International Swaps and Derivatives Association
International Securities Market Association
International Primary Market Association
Association of Norwegian Stockbroking Companies
Bankers and Securities Dealers Association of Iceland
Bond Market Association
Danish Securities Dealers Association
Finnish Association of Securities Dealers
Futures and Options Association
London Investment Banking Association
Swedish Securities Dealers Association

Joint Response to CESR's March 2005 consultation on Draft Technical Advice on Possible Implementing Measures of the Directive 2004/39/EC on Markets in Financial Instruments (MIFID): Investment advice, best execution, market transparency, Second consultation paper

4th April 2005

CONTENTS

INTRODUCTION

1. This response is a compilation of the agreed views of the eleven Associations listed at the beginning. The Associations represent a significant proportion of investment firms active in the European securities and derivatives markets, especially its wholesale markets.

2. Our response follows the order of the CESR consultation paper.

3. For the purposes of its analysis of responses CESR should count this response as coming from eleven respondents and weight it accordingly.

4. Our ability to do full justice to CESR's consultation has been limited by:

   (a) The very short consultation period in which to consider the implications for business efficiency, trading and investment costs, and firms' ability to address customer needs,of complex proposals, many of which in the market

transparency area have not been the subject of previous specific consultation, and

(b) The lateness, and inconsistent presentation, of CESR's data and worked examples.

5. Because of the complexity of the issues, we may need to make further comments on technical questions, either in the next few days or in the context of the continuing development of Level 2 measures relating to these matters.

SUMMARY OF KEY POINTS

6. We draw CESR's attention in particular to the following key points. We elaborate on them in the rest of this response.

(a) We consider that the definition of **investment advice** should not encompass generic information or advice.

(b) In most respects we support CESR's proposed advice on **best execution**. However, we think that the proposals to include lists of venues in firms' disclosed execution policy would not represent 'appropriate information'. The proposal to require a risk warning relating to client instructions, especially as regards professional clients, is not appropriate.

(c) We do not consider that any of the matters dealt with in **CESR's questions in the best execution section** give rise to the need for any new proposals relating to them to be included in the final advice.

(d) We consider that CESR's proposals relating to **systematic internalisers** need to have more regard to the need to continue to encourage investment firms to provide liquidity to their clients and facilitate clients' trading needs where straightforward on-exchange execution would not be in the client's best interests.

(e) We consider that CESR has improved its proposals for **criteria relating to 'systematic, organised, and frequent basis' under Article 4.1.7**. But further improvements are needed, in particular to make clear that they relate to a separately identifiable activity within a firm to which Article 27 would apply, to make clear that the positive criteria must be fulfilled cumulatively, to ensure that the 'frequent' criteria apply only to firms whose systematic internalisation activity represents a substantial market share, and to introduce specific negative qualitative criteria to exclude activities that should not be included, in particular those excluded by Recital 53.

(f) On setting **criteria for shares which have a liquid market** for the purpose of Article 27, CESR's proposed criteria would include too many shares that investment firms would not consider sufficiently liquid to justify the costs and risks of taking on Article 27 obligations. We continue to consider that a two-stage approach, starting with highly liquid shares, would be the most appropriate way of introducing the new obligations to limit the risk of damage to liquidity provision in less liquid shares. The provisions would then be extended as a second stage across a wider range of liquid shares in the light of experience of

operation of Article 27. We consider that CESR should at the very least increase some of its proposed criteria to more realistic quantitative levels.

(g) We think that there is no justification for denying the benefits of '**negotiated trades**' to the clients of systematic internalisers.

(h) We continue to think that the proposals on '**exceptional market circumstances'** that would allow the withdrawal of Article 27 quotes are not broad enough. These provisions should at least parallel those relating to on-exchange market makers, but also take into account the greater risks and fewer benefits attaching to off-exchange quoting.

(i) The **portfolio transaction exemption** should not be subject to a monetary limit.

(j) **'Orders subject to conditions other than current market price'** should include limit orders, which by definition cannot be at current market price.

(k) **Customary Retail Size** should be smaller than €7,500.

(l) We consider that '**large in scale compared to normal market size**' should be determined by reference to a percentile (but lower than 95%, for example 90%) of the number of trades in order of size (Annex 1, Option 2, second method). This is particularly important to ensure that standard market sizes are kept at a level which does not restrict liquidity provision.

