autumn on other MiFID issues, asking for interpretation, and we got the unofficial answer that we would not get any official response from the European Commission services because of this lack of interpretation power, contrary to the ECJ.

Second, we consider that the issue at stake here is a question of *practical implementation* to specific instruments/markets, and not a question of legal interpretation: only practioners knowing from their daily experience the reality of markets can provide for a sound implementation advice.

Usually CESR provides for technical advice to the European Commission (e.g. in order to help the European Commission preparing the draft Level 2 measures). Here the process has been reversed and we don't understand why: we understand that now CESR is waiting for European Commission services' advice (but not official legal interpretation, as it is not legally possible for the European Commission as opposed to the ECJ- see above) but we still wonder how CESR would take on board the technical advice of *political* bodies such as the European Commission.

[2] Subject of course to the agreement by intermediaries for accepting or not to give the status of professional clients to eligible counterparties (such as management companies).

Therefore, we urge CESR to clarify the way it intends to deal with the forthcoming "technical advice" of the EC and to adapt it to the reality of markets. On the substance, we hope CESR will share our analysis of the issue of best execution for instruments dealt on OTC markets.

2. Complementarity between the obligations applicable to intermediaries and the obligations applicable to portfolio managers /RTO providers:

Regarding the issue of best execution, which is one of the major innovations of the MiFID as compared to the repealed Investment Services Directive (ISD), AFG members have reached the following conclusion on the way to implement in practice the best execution mechanism set up by the MiFID Levels 1 and 2 for management companies.

To start with, we want to make clear that on this best execution issue, the portfolio management service and the reception/transmission of orders (RTO) service are only covered by Article 19 of MiFID Level 1 and the related Article 45 of MiFID Level 2, as compared to the service of execution of orders which is covered by Article 21 MiFID Level 1 and the related Articles 44 and 46 MiFID Level 2. In application of Article 45 of MiFID Level 2, we agree that the criteria of Article 21 of MiFID Level 1 have to be applied by the entities that are providing the service of execution of orders to portfolio managers acting on behalf of their own clients; but in no case the requirements of Article 21 MiFID Level 1 are applicable to the services of portfolio management and RTO themselves.

The best execution obligation as applied to the service of portfolio management (or RTO) is a **specific** regime based on the overarching principle of Article 19 (the obligation to act in the best interests of the client) and not on Article 21 ('genuine' best execution obligation). This is the significant difference between the final version of MiFID Level 2 as adopted by unanimity of Member States' representatives in the European Securities Committee (ESC) as well as by the European Parliament, as compared to the approach that CESR had initially proposed to the European Commission in its Level 2 'Technical Advice' last year. In particular, let's remind that this crucial need for a *specific treatment of best execution for portfolio management and RTO* was the major remaining political point of disagreement between the European Parliament and the European Commission itself on the original draft Level 2 proposed by the European Commission last spring – and on which the European Commission finally followed the approach asked by the European Parliament as opposed to the initial CESR's approach.

CESR's original aim in its initial Level 2 Technical Advice apparently wished to apply an 'analogous' treatment for intermediaries in charge of execution of orders and for portfolio managers. This approach has been initially followed by the European Commission in its initial draft Level 2 proposal.

But the European Parliament (EP) then strongly – and unanimously – reacted by asking for a differentiated treatment between the regime applicable to intermediaries in charge of execution of orders on the one hand and the regime applicable to portfolio managers on the other hand. Thanks to this, the European Commission amended its draft Level 2 measures and the EP then took note that this differentiation had finally been made by the European Commission and the ESC in the last, adopted version of MiFID Level 2.

From a legal point of view, the European Parliament had made clear that applying an 'analogous treatment' to the service of execution of orders on the one hand and the service of portfolio management on the other hand would have meant to illegally extend, through the Level 2 implementing Directive, the scope of the 'best execution' of Art. 21 Level 1,, beyond the mere service of 'execution of orders' (single service mentioned in Art. 21 Level 1) to other services (portfolio management and RTO) not mentioned in Art. 21. It would have then led to an 'ultra vires' implementation by the European Commission, going beyond the delegated powers it had received from the European Parliament and Member States.

