Setting the global standard for investment professionals

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Dear David,

WORKING DOCUMENT ESC/23/2005 ON CONDUCT OF BUSINESS

The CFA Centre for Financial Market Integrity (CFA Centre)[1] is grateful for the opportunity to comment on the European Commission's Working Document ESC/23/2005 on conduct of business rules, best execution, client order handling rules, eligible counterparties, clarification of the definition of investment advice and financial instruments ("Working Document").

The CFA Centre represents the views of more than 71,000 financial analysts, portfolio managers, and other investment professionals in over 100 countries worldwide on issues that affect the practice of financial analysis and investment management, education, and licensing requirements for investment professionals, and the efficiency of global financial markets. The CFA Centre also develops, promulgates, and maintains the highest ethical standards for the global investment community through such standards as the CFA Institute Code of Ethics and Standards of Professional Conduct.

General Comments
We appreciate the open and transparent process which the Commission has adopted by publishing the Working Document and are grateful to be able to offer our comments.

Investor interests are paramount and overall we strongly support the Commission's proposed implementing measures contained in the Working Document, seeing them as a significant step forward for investor protection in Europe. However, as highlighted below, there are a number of important aspects in which the draft measures merit changes before they are finalised, the most important of which are as follows:

[1] The CFA Centre for Financial Market Integrity is a part of CFA Institute. With offices in London, Hong Kong, New York, and Charlottesville, VA, CFA Institute, formerly, the Association for Investment Management and Research®, is a global, non-profit professional association of more than 71,000 financial analysts, portfolio managers, and other investment professionals in 119 countries and territories of which more than 57,900 are holders of the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 131 Member Societies and Chapters in 52 countries and territories.

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- Article 3 – The need to address issues related to performance presentation.

- Article 7 – Specific inclusion of trailing commissions, soft commissions, or other discounts and referrals in the fees and costs to be disclosed to clients.

- Article 27 – (1) Explicit inclusion of “gifts and entertainment” in addition to fees, commissions, and non-monetary benefits within the scope of “inducements”. (2) The requirement for firms to disclose their policy regarding inducements. (3) The requirement to disclose what soft or bundled commissions were received and how those goods and services benefited the client.

Specific Comments

Title II – Article 3
Information provided to clients and potential clients must be truthful, accurate, complete, understandable, and presented in a format that communicates the information effectively. We believe that client communications must also be timely and must include any relevant material facts. It is important that this information be presented in a manner that is useful to investors.

In the past, many disclosures have been made in a way that obscures the information. Boilerplate-type disclosures do not meet the spirit of meaningful disclosure. Similarly, to say that a firm may or may not have a banking relationship with a particular company does not provide investors with any information. We support the Commission’s effort to ensure that disclosures are meaningful.

The Commission might consider requiring that communications with clients and potential clients include the basic format and general principles of the investment process used to analyse investments, select securities, and construct portfolios and to promptly disclose any changes that may materially affect those processes.

We also believe it is important for any communication to distinguish between facts and opinions.

Performance presentation is of particular interest, given our experience with the creation of the Global Investment Performance Standards (please see attachment for details). We urge the Commission to consider adopting the principles contained in these standards to address issues related to performance presentation. The GIPS standards require firms to group similarly managed portfolios into composites, aggregate the performance of those portfolios, and present the performance of the composite to the potential client. This reduces the opportunity for “cherry picking”.

Like the Commission, we take a very cautious view of simulated or back-tested performance. For many start-up firms, however, this is the only information they have available to present. We recommend the Commission consider requiring firms to clearly label any simulated or back-tested performance as such, rather than an outright prohibition. Key assumptions

should also be disclosed. Any simulated or back-tested performance should also include a disclosure/warning that the performance is not an indication of actual returns had the strategy actually been used historically, nor are they a guarantee of future results. Similarly, the Commission should also consider this point as it relates to the discussion of forecasted future performance.

The proposal also states that past performance must use a reference period of at least one year. We encourage the Commission to consider if it might be better to require performance since inception for those firms that do not yet have one full year of performance. If so, it would be important to require that performance of less than one year **not** be annualized.