(m) On **block trades for post-trade reporting** purposes, we consider that, particularly at the most liquid end of the market, block sizes need to be smaller, and reporting delays longer, than CESR proposes.

(n) We consider that **portfolio transactions** should be treated as a single transaction, without restrictions, for the purposes of calculating block size for post-trade reporting. CESR's proposals in this area are not workable.

DETAILED COMMENTS ON CESR'S CONSULTATION PAPER

Chapter 1: Lending to retail clients

We refer CESR to the comments of FBE, BBA and APCIMS on this Chapter.

Chapter 2: Definition of Investment Advice

Q1. *Do you believe that investor protection considerations require the application of the above conduct of business requirements from the point at which generic advice is provided or do you believe that sufficient protection is provided in any event to allow the definition of investment advice to be limited to specific recommendations?*

Q2. *Do you believe that considerations relating to the scope of the passport and the scope of the authorisation requirements point towards the inclusion or exclusion of generic advice from the definition of investment advice?*

Investor protection considerations do not require or justify the application of conduct of business requirements from the point at which 'generic advice' is provided. It is appropriate to limit investment advice to recommendations relating to specific financial instruments. This approach would not enable firms to circumvent conduct of business obligations. Loopholes of the kind which CESR fears would not arise, because clients are fully protected if specific advice follows generic discussions. In effect it would be reasonable for any generic advice which is seamlessly linked to specific advice to be deemed integrated into and part of the specific advice and thus subject to the investor protection provisions. However generic advice that stops at that would not be covered. Any unsuitable generic information which was closely linked to subsequent investment advice would be covered by conduct of business obligations relating to the specific advice itself. If the client chose to invest on the basis of generic advice without obtaining further advice, they would be entering into an execution only transaction.

Furthermore, the inclusion of generic information would go beyond the Article 4.1.4 definition: 'the provision of personal recommendations to clients…in respect of one or more financial instruments'. A broader definition encompassing generic information would not respect the distinction between investment advice as an investment service or activity (Annex 1, Section A (5)) and 'other forms of general recommendation relating to transactions in financial instruments' as an ancillary service (Annex 1, Section B(5)).

As we pointed out in our response to CESR's previous consultation, an approach which attempted to broaden the scope of the definition of investment advice would risk a number of unintended consequences. Companies might find that they were unable to rely on exemptions that were thought likely to apply, because they might engage in activities which strayed over into the area of investment advice. For example, a person providing information that amounted to investment advice, within an extended definition, might lose the benefit of exemptions such as Article 2(1)(d), (e), (f) or (i). Alternatively, it might lose the benefit of the optional exemption in Article 3 because the information related to matters not permitted by the second indent in Article 3(1). Also, if the provision of particular information amounted to investment advice, firms would be restricted in their ability to provide that information to clients, even professional clients, without first obtaining information from the client to assess suitability. The benefits of the European passport for such firms would not compensate for the additional regulatory burdens that would attach to them.

Chapter 3: Best Execution

Overview

In most respects, we think that CESR has taken a sensible approach to its advice on this matter, and has delivered a pragmatic set of measures, broadly capable of application in most circumstances. We particularly support the extent to which, in Boxes 2 and 3, the effect of CESR's proposals is to determine the regulatory outcomes to be achieved by firms, while leaving it to firms to determine how best to achieve these outcomes. This is an approach to level 2 measures that could be usefully adopted more generally across MIFID and the other Directives.

However, the approach to determining the appropriate information that firms must provide to clients requires careful reconsideration both from a policy perspective (what is to be achieved through the provisions?) and the Level 1 text (what is necessary to deliver Article 21(3) of the Directive?). On this last point, we are not at all sure that a purposive reading of Article 21(3) leads to all the conclusions that CESR has reached in Box 4 (or would justify more extensive disclosures of the type discussed in Q110).

We welcome CESR's recognition that the advice must cater appropriately for different market structures and financial instruments. We agree that there is no need for more detailed Level 2 measures for non-equity markets. However, some aspects of Box 4 are particularly problematic for non-equity markets.

