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Dear Sirs

ESMA Consultation Paper – MiFID II/MiFIR

The City of London Law Society ("**CLLS**") represents approximately 14,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi-jurisdictional legal issues. The CLLS responds to a variety of consultations on issues of importance to its members through its 19 specialist committees.

This letter has been prepared by the CLLS Regulatory Law Committee (the "**Committee**"). The Committee not only responds to consultations but also proactively raises concerns where it becomes aware of issues which it considers to be of importance in a regulatory context.

The Committee has submitted a response to the European Securities and Markets Authority's ("**ESMA**") Consultation Paper on MiFID II and MiFIR in the form provided on the ESMA website, but for ease of reference, has set out the Committee's response in full in this letter. This is not intended to be a comprehensive response to all aspects of the Consultation Paper. We have responded only to those sections where we hope that we may have a useful input as lawyers. Our views are as follows:

Section 2.1 (exemption for investment service provided in an incidental manner)

We agree that the development of common criteria for the application of this exemption should, if drafted clearly, reduce the scope for different interpretations in different Member States.

Our comments on the draft technical advice are set out below.

We do not understand why the required connection must be "factual". The use of "factual" in this context adds an element of uncertainty into the first condition, as its meaning is not clear. Does it mean that the connection must be "real" rather than "fabricated"? Or does it mean that there must be observable evidence of the connection? We suggest that "factual" should be deleted, possibly to be replaced by a clearer term.

In respect of the second condition, we assume that the intended meaning is that the provision of investment services should not aim to provide a systematic source of income in respect of the investment services, i.e. it is not acceptable for the investment service to generate its own systematic revenue. However, the occasional provision of investment services could have as its aim the generation of a systematic source of income from services which are not investment services. The addition of "in respect of such investment services" to the end of the second condition would clarify the point.

Section 2.2

We support the clarification of article 52 of the Implementing Directive which currently provides that “a recommendation is not a personal recommendation if it is issued exclusively through distribution channels or to the public.” CESR states at paragraph 60 of its Consultation Paper entitled “Understanding the definition of advice under MiFID” that this exemption only applies when the recommendation issued through distribution channels or to the public is addressed to the public in general. This ignores the word “or” in the MiFID definition and some clarification is therefore needed.

We do not, however, support the removal of the words “through distribution channels” without any further amendments because, as rightly pointed out by the IMA in its response to CESR/10-4, such deletion could have a knock on effect on the treatment of investment research, as that term is defined in Article 24. Investment research rightly falls outside the definition of investment advice thanks to the current exemption.

Section 2.7

As an overall comment, we feel that the product governance proposals made by ESMA in its consultation paper should not cover the entire investment market and appear to be suitable only for structured retail products.

It is crucial that ESMA clarifies exactly which products fall within the scope of “structured retail products”.

Furthermore, the proposed product governance rules should not apply to professional clients and eligible counterparties.

In respect of the statement by ESMA on page 42 of the consultation paper that “product governance arrangements should be considered broadly, meaning that they should also apply, where relevant, to the provision of investment services”, this would be a massive extension of scope and beyond that which is envisaged under MiFID II.

It should also be clear that there should be no overlap between the proposed product governance rules in respect of MiFID II and UCITS and AIFMD.

In addition, it is important to stress that any third country exemptions in respect of structured retail products will discriminate heavily against EU-products which would be unsatisfactory; therefore any proposals should be applied uniformly, either to the manufacture or to the distribution of structured retail products, whether the product in question is an EU or third country manufactured product.

Section 2.9

We understand and have no comment on the policy that a firm should only rely on disclosure of a conflict as a measure of last resort, where the arrangements established by the firm are not sufficient to ensure, with reasonable confidence, that the risks of damage to the interests of the client will be prevented. However we would not want this to be interpreted as meaning that firms may not make disclosures to their clients of the types of conflict that may arise in the course of the firm's business. We consider this to be important information for a client and disclosures of this kind may be thought necessary under applicable law relating to conflicts of interest generally.

Section 2.10 (underwriting and placing)

At paragraph 5, it is stated that underwriting and placing "includes the above services where they are provided in relation to financial instruments as defined in MiFID II whether through a public or private placement, or on the primary or secondary markets or otherwise". Our view is that MiFID is silent on the question of whether these services apply in respect of secondary markets. It is clear that they apply in respect of primary markets and our view is that the correct interpretation of MiFID is that it applies only in the context of primary markets. If these services were to apply in respect of secondary markets, it would be better for this extension to be based in clear, legislative drafting, rather than to take effect because of the assumed interpretation used by ESMA in this consultation paper. We note that the subsequent discussion of placing (see paragraphs 25 to 30) uses examples which are solely in the primary market context.

We agree with the statement at paragraph 6 that it is important to identify clearly the person to whom the firm owes a duty in the provision of underwriting and placing services.

Our comments on the draft technical advice are set out below.