In addition, the European Parliament had also made clear that obviously the entities providing for the service of portfolio management (or RTO), while placing (or respectively, transmitting) orders, do not have to duplicate the obligation applicable to the entities providing for the service of execution of orders itself.

The mechanism set up by Article 45 is in fact the following (let's take the case of portfolio managers providing the service of portfolio management):

- Portfolio managers have the obligation to take all reasonable steps to obtain the best possible results for their clients (following the requirement of Art. 19 Level 1), in particular through the selection of intermediaries in charge of execution of orders, taking into account the factors of the best execution to be further applied by those intermediaries (Article 21 Level 1) , modulated by the criteria defined at Level 2 (Article 44 Level 2);

- Portfolio managers fulfil their obligation (based on Article 19 Level 1 and Article 45 Level 2) by setting up a policy which is not an 'execution' policy as such (as they don't usually execute orders) but a policy enabling them to select the intermediaries to which they place orders for execution. This policy is a policy of '**best selection'** of intermediaries. Portfolio managers have the obligation to select for each class of instruments the intermediaries who would enable them to comply with their own obligations [which is to take reasonable steps to obtain the best possible result for their clients by selecting the most appropriate intermediaries ('selection' policy)];

- These intermediaries executing the orders are subject themselves to an 'execution' policy;

- Portfolio managers have the obligation to monitor the effectiveness of their own policy of 'best selection' by checking the intermediaries ex post. According to Article 45 Level 2 and the related Recitals, portfolio managers do not have the obligation to 'redo' the execution of the transactions.

One of the main concerns of the asset management industry is linked to the status given by the MiFID to portfolio managers, which are eligible counterparties. The paradox is the following. Portfolio managers have the obligation to select the 'best' intermediaries that would ensure the best execution, on the basis of the 'execution policies' delivered to the portfolio managers by the intermediaries and regularly monitored afterwards by portfolio managers. However, intermediaries do not have themselves the obligation of providing for the best execution to eligible counterparties. According to Article 50 Level 2, eligible counterparties have the possibility to ask for a reclassification into professional clients (benefiting from the best execution obligation); but the same article offers to the intermediaries the possibility of refusing this request of reclassification. It means that Article 45 imposes an obligation of 'best selection' on the portfolio managers' heads without providing them with the guarantee (through their status) to be able to obtain the best execution from the executing intermediaries. CESR should keep in mind that portfolio managers are acting on behalf of their clients; so if they cannot benefit from the best execution obligation themselves, their own clients will not be able as well to benefit from this obligation - harming therefore investors' protection (which is the ultimate goal of CESR Members). It should naturally lead to the conclusion that portfolio managers could be considered as legally responsible vis-à-vis their clients through their Level 1 general obligation, i.e. '*acting honestly, fairly and professionally in accordance with the best interests of their clients*' but that they cannot be taken responsible vis-à-vis their clients of intermediaries' refusal to offer them the benefit of the best execution obligation.

We therefore urge CESR to adapt its Level 3 guidelines following this interpretation of Article 45, which is the only possible interpretation in practice enabling portfolio managers to comply with their obligations.

We provide hereafter our detailed comments on CESR's analysis.

SPECIFIC COMMENTS:

Introductory part

Para.6, we strongly disagree with the symmetry made by CESR between Article 21 (the general obligation of 'best execution') and Article 45 (the specific obligation tailored for RTO and the service of portfolio management), when CESR states '*the overarching best execution requirement to deliver the best possible result is the **same** under Article 21 and Article 45*' and that the '*steps are **similar** in that they require firms to have a comprehensive execution approach to achieving the best possible result*'. As mentioned in our general comments above, the overarching principles and the steps to fulfil them in practice are clearly different – and complementary - in the two cases. We therefore urge CESR to acknowledge this difference and complementarity in overarching principles and associated steps, depending on the relevant situation. It is crucial to avoid any ambiguity in the starting point of the analysis of CESR between Art. 21 Level 1 (and Art. 44 and 46 Level 2) on the one hand and Art. 19 Level 1 (and Art. 45 Level 2) on the other hand.

As already mentioned above, intermediaries executing transactions and portfolio managers/RTO providers do not have the same obligations. They have **complementary** obligations leading to the execution: the first ones have the obligation of executing at the best conditions on the market and the latter the obligation of selecting the best intermediaries providing for the best execution as expected *ex ante* from their disclosed 'execution policy' and *ex post* from the regular monitoring carried out by portfolio managers, on the basis of information delivered by intermediaries to portfolio managers.

As a conclusion on this point, we think CESR has not made a proper distinction between the executing intermediaries and the portfolio managers/RTO providers. There is therefore a major risk of confusion for their respective obligations.

Para 7, we wish to point out a very dangerous confusion introduced by CESR regarding the '*firm's (execution) policy'*. Footnote 2 states that the term '*(execution) policy*' refers to the '*execution policy*' of Art. 21 Level 1 together with the '*policy*' of Art. 45 Level 2. First, in terms of legal parallelism, Art. 21 Level 1 must be compared to Art.19 Level 1 (or, respectively, Art. 44 and 46 Level 2 must be compared to Art. 45 Level 2). Second, on the substance, this sentence introduces once again a confusion between the policy required from the entities executing orders (i.e. '*execution policy*') and the policy required from the entities providing the services of portfolio management (or RTO), (i.e. '*selection policy*'). Once again, these two policies are *complementary* and must therefore be **clearly differentiated** in order to avoid any ambiguity.

Para. 12, we would like CESR to officially disclose the exact questions asked to the European Commission on the scope of application of the best execution obligation.

Para 14, regarding the structure of the document, and as mentioned above, we would appreciate an analysis made on the clear distinction of the obligations of the executing intermediaries on the one hand and the obligations of the portfolio managers / RTO providers on the other hand.

Execution Policies and Arrangements

Q1 : 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 firms' 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?*

Para 17, we very strongly disagree with CESR's wording stating that Article 21 and Article 45 are only 'worded differently' but cover the same requirements. **The two articles are worded differently because they do not cover the same situations and obligations**.

Para 19, we strongly support CESR's analysis that for portfolio managers or RTOs "*there are no requirements in Article 45 of Level 2 for client consent or demonstration of compliance to clients.*'

Para 21, we dispute the use of the adjective '***analogous***' when describing the policy that portfolio managers have to establish under Article 45, as compared to the execution policy that executing intermediaries have to establish under Article 21: CESR is making a direct link between Art. 21 Level 1 and Art. 45 Level 2, which are on the contrary clearly differentiated in the Level 2 Directive. The two policies are not identical but **complementary** and therefore should not contain '***similar***' elements, contrary to the statement made by CESR ('*As the Article 45 policy (…) is **analogous** to the Art. 21 execution arrangements (…), we would expect the Article 45 policy of a portfolio manager or RTO to include **similar** elements to those contained in the Article 21 execution policy (…)*'). The 'best execution' policy required from the entity in charge of the execution of orders has to describe elements relating to the execution (choice of venues depending on the different factors and criteria of the best execution), whereas the 'best selection' policy has to include elements that allow the portfolio manager to select the 'best' intermediary based on the criteria and factors of the best execution required from this intermediary. This means, for example, that intermediary X would be preferred to intermediary Y because its own 'best execution' policy matches better with the 'best selection' policy of the portfolio manager than the execution policy of Y.

Content of an (execution) policy:

We very strongly disagree with the approach taken by CESR, which is to mix and mingle the 'best execution' policy with the 'best selection' policy. Since these two policies are **complementary** and have different aims, they cannot contain similar elements. The 'selection' policy should contain the criteria allowing the best selection of the entities providing for the service of execution of orders.

Although we agree with the fact that the activity of carrying out execution of orders is linked to the execution policy, we strongly disagree with CESR's interpretation on the meaning of

'carrying out'. In no case, should it refer to the service of portfolio management when placing an order since the general obligation of 'carrying out orders' is provided by Article 22 Level 1, which only encompasses the service of execution of orders: 'carrying out' orders does **not** encompass any other services than execution of orders, such as portfolio management or RTO for instance.

In order to tackle the issue of the 'best selection' policy , we suggest CESR to ask trade associations to start working on the content of the 'best selection' policy, which would be complementary or the 'best selection' policy proposed by CESR.

The execution policy should not be considered as a distinct part of a firm's execution arrangements for firms covered by Article 21. It should be a part of the execution arrangements.