Title II – Article 4
The Commission should also require in this section that such disclosures must be made in language that is easily understood.

Title II – Article 5
We generally support the disclosures required in this article and the conflicts of interest policy in particular. In addition, we encourage the Commission to consider requiring firms to disclose any significant personnel or organizational changes. This information is particularly relevant and useful for investors.

We believe that the delegation of discretionary management should always be disclosed and recommend the Commission delete the phrase "where relevant" from paragraph 2(c).

In addition, paragraph 2(d) should be clarified to specify what information is intended and that such information is meaningful.

We also encourage the Commission to consider paragraph 2(e) as to whether "widely used financial indicators which are produced by a third party" may be too narrow a definition. There may be situations where a custom benchmark may be the most appropriate for a particular client. If a custom benchmark is used, the firm should disclose how it is constructed and calculated.

Title II – Article 7
We believe that the investor should clearly understand the fees and costs associated with the services being offered or provided. Items that do not seem to be specifically mentioned are trailing commissions, soft commissions, or other discounts and referrals. We firmly believe that commissions are client assets and, therefore, must be spent in their best interests. We strongly support the recent UK FSA Policy Statement 05/9 on soft and bundled commissions and encourage the Commission to take the same approach.

Paragraph (a)(i) should be clarified to differentiate between ex-ante disclosures on expected fees and expenses and ex-post reporting of the actual expenses incurred.

Title II – Article 9
We appreciate the idea of discerning the level of understanding between clients. Without additional information, however, it is unclear if the aptitude test would have the desired effect. It is difficult to imagine a test that is short enough that potential clients would take it, yet rigorous enough to effectively measure and discern their understanding of the markets.

In addition, we believe that the disclosures required in Article 5(2) and Article 6 should be made to all investors, not only to those clients who do not score sufficiently on the aptitude test.

Furthermore, we recommend the Commission consider for those clients who do pass such an aptitude test, that firms be required to obtain positive agreement from the client that such client agrees to “opt out” of receiving the information. Similarly, a positive “opt out” should be required for all unique investment products and strategies.

Title III – Article 11
We strongly support the need to assess the suitability and appropriateness of investments and strategies for each client. For many years, the CFA Program has taught the importance of developing an Investment Policy Statement (IPS) for each client that discusses risk tolerance (both the willingness and ability to bear risk), return objectives, time horizon, liquidity requirements, tax considerations, legal and regulatory constraints (e.g., specific requirements for pensions), and constraints that are unique to the specific client (total wealth, income, dependant children, etc.). This information should be updated on a regular basis and as the client’s situation changes.

Paragraph 1 discusses the ability of clients to bear risk. In some cases, it may not be possible for the firm to fully assess a client’s ability to bear risk. Often the firm does not have a complete picture of the client’s financial condition. We also ask that the Commission consider if it is appropriate to assume that professional clients can bear the risk of any loss. This may be appropriate in the context of making recommendations, where the professional client can then assess the risks for themselves, but it may be imprudent in the context of discretionary portfolio management on behalf of the professional client.

Paragraph 5 – We recommend the Commission use the word “induce or advise” in this context.

Title IV- Article 13
Paragraph 3(b) includes the provision of “where the time of execution is not available”. We are unaware of situations when that is the case. Can this be clarified?

In addition, it may be appropriate to include information on soft or bundled commissions in this section as well, including the amount spent, what goods and/or services were received in return, and how those goods and/or services benefit the client. In addition, it is unclear if this Article is requiring the “unbundling” of commission. This should also be clarified.

Title IV – Article 14
The reporting obligations of portfolio managers established under this Article do not currently include disclosure to clients of how proxies were voted. We note the Commission is pursuing this issue as part of a separate line item in Company Law and Corporate Governance Action Plan, and urge work in this area to be initiated as a matter of priority. The proxy vote has economic value and must be voted in the client's best interest.

In addition, the Paragraph 2 (b)(i) discusses the use of market values, but the Commission should also include the use of fair valuations when market values are unavailable.

Title IV – Article 15
Paragraph 3 indicates that firms can use trade date or settlement date as the basis for the client statement. Firms should be required to clearly identify the date (trade or settlement) that the information is based.