The explanations to be given to clients by investment firms under part 3 must be given "before it accepts a mandate to manage the offering". Some of the explanations will require significant work by the investment firm, and it is unfair to require this even before the mandate has been awarded. Greater care should be taken to isolate those steps which can reasonably be taken by an investment firm before it is awarded the mandate (e.g. generic descriptions of its processes). In addition, investment firms should be permitted to provide the remaining explanations promptly following upon being appointed to the relevant mandate. For example, it is unfair to expect an investment firm to provide a potential issuer client with "details of the targeted investors" prior to its appointment.

There is an incorrect implication (see paragraph 24 and part 5 of the draft technical guidance) that pricing is determined by the investment firm. The price is determined by the issuer, with advice and input from the investment firm.

In part 9 of the draft technical guidance, it should be made clear that the policy can be made available shortly before the issuer and investment firm agree on the placing.

Section 2.21 (best execution)

The draft Technical Advice seeks to clarify how best execution requirements apply to investment firms carrying out the MiFID services of "*portfolio management*" and "*reception and transmission of orders in relation to one or more financial instruments*".

As a general observation, the Committee notes that the scope of the service of "*reception and transmission of orders"* is unfortunately not coherently and exhaustively defined in MiFID I or MiFID II. This has resulted in a degree of ambiguity in identifying the constituent elements of that activity. There are a diverse range of circumstances which are potentially captured and it could extend to services that do not directly involve the execution of client orders. Accordingly, absent a more precise definition of the service, the Committee considers that the draft Technical Advice should be clarified such that the best execution requirements apply only to reception and transmission if it leads directly to the execution of orders on behalf of clients.

The Committee is concerned that, pursuant to the draft Technical Advice, investment firms that receive and transmit orders (i.e. by performing the role of an intermediary for order flow) and portfolio managers appear to be subject to the same best execution standards as those firms that pass orders directly to an execution venue. This may lead to requirements being applied notwithstanding that it would be inappropriate for there to be a duty as to the execution of an order (e.g. where the firm has no control over or minimal impact on execution).

ESMA's assertion that "*MiFID II does not set out major changes to the best execution requirements*" may be thrown into question given the apparent mismatch between the approach of the draft Technical Advice in this area and the best execution framework in MiFID I[1]. Article 21 of MiFID I sets out the relevant requirements for investment firms that execute client orders, while the requirements applying to investment firms that receive and transmit orders and portfolio managers are set out in Article 45 of the Implementing Directive[2], a provision made under Article 19 of MiFID I. Article 21 (but not Article 19) applies when an investment firm that receives and transmits orders or manages portfolios also executes the orders received or the decisions to deal on a client's behalf. As such, there is a clear line (seemingly removed pursuant to the draft Technical Advice) for best execution purposes between order reception and transmission and portfolio management on the one hand and the execution of client orders on the other.

An investment manager or other market participant that transmits an order to a broker is currently able, to a large degree, to rely on the broker to obtain best execution (subject to monitoring the latter's execution arrangements). With that in mind, the Committee welcomes ESMA's acknowledgment that the "*best execution provisions are not intended to require a firm that transmits or places orders with other entities for execution to duplicate the efforts of the execution entities*". The Committee is concerned, however, that a blanket application of best execution requirements to firms that receive and transmit orders or manage portfolios

[1] 2004/39/EC.

[2] 2006/73/EC.

may result in the duplication of effort that the Directive seeks to avoid. It could also cause confusion as to the extent to which a portfolio manager or receiver and transmitter may rely on an intermediary to provide best execution.

Moreover, it is not clear how the provisions apply where an intermediary or venue in a chain of execution is located in a third country jurisdiction and is not subject to MiFID best execution requirements. In such circumstances, it may be challenging for an investment firm in the chain to ensure that it has complied with the relevant requirements including, for example, by providing clients with an execution policy. We consider that it would be useful if the draft Technical Advice could recognise this difficulty and provide for greater certainty in this area; in particular, we suggest that the obligation should in any case apply only in respect of products traded on relevant execution venues.

Under paragraph 6 of the draft Technical Advice it appears that firms that receive and transmit orders or manage portfolios should provide all clients (not just retail clients) with relevant information on the execution policies of the entities that they have selected to execute transactions, in each category of financial instruments, before proceeding to transmit or place their orders. This appears to be a minimum information requirement. The Committee suggests that such firms should instead be required to make that information available on request.

At present, the Implementing Directive clarifies at Article 45(4) that portfolio managers and receivers and transmitters are deemed to have satisfied best execution requirements to the extent that they act in accordance with a specific instruction from their client "*when placing an order with, or transmitting an order to, another entity for execution*". As a point of clarification, it would be helpful if ESMA could reproduce this statement in its draft Technical Advice. (An analogous provision in Article 27(1) of the MiFID II Directive[3] applies when firms are executing orders on behalf of clients but seemingly not when firms are merely passing on orders on express instructions of the client).

The Committee supports the statement in the draft Technical Advice that "…*the [execution] policies of firms transmitting or placing orders with other entities for execution should be customised depending on the class of instrument and on the type of service provided*". The Committee sees this as useful confirmation as to the scope of the best execution requirements and believes that it should be up to firms to adopt policies on best execution that reflect the particular nature of the services they provide.