In conclusion, CESR should modify the title of the section into '*content of an **execution** policy*' **by deleting the brackets** to reflect the fact that this section only deals with execution policies and that the term 'carrying out' does not encompass the service of portfolio management or the service of RTO.

Factors and criteria

Q2: 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?

Para 23, among the factors referred to Article 21 (1) of Level 1, CESR lists "any other consideration relating to the execution of the order". We are wondering whether CESR should specify or provide examples of the 'any other consideration', which might lead to gold plating.

Para 26: we wish to recall that portfolio managers are out of the scope of Art. 44 Level 2, and therefore that the related obligations do not bind them for the service of portfolio management or RTO.

Same remark for Para 27.

Regarding whether implicit costs are relevant for retail clients and how they should be taken into account, we consider that the Directive does not say anything on the implicit costs and therefore they should not be taken into account in the 'total consideration'.

Q3: Do respondents agree with CESR's views on the use of a single execution venue?

Regarding the execution venues, we want to mention that the decision of switching from an execution venue to another one induces operational risk (due to the settlement of the operations). Consequently it is not necessarily in favour of the clients to decide switching to another execution venue.

Regarding the use of a single intermediary by portfolio managers, or the investment firms providing for the service of RTO, we are supporting the analysis made by CESR in Para 40. Therefore depending on the structure of the market, it might be better for portfolio managers and RTO providers to use a single executing intermediary, providing they comply with their obligations under Article 45.

Q4: Do respondents agree with CESR's views on the degree of differentiation of the (execution) policy?

Yes.

But CESR should also differentiate the types of policies depending on the category of investment firms: the executing intermediaries ('best execution' policy), the portfolio managers ('best selection' policy) and the investment firms providing for RTO ('best selection' policy as well) .

In addition, regarding Para 42, for the policy of a portfolio manager (or RTO), there is no requirement in Art. 45 Level 2 to provide for appropriate information '*about these significant variations*': Art. 45 Level 2 only requires to provide '*appropriate information on the **policy***' **At Level 3, CESR should not introduce any gold plating beyond the restrictions imposed at Levels 1 and 2.**

Para 43, we agree that the policy should include how the transactions are executed (execution policy), how the orders are transmitted ('best selection' policy for RTO). However, we strongly disagree with the statement following which the policy should also mention how the client's portfolio is managed: the 'best selection' policy for portfolio managers should absolutely not cover the management of the portfolio (this is clearly out of the scope of Article 45) but should describe how the orders are placed with executing intermediaries and on which criteria/factors these intermediaries are chosen.

Para 46 : Should only apply to the entities executing the orders, not the portfolio managers (there is no 'execution service' usually offered by the portfolio manager to the client]

Disclosure:

Q5: 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?

Para 53, CESR interprets the 2nd subparagraph of Article 45 (5) requiring investment firms (portfolio managers) to provide for an appropriate information to clients as meaning the disclosure of the executing entities for each class of instrument when the client is a retail client.

We do not understand how CESR can reach such an interpretation since it is not mentioned in the MiFID Levels 1 and 2 that retail clients are entitled to get a disclosure of entities chosen for execution for each class of instruments**. CESR should not introduce any goldplating at Level 3.**

Para 55, we disagree with the fact that based on Recital 44 of Level 2, investment firms could be obliged to disclose more information to professional clients than the ones provided to retail clients under Article 46(2) of Level 2. Recitals do not induce additional obligations than the ones already contained in Articles themselves. Once again, CESR should avoid any goldplating. Having said that, we would like CESR to note that in any case, portfolio managers not executing transactions are not bound by the obligation of Article 46 (2) of Level 2.

As a conclusion, we agree with the first part of the Q.5 considering that the 'appropriate' level of information disclosure for professional clients is **at the discretion of the investment firms.** We do not contest the fact that investment firms will respond to reasonable and proportionate requests from their clients. However, CESR should not impose any obligation on the professional clients to provide more information that what is covered under Article 46 (2) Level 2.

Chains of execution:

Q7: Do respondents agree with CESR's analysis of the responsibilities of investment firms involved in a chain of execution?

Para. 66 and 67, it is true that under Article 45, portfolio managers have the obligation of monitoring the quality of the execution made by its intermediaries. However, the portfolio managers do not have the obligation of re-doing the execution. In the chain of execution, there are several players: the portfolio managers placing the orders and responsible for selecting the best intermediaries (and changing of intermediaries in case these latter do not have the mechanisms to provide for the best execution), the investment firms providing for RTO responsible for choosing the best intermediaries for execution and the executing intermediaries who are the only ones responsible for the best execution itself.

Para 68, it is also true that portfolio managers have the obligation of monitoring the quality of execution but only have an obligation of amending/correcting their own 'best selection' policy in case an executing intermediary does not meet the criteria of their 'best selection' policy anymore. In no event, the portfolio managers would correct deficiencies in the execution: neither it is their role nor they have the power to do so.

Para 72, the portfolio managers or RTOs may not but must rely on the decisions made by the executing intermediaries complying with Article 21. The whole mechanism put in place by the MiFID Level 1 and Level 2 can only work if portfolio managers/RTOs are only responsible for the best selection of the executing intermediaries and if these latter are fully responsible for the best execution itself since they are the only entities in charge of the execution.

Para 74, CESR has not clearly assessed the issue of the territorial application of the MiFID to non-European intermediaries or venues. The MiFID explicitly covers the issue of non-European entities in the context of outsourcing only but does not deal with the question of non-European intermediaries or venues in the context of execution of orders. CESR must clearly state that portfolio managers are deemed to have made their best efforts for ensuring

their 'best selection' obligation of intermediaries, even if these intermediaries are not subject to the 'best execution' requirements in their own non-EU jurisdictions (for instance if there is not any best execution requirement at all in these non-EU jurisdictions).

Para 75, there should not be any overlap between Article 21 and Article 45 since Article 45 (7) states that in case the portfolio manager executes orders, he must then comply with Article 21 and he is not covered anymore by the obligation of Article 45, only applicable to non-executing entities: the obligations of the portfolio managers/RTO providers and intermediaries executing transactions are **different and complementary.**

Review and Monitoring

Para 81, we contest the requirement of 'analogous' reviews. We agree that in application of Article 45 (6) Level 2, portfolio managers and RTO providers have to review the efficiency of their 'selection' policy. However, Article 21 Level 1 and Article 45 Level 2 do not require 'analogous' reviews. Once again, the obligations covered by these two Articles are not analogous or similar but complementary. Therefore the reviews they each put in place cannot be considered as being analogous.

Para 85, remark about OTC: it is not always possible to provide for comparable 'similar' transactions (in very illiquid markets for instance).

Para 87, 2nd bullet point: **it is not possible for portfolio managers to compare** the results of their intermediaries with the results of other intermediaries. The obligation of portfolio managers consists in checking, on a regular basis, if the ex post execution of orders **complies** with the execution **policy** provided ex ante by the intermediary, managed in practice on the basis of information provided by the intermediaries themselves. Portfolio managers cannot check the quality of execution of orders themselves, because they cannot have access in practice to the same level of information as the one accessible to intermediaries: portfolio managers have an obligation of assessing the way intermediaries execute transactions and not an obligation of assessing the results intermediaries obtain.

Execution Quality Data

Q8: What core information and/or other variables do respondents consider would be relevant to evaluating execution quality for the purposes of best execution?

Para 88: CESR must be more in line with MiFID, regarding the degree of requirement for portfolio managers:

- the execution quality must be monitored 'on a regular basis' (not a permanent basis);

- it must consist of checking the consistency between the ex post executions with the execution policy provided beforehand: we don't have to check the execution of orders itself – it is the duty of the intermediaries themselves

Our members have suggested variables such as:

- After-sales services

- Quality of back offices
- Risk of counterparties
- Operational risk
- Legal documentation.

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If you wish to discuss the contents of this letter with us, please contact myself at 01 44 94 94 14 (e-mail: p.bollon@afg.asso.fr), Stephane Janin, Head of International Affairs Division, at 01 44 94 94 04 (e-mail: s.janin@afg.asso.fr) or Catherine Jasserand, Deputy Head of International Affairs Division, at 01 44 94 96 58 (e-mail: c.jasserand@afg.asso.fr).

Yours sincerely,

(signed)

Pierre Bollon