CESR has asked a number of questions on matters where there is no corresponding draft advice. We do not consider that CESR needs to provide advice on any of these matters, for the reasons we explain below. Consistently with its consultation policy, if CESR should think that there is a need to produce advice on any of these matters, it should give interested parties the opportunity to comment on draft advice first.

These points and others are set out in more detail below.

Box 1

We recognise that the application of the advice to firms which carry out portfolio management for private clients as set out in the explanatory text is appropriate, provided that it is interpreted and applied in a way which is consistent with the specific agency and contractual obligations of each intermediary in the execution chain.

As regards order receipt and transmission, likewise we support the application of the advice, subject to the same proviso, thus placing on the firm the responsibility for determining how to achieve best execution for its clients. We would however insert one note of caution which arises from Recital 20 of MIFID which extends the definition of reception and transmission to include bringing together two investors. Thus there is a risk that, in practice, some merger and acquisition, private equity or other similar work may involve activities which may fall within the definition of reception and transmission of orders. It would be inappropriate to seek to apply the best execution requirements to such activities. The advice should make this point clear.

Boxes 2 and 3

In respect of Boxes 2 and 3,there is much in the explanatory text and draft advice with which we agree:

(a) The clear adoption by CESR of the principle set out in Recital 33 that the best execution obligation 'should apply to the firm that has the contractual or agency obligation to the client'. This should substantially eliminate debate at an operational level over the application of Article 21. (paragraph 11)

(b) CESR's commitment to creating at Level 2 a workable regime for firms enabling them to use other investment firms to execute their client orders. (paragraph 13)

(c) The recognition that a prescriptive approach to the application of the factors in Article 21(1) is unlikely to be workable and a preference therefore for a principles-based approach, which is reflected in the draft advice in Box 2. (paragraph 41)

(d) The recognition that the Level 1 text provides comprehensively for the circumstances in which changes to a firm's execution policy may be appropriate and that further elaboration at Level 2 is unnecessary. (paragraph 98)

(e) The recognition that the practical application of Article 21 must take account of the characteristics of different market structures and financial instruments. (Box 2) We believe that no further elaboration is necessary at Level 2 to enable regulators to deal effectively with best execution as applicable to non-equity or specialised narrowly-traded markets.

(f) The decision (paragraph 77) not to impose prescriptive measures which go beyond the requirement of Article 21(4) (regular assessment of effectiveness of execution arrangements) and the similar decision in paragraph 98 (need to make changes when deficiencies are identified)

Indeed, the only changes we would suggest making are the following technical changes to Box 3:

(a) In (a)(iii) the reference should be not to when a material change occurs but when an investment firm becomes aware that the material change has occurred.

(b) In the last sentence of (b) we suggest that the 'where relevant' wording should be at the beginning of the list since not all these costs will be relevant to all transactions. The list should also be qualified by 'where paid by the client'.

(c) Although the list of factors in (b) is not exclusive, we think it would be useful to be clear that 'client preference' (which we take to be CESR's meaning, rather than 'client reference') is equally applicable to 'execution intermediaries' and 'execution venues'.

Box 4

Box 4 encapsulates CESR's current thinking on the information to be provided to the client or potential client pursuant to Article 21 (3) of the Directive.

The Directive says that 'Member States shall require that investment firms provide appropriate information to their clients on their order execution policy. Member States shall require that investment firms obtain the prior consent of their clients to the execution policy'

There are two points here. The first is what can be considered 'appropriate' information, and the second is what specific disclosure is necessary to obtain prior client consent to the execution policy. At one extreme, the firm could supply a copy of the policy to the client. However, in our view, the Directive rules this out through the emphasis on 'appropriate' information. Therefore, a key question is what is 'appropriate'? For retail clients, in particular, 'appropriate information' must be information presented succinctly and in context, enabling them easily to understand the key features of the policy and so give informed consent to the policy and also to 'shop around' amongst firms' execution policies. Consequently, in our view, the Article 21(3) emphasis on 'appropriate' information is inconsistent with flooding clients with information or presenting them with information (such as a list of execution venues or information on the percentage of a firm's orders that have been directed to each venue) which is not easily understood in context. Professional clients also may not find such information useful. Regulation should certainly not prescribe that professional clients should receive it.

The technical concerns with any requirement to list directly accessible execution venues include:

(a) In equity markets, large broker dealers will have, within their group, direct memberships of many of the world's stock and derivatives exchanges. Retail investors generally concentrate on investing in one or two jurisdictions for which this long list will be irrelevant. Professional investors, who may invest globally, know that such large firms have direct access to many exchanges, MTFs, and dealer counterparties, and listing them as part of the disclosure of the execution policy is equally irrelevant. Changes to the population of MTFs are more frequent than in the case of exchanges, which under CESR's proposal would necessitate frequent updates of the information provided to professional clients.

(b) In OTC markets, such as OTC derivative and most bond markets, execution is provided by dealers. As noted earlier, some dealers are prepared to commit to making prices to their clients in a specified (but fluctuating) small subset of outstanding bonds. In the Eurobond market for example, 42 member firms of ISMA have undertaken this obligation. At any moment some 11,000 bonds are so covered, with each bond having on average 2 to 3 dealers. However, there are more firms than this active in the market, since there are other firms which make markets in government and domestic bond issues which are not picked up by ISMA. This will be particularly the case for countries with large domestic markets such as the US and Japan. An investment firm wishing to provide a comprehensive service in bonds to its clients needs direct access to a large number of dealers. This is not difficult to obtain (see our response to Q87 regarding the competition for order flow). But we do not see what benefits clients will obtain from receiving long lists of investment firms with which their intermediary has a business relationship.

While the universe of exchanges is relatively static , that of MTFs is dynamic, and of dealers even more so. Changes take place on a weekly basis.

If despite these facts CESR concludes that such large amounts of undigested information will provide 'appropriate' information to investors, a cost effective solution might be to require investment firms to provide these lists (with appropriate de minimis exemptions, e.g. identifying only venues which get more than 5% of order flow) on their internet sites with appropriate links to the execution venues' own web sites, thereby enabling those clients with an interest in such matters to pursue their research in a cost-effective manner.

Therefore, while we support the inclusion of most of the material for disclosure in Box 4 (although we have some detailed points which are set out below), we do not think that the 1(a)v list of execution venues is called for from an investor protection perspective, or consistent with or required under the Article 21(3) requirement for firms to provide 'appropriate information' to clients. For the same reasons, and in response to paragraph 105, we also do not think it is appropriate to import the US SEC rule 11Ac1-6. The relevant information need of clients in both cases is correctly to understand, without difficulty, the extent to which a firm's approach to selecting and using execution venues is likely to deliver the best available quality and 'value for money'. Neither the current 1(a)v nor US SEC rule 11Ac1-6 is likely to deliver this outcome. We provide further elaboration on these points in our detailed answers to Question 110 below (particularly question 110(e)).

Our additional detailed points are as follows:

We do not consider that it is necessary to warn professional clients, as proposed in 1(a)(iii), that specific instructions may affect the firm's ability to achieve the best possible result for that client's orders. Although such a warning may be appropriate for retail clients, it is important for any measures on this point to recognise that, as regards any type of client, Article 21.1 is clear that the obligation to execute the order following the client's specific instruction overrides the obligation to take all reasonable steps to obtain the best possible result. A professional client has the necessary expertise to judge how to obtain the best possible result for its needs when deciding its specific instructions, for example, choosing speed or the cost of market impact over other factors. In these circumstances a 1(a)(iii) warning would be inappropriate.

As regards those clients to which 1(a)(iii) does apply, it should be clear (taking account of CESR's caution in paragraph 130) that the reference in 1(a)(iii) to 'specific instructions from clients', which would trigger a risk warning which must be provided in a durable medium and in good time, is not interpreted in a way that would:

(a) prevent the firm from issuing the warning clearly and prominently in the terms and conditions agreed with the client (as provided for in Article 21.3) or
(b) seriously constrain the ability of the firm to execute a client's order. (For example, we would not expect obligations arising in relation to specific instructions to extend beyond instructions relating to choice of venue or execution criteria.)

This interpretation is necessary to give validity to the requirement in Article 21.1 that whenever the client gives a specific instruction, the firm shall execute the order following the specific instruction. Article 21.1 does not imply that if the specific instruction is not consistent with the policy, the firm should either persuade the client to withdraw the instruction, or decline to deal until it has delivered the specified risk warning to the client in a durable medium.

It is important that 1(b)(ii) does not give rise to an obligation to obtain express consent in relation to instruments which are not traded on a regulated market or MTF.

Finally, consistently with 1(c), it should be possible, under 1(d), for the firm to cross-refer to the description of its conflicts policy.

Response to questions

Q30(a). *How do firms compare venues (or intermediaries) that offer inducements with those that do not?*
Q30(b). *Where the fees and commissions that firms pay to execution venues or intermediaries include payments for good or services other than execution, please indicate the circumstances in which firms might determine how much of these commissions represents payment for goods or services other than execution? Under what circumstances do firms consider the entire commission as payment for execution?*

We are not clear what CESR's purpose is in Questions 30(a) and (b) since the topic of inducements has been well covered in CESR's advice on Article 19, as the explanatory text recognises at paragraph 120. Furthermore, and consistent with this position, as set out in Box 4(c) CESR's draft advice on best execution deals only with the issue of the location of the disclosure in the context of providing information on a firm's best execution policy to clients. As regards execution venues which offer volume rebates or other incentives these are (or should be) on the public record. As such they are not inducements, if that term intended to imply hidden means of inappropriately influencing an investment firm's decisions. Rather they are merely one of many commercial cost and other factors which an investment firm can and should legitimately take account of as set out in Article 21(1). As CESR will be aware, the ability of fund managers that owe fiduciary responsibilities to their clients to take advantage of 'bundled' commissions, its consequences, and the appropriate regulatory response, have been extensively explored in the UK, where the FSA's concerns focus on the over-consumption of services. Whether a fiduciary fund manager uses a broker on an execution-only or full-service basis, it must still obtain best execution. The UK FSA has examined the fiduciary implications of 'bundled' services, and the possible need for additional disclosure, but it has rightly done so under inducement requirements, not under best execution. Should CESR decide to pursue this issue further, it should, consistently with its statement in paragraph 62 that brokerage commissions are not part of the best execution analysis, do so in the context of inducements, not best execution. Level 2 provisions implementing MIFID are also not the right context because study of this complex issue will not be possible in the short time available for CESR to issue its advice.

Q56*. Please suggest situations and circumstances in which a firm might satisfy the requirements of Article 21 using only one execution venue.*

The starting point is that a firm should regularly survey the business environment in which it operates, and, when a new execution venue emerges, should consider whether it might enable the firm to meet its best execution obligations on a consistent basis. However, there will be circumstances in which the use of one venue will be justified.

For example, almost all derivatives contracts created by, and traded on an exchange can be traded only on that exchange (although there are limited exceptions in the metals and oil markets). In these circumstances the issue is not therefore where to execute the trade but the broader one of the extent to which a contract traded on another exchange or

created in the OTC market can be considered a valid substitute for the contract which is the subject of the client's order. Best execution provisions, and the consequent comparison requirements, imply the existence of fungible, if not identical, products, and competing venues.

In equity markets, CESR has recognised in its research into issues surrounding the definition of most liquid market for Article 25 purposes that almost all trading in the shares of a particular company is concentrated on one exchange. According to CESR 'in 95% of all the cases, the most liquid market had at least five times the size of the second biggest market (using the criterion 'volume' as well as the criterion 'turnover'). In 90% it had even more than eleven times the size of the next biggest market'[1]. While these statistics may not be definitive in all cases and may change in the future if competition between exchanges for order flow in particular securities becomes the norm in Europe rather than the exception, it is highly unlikely that currently, or for the next few years, the second or third biggest markets will enable firms to meet the requirement to provide best execution on a consistent basis. The effect on best execution of search and linkage costs to alternative venues may also need to be taken into account in these circumstances.

As for bond and OTC derivatives markets, when the firm owes contractual or agency obligations to its client, and is itself is able to meet its obligations under Article 21 as the execution venue, it will not need to execute elsewhere. We welcome the recognition by CESR that the use of various methodologies, including statistical analysis, to establish a price which enables a firm that owes contractual or agency obligations to its client to provide the client with the 'best possible result', will be acceptable to regulators since a substantial majority of these products will have no publicly available current prices, no venue which can provide the best possible result on a consistent basis, or even no alternative execution venue at all, for example if they are very illiquid[2] or tailored to individual client requirements, for which there will be no benchmark price. Moreover, in the last case the cost of seeking dealers willing to offer better conditions (or comparable contractual conditions for OTC derivative products) would be extremely high and could imply the disclosure of proprietary information about the client's order which would be detrimental to both the client and the firm. The final result would then need to be evaluated against the other factors provided for under Article 21, such as speed of execution (the search would be likely to be very time-consuming) and likelihood of execution and settlement (different intermediaries would give rise to different credit risk). It should also be acceptable for the firm to rely on the specific instructions of a professional client as provided for in the terms and conditions agreed with such a client.

Also in cases where some sort of price information is publicly available, it should be considered that for OTC derivatives transactions, which will generally result in a long-term exposure of the firm to its client, a key determinant of the terms of the transaction will be the firm's view of the creditworthiness of the client and therefore the risk to which the transaction will expose the firm. So third party standard rates, even when available, will provide, at most, merely a median around which the transaction can be completed.

***Q65**. Do market participants consider that the distinction between internal and external costs is relevant? Does the investment firm have to take into account also internal costs? If so, which ones?*

[1] CESR/04-261b page 107 paragraph 12

[2] Of the 80,000 fixed income securities on the ISMA database, only 11,000 have at least one dealer who has indicated a willingness to make a price to a client.

Unless there are additional external costs such as government-imposed stamp tax, the client is not directly concerned about what the broker's internal costs are because he sees only an execution price and a commission. The commission is the broker's revenue from the transaction. The broker therefore needs to be able to take into account the commercial aspects of operating in a particular market (for example the costs of accessing and searching different venues) so that it can provide services at a competitive rate of commission. But it is important that, consistent with CESR's overall approach as set out in Boxes 2 and 3, the management of internal costs is left to the discretion of firms. In particular, it is important to avoid an outcome whereby the effect of Level 2 provisions on best execution leads to the indirect regulation of commissions, particularly as there is no evidence to suggest that these and other internal costs are not responsive to competitive forces. We would add that it is very unlikely, other than for very short periods, that two venues in the same jurisdiction would trade the same instrument at different prices. Normal market forces would prevent business from going to the venue with worse prices. Venues that compete on costs would also have to offer the best prices available.

***Q82**. How do you assure that your execution arrangements reflect current market developments? For example, if you do not use a particular execution intermediary or venue, how would you know whether they have started to offer 'better execution' than the venues and intermediaries that you do use?*

As discussed in our answer to Q56, and confirmed by CESR's survey, trading in shares will tend to concentrate in a single venue. Many academics and others have commented on the phenomenon in these markets that "liquidity begets liquidity", and that "normal" orders will tend to concentrate in one trading venue. Other venues may exist in competition but these will tend to attract certain types of orders or investors that do not fall within the "normal" range (e.g. while retail orders go to exchanges, institutional orders which tend to be larger in size may use MTFs). Firms compare the public information provided by execution venues they do not use with their practical experience of the execution venues they do use. They may also test such claims with, for example, orders for their own account, to see whether the 'promotional literature' is matched by actual results from trade execution. Also, many eligible counterparties and professional clients will require that a small proportion of their orders be executed in this way from time to time since they too are constantly seeking new execution venues which will enable them improve their performance.

However investment firms, which are subject to commercial pressure to keep costs down and regulatory obligations to obtain the best possible result, should not be expected to carry out tests on new execution venues with the orders of clients to whom they owe a duty of best execution where these clients have not given explicit permission for such tests to be carried out with their orders.

***Q87**. Are intermediaries likely to inform investment firms that manage portfolios or receive and transmit orders about material changes to their business?*

Yes. The pursuit of order flow is a highly competitive and client-focused business and any firm which is known as a source of order flow can expect to be kept fully informed of material changes which the intermediaries concerned believe will improve their competitive position as regards their capacity to assist their clients to meet their own best execution obligations.

Q110 (a – f). These questions have, according to the explanatory text, been stimulated by consideration of SEC rule 11Ac1-6 which requires brokers and dealers in the US to make quarterly reports available to the public on their order-routing practices. Our broad misgivings on this approach are outlined above in our comments on Box 4. More detailed comments are set out below.

Our overall view is that CESR has a number of issues to consider, notwithstanding our earlier comments. The usefulness of the information required to be provided under SEC rule 11Ac1-6 is to a large extent determined by the information provided on order execution by 'market centres', including exchanges and ATSs under SEC rule 11Ac1-5. Without the imposition of a similar requirement on Regulated Markets and MTFs to publish data on execution quality, imposing an obligation only on brokers and dealers is unlikely to be of any substantive use to investors Also, these two US rules were developed as integral parts of the National Market System which has steadily evolved since being mandated by Congress in 1975. In the US there is a single market in which all US exchanges and dealers can compete for order flow in US listed shares. It is also important to note that the SEC does not apply this rule beyond exchange/NASDAQ listed shares and options. The same approach may be possible for EU shares in the EU at some point, but today, and for some years to come, competition in the EU will be very limited due to infrastructure, legal, and tax issues, not the least of which are the clearing and settlement issues currently under examination by the Commission with the assistance of industry experts. The work to establish whether a similar approach should be adopted in Europe should therefore be carried forward in tandem with other work CESR plans to do on issues such as the removal of barriers to the publication of trade data in a consolidated form, in which there are lessons to be learned from the US experience. In that regard we warmly welcome CESR's decision, as set out in paragraph 186 of Chapter 4 of the current consultation paper, to work with the industry on these issues 'when the Level 2 advice has been finalised'. For the reasons set out above, and to be consistent with best consultation practice, it would, we believe, be appropriate to take forward work on detailed order execution information as part of that agenda.

The answers to the specific questions which follow should be read in the context of our views as set out above.

Q110(a). *Please identify and estimate the specific costs that investment firms will incur to identify the execution venues and intermediaries that have executed or received and transmitted their client orders and to collect historical information about what portion of their client orders they directed to each such venue or intermediary, For example, what costs would be associated with determining what percentage of client orders an investment firm directed to each venue or intermediary it used in the last 12 months, based on both the number of trades and the value of traders?*

Raw data on OTC business may be maintained by some firms as part of the records they keep of individual customer orders, but is likely not to have been kept cumulatively. Where this is the case as part of their current process of reviewing execution venues in order to consider how best to improve the quality of pricing that they are able to offer clients, the information may be reviewed by firms on a regular basis. However, for many firms such a requirement would require new systems to be established to gather and sort data, and even for those firms that currently have data, incremental costs would arise from assembling the data into a user-friendly form for clients and from distribution to clients. It would not be appropriate to proceed further with such a proposal without identifying

what benefits would justify the costs of assembling and providing such information, and other regulatory impacts.

***Q110(b)**. Please explain what competitive disadvantage or other damage to their commercial interests firms would experience if they were to publish the percentage of their business that they direct to different execution venues and intermediaries.*

While each disclosure would have to be judged on its merits, generally it appears that the confidentiality of such information would not be the most important objection to such an obligation.

***Q110(c).** If firms are required only to make this information available on request, would that address respondents concerns about overwhelming clients with too much information?*

While we recognise that this approach would result in the information going only to those clients who believe it to be of benefit, it would mean that the incremental costs incurred would be added to the client servicing function to be borne ultimately by all clients, in order to meet the requests of what we continue to believe would be a very small sub-set of clients. There are three sources of costs. The first is the cost of collecting the information; the second of assembling it in a format which could be distributed to clients; the third is the cost of distribution. This proposal deals only with the third. We do not see the benefit of disclosing general data bearing in mind that the client can always ask for and receive information on where his own order was executed, which is what he cares most about.

***Q110(d).** Please suggest approaches to focus this information. For example, should this information be disclosed for each execution venue, for different types of instruments, country-by-country etc? Should firms break out this disclosure for different business lines (e.g. retail versus institutional. How?*

This proposal would add further costly elaboration to a process which we believe would be of limited benefit to clients. Furthermore, as we have observed earlier, without parallel disclosures by RMs and MTFs on the quality of execution, prepared on a consistent pan-European basis, the utility of such information to investors would be very low.

***Q110(e).** Should there be information for execution venues that investment firms access indirectly? And, if so, should it be on the main intermediaries to whom the firms usually entrust the execution of their orders?*

In our view, sufficient consideration has already been given to the issue of providing information on execution venues indirectly accessed by firms, and, given our views on listing execution venues, as outlined above and in detail below, we clearly agree with CESR's current conclusion on this matter.

***Q110(f)**. Please provide specific information about why, in less liquid markets, this sort of disclosure actually might be misleading. Is such disclosure about equity transactions more meaningful or useful than disclosure about transactions in other types of instruments?*

Aggregate information about the firm's overall executions will not necessarily bear any relation to how the firm has executed the client's own orders. Such disclosure might have value to investors in those liquid equity markets in which there is competition between execution venues for order flow (which is with, very few exceptions, not presently the case in Europe). It might, for example, prompt questions as to why a particular investment firm was routing all, or substantially all, of its customer order flow to one venue. At the other extreme, in illiquid markets finding even one execution venue, including in house execution, might be the best that can reasonably be achieved. The information would also not be relevant in markets where there is only one venue, such as listed derivatives and OTC derivatives.

***Q115**. With respect to the fourth disclosure suggested by respondents ('disclosure about the investment firm's error correction policy, error rates and client order handling policy'), CESR requests further comment on whether investment firms that execute client orders directly or indirectly should be required to disclose information about their error correction and order handling policies.*

We believe that this issue should be dealt with as part of the obligations on a firm to handle complaints properly. In practice firms will correct errors and compensate clients as they have a contractual obligation to do so.

***Q126(a).** How might an investment firm gain the necessary consents required under Article 21(3) of the Directive as part of a voice telephone communication?*
***Q126(b)**. What impact would there be on cross-border business and distance marketing if investment firms are not permitted to obtain client consents required by Article 21 using voice telephone?*
***Q126(c).** Can respondents suggest a different approach from the one used in paragraph 5 of the advice under Article 19(3) that would permit investment firms operating via voice telephone to satisfy the objectives of Article 21's consent requirements?*
***Q126(d)**. How might firms evidence that they had obtained client consent if they obtained that consent via voice telephone?*

These questions all deal with the issue of obtaining consent to a firm's execution policy in the course of a telephone conversation. We were encouraged that CESR stated at the Paris hearing that it is not intended that its advice should conflict with the Distance Marketing Directive. However, in professional markets a firm would not accept an order over the telephone without first having undertaken anti-money-laundering and credit checks, and put terms and conditions in place.

As to the methodology for obtaining and evidencing consent where appropriate, we suggest that there is a three stage approach to resolving this problem. The first stage lies in reading the required disclosures to the potential client – which is a further reason to ensure that these are succinct and in context, enabling the potential client easily to understand the key features of the policy. The second stage consists of the expectation, where relevant, that such consent will be given on a recorded telephone line as proposed by CESR in its advice on Article 13(6). But given that evidence of the initial consent should be a matter of record throughout the period that the client has a relationship with the firm (and longer for some purposes) the third stage requires that the firms should follow up the oral consent with a request for consent in a 'durable medium'.

***Q129**. Should investment firms that do not consider speed to be an important factor in the execution of retail client orders be required to highlight this judgement?*

Firms do not have a predetermined view on the importance of factors. That is subject to discussion with the client. In the case of automatic execution systems, and consistent with the requirements of the order handling obligations, on receipt, orders will be sent to the execution venue with which the automatic execution system(s) is connected.

Chapter 4: Market Transparency

General comments:

CESR does not describe the methodology that it has used to arrive at several of its proposals, for example:

(a) the proposed thresholds for 'frequency' (Box 1),
(b) the proposed criteria for determining 'shares in which there is a liquid market (Box 2),
(c) the proposed definition of 'customary retail size' (Box 3), and
(d) the proposed thresholds for 'large in scale compared to normal market size' (Box 6).

We recognise the difficult task that CESR has faced in preparing its advice on these issues. We understand that some of these proposals represent an attempt to compromise between different positions within CESR. The specific proposals themselves have been helpful to us as a starting point for considering how they can be improved, though it was unhelpful that CESR was not able to publish most of its statistics and worked examples based on its proposals until near the end of the consultation period.

In the light of the resulting data and worked examples, we suggest that CESR and the Commission should draw the following general conclusions from CESR's inability to provide a principled justification for its advice on so many issues that will have a critical impact on the efficient regulation of European share markets:

(a) Level 2 measures should avoid wide-ranging prescription of how markets should organise themselves. We welcome the extent to which CESR has recognised this need on a wide range of issues, particularly as regards dealing on