We are, however, concerned that it will not be possible to assess the "fairness" of the price of bespoke OTC products, as required by paragraph 4 of the draft Technical Advice, in any meaningful way. As is currently acknowledged in the MiFID Implementing Directive, transactions involving customised OTC financial instruments "involve a unique contractual relationship tailored to the circumstances of the client and the investment firm" (Recital 70). Certain instruments that are traded over the counter are so customised that price comparisons are essentially meaningless since there is little or nothing against which to compare the transaction. As such, firms may not be in a position to search the market to

[3] 2014/65/EU.

check that a price quoted is “fair” and could in some circumstances be concerned that to attempt to do so may give rise to competition law risks. The Committee therefore suggests that this provision is deleted in its entirety (or at the very least framed differently).

Section 3.1

3.1 (paragraph 29 which suggest there are only two types of instruments which are “certificates”)

The definition of the term “certificates” under Article 2(1)(27) of MiFIR is drafted so widely that it could, on the face of it, potentially cover such items as additional Tier 1 securities, preferred securities and subordinated securities.

This interpretation seems odd as, although these products are “equity-like”, they would not, in the normal course of events, ever be described as “certificates” in general capital markets usage. In capital markets terminology, the term “certificates” would more likely be used to describe various types of structured securities but these would likely not be preferred or subordinated so would not fall within the definition of certificates as set out in MiFIR and would fall into other categories of ‘transferable securities’ under MiFID.

It is unclear from the ESMA CP exactly how ESMA has conducted its analysis and concluded that only two types of instrument fall within the category of certificates (page 183 at paragraph 29). One possible interpretation (unlikely in our view) is that, in reality, only those two types of “certificates” are likely to be traded and to breach the liquidity thresholds and, consequently, actually become subject to the transparency requirements for equity-like instruments.

Consequently, in response to Q116 the above examples could be viewed as additional instruments that could be caught by the definition of certificates under Article 2(1)(27) of MiFIR but we really need a clarification.

Section 3.2

3.2 (proposal to classify asset-backed commercial paper (ABCP) as a Structured Finance Product)

Lack of relevance of reference to CRA Regulation as a legal precedent

It is not clear to us why ESMA has chosen, see page 190 at paragraph 10, to refer to Delegated Regulation 448/2012 relating to the CRA Regulation as the “legal precedent” and justification for including ABCP in the Structured Finance Products bucket. The CRA Regulation has a different purpose (namely, to address issues relating to reliance on external credit ratings) and the definition of structured finance instrument in the CRA Regulation links back to the CRR (as opposed to MiFID). The fact that ABCP is rated and therefore classified as a structured finance instrument for the purposes of the CRA Regulation (which makes sense as an ABCP issuer is a conduit) does not mean that it follows that the CRA Regulation classification is relevant in other contexts such as MiFID transparency requirements.

Inconsistency of treatment of ABCP in EU legislation

In the context of the proposed Money Markets Funds (MMF) Regulation (which refers to the UCITS Directive definition of Money Markets Instruments (MMI) and which does not appear to have been drafted to exclude ABCP), references to the definition of MMI suggest that ABCP would be regarded as MMI. It is not clear why ABCP is included in the definition of MMI for some purposes but not others. Absent a good argument for the distinction based on sound policy objectives, there is a strong argument for consistency.

ABCP is treated differently for disclosure purposes more generally in the EU Prospectus Directive (PD) context - The PD defines securities as transferrable securities under MiFID with the exception of MMIs under MiFID with a maturity of less than 12 months. In the UK, this is tracked through in the FSMA implementing provisions - see section 102A and the references to application to transferable securities in section 85. No one has suggested that ABCP should not be regarded as an MMI for the purposes of this PD scope carve-out, and it would be a problem if such a view were taken. Therefore, the EU authorities have accepted that ABCP should be treated like other short term MMIs in the context of other disclosure requirements.

The draft advice states that "ABCP should be classified as a SFP for the purposes of MiFIR" [see CP page 190] – ESMA should consider and be alert to any 'knock-on' consequences of this determination due to references of the MiFID definition of transferable securities being used in other legislation (e.g. the PD) and if it is the intention that ABCP should only be classified in this way for MiFIR transparency purposes then that should be made explicit.

SFP definition and the fact that ABCP is often fully supported by a bank – As ABCP is often fully supported by an originating bank, the risk of default is mitigated and will ultimately be dependent on the relevant credit enhancement provider rather than the performance of the underlying assets. The definition of SFP states that payments "depend on the cash flow from the underlying assets" which is therefore not strictly the case in respect of a significant proportion of ABCP.

If you would find it helpful to discuss any of these comments then we would be happy to do so. Please contact either Peter Richards-Carpenter by telephone on +44 (0) 20 3400 4178 or by email at peter.richards-carpenter@blplaw.com or Karen Anderson by telephone on + 44 (0) 20 7466 2404 or by email at karen.anderson@hsf.com in the first instance.

Yours sincerely

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