Title VIII – Article 18
We agree that Best Execution is not defined as simply the lowest commission, but also must consider the price. It has been proven that the commission is generally one of the smallest costs of the overall transaction, with market impact (price movement) being the largest.

In contrast to paragraph 1, paragraph 2 specifically relates to "retail client." So, if in the midst of the inquiries required by paragraph 1 a firm recognizes that the client is a "retail client", this paragraph requires firms to seek the "best possible result," meaning including the price paid or received for the security and the transaction costs in arranging the transaction. (As footnote 13 notes, this excludes the commissions and fees charged by the investment firm, but does include settlement and exchange fees.) We agree with these issues, although we believe the firm's commissions should also be included.

Article 18 does not appear to consider the possibility that new trading venues could emerge that could execute trades even more favorably. In addition, it does not appear to give firms leeway to use different venues if those venues do not consistently provide the best possible result. If a new venue is created, but does not consistently provide the best possible result, then firms could face penalties for using it. We are afraid that this may create a barrier to entry to new potential venues (e.g., electronic crossing networks).

Title VIII – Article 20
We agree with these requirements and encourage the Commission to review our Trade Management Guidelines (see attachment for details) that outline, among other things, creating policies and procedures to govern the trade management process and seeking Best Execution, the creation of a trade management oversight committee, and instituting trade evaluation and broker selection processes. We believe that firms must conduct a regular review of their execution policies and trading venues. A regular review allows the firm the opportunity to recognise other trading venues that may offer better execution than the existing venues being used by the firm. This is in the client's best interest.

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Title VIII – Article 27
We generally agree with the proposed language in the Article. Inducements undermine the trust that clients place in their investment advisors. Investment advisors owe a duty of loyalty to their clients and inducements can cause the advisor to act in a manner that is not in the client's best interest. The Commission should consider explicitly mentioning gifts and entertainment in addition to fees, commissions, and non-monetary benefits. Entertainment, such as tickets to sporting events, is generally differentiated from gifts by the fact that the party offering the entertainment is also present. We do not believe there should be any differentiation between gifts and entertainment and believe both have the potential to influence those who receive them.

Investment professionals must maintain independence and objectivity so that their clients will have the benefit of their work and opinions unaffected by any potential conflict of interest or other circumstance adversely affecting their judgment. They should endeavor to avoid situations that could cause or be perceived to cause a loss of independence or objectivity in recommending investments or taking investment action.

External sources may try to influence the investment process by offering analysts and portfolio managers a variety of benefits. Corporations may seek expanded research coverage; issuers and underwriters may wish to promote new securities offerings; brokers may want to increase commission business. Benefits may include gifts, invitations to lavish functions, tickets, favours, job referrals, and so on. One type of benefit is the allocation of shares in oversubscribed IPOs to investment managers for their personal accounts. This practice affords managers the opportunity to make quick profits that may not be available to their clients. Such a practice should be prohibited. Modest gifts and entertainment are acceptable, but special care must be taken to resist subtle and not-so-subtle pressures to act in conflict with the interests of clients. Best practice dictates that any offer of gift or entertainment that could be expected to threaten their independence and objectivity must be rejected.

Paragraph 2 should also indicate that the disclosures should be made in a timely manner, while the information is still relevant.

With regards to Paragraph 1 (b)(ii), we believe that firms should be required to disclose their policy regarding inducements. As they relate to soft or bundled commissions, we believe that those commissions should only be used for the purchase of goods and services that benefit the client and directly assist the firm in the investment decision-making process and in the management of the firm. The firm should be required to disclose what goods and services were received in the most recent period and how those goods and services benefited the client.

In addition, we suggest that the Commission consider requiring not only the disclosure of the inducement, but as in the case of financial advice paid for via trailing commissions, allow investor the option to pay for the advice up front and do away with the trailing commission.

Conclusion
We thank the Commission for its consideration of these comments. If you should have any questions, please do not hesitate to contact John Barrass at +44 (0) 20 7712 1553 or john.barrass@cfainstitute.org.

Respectfully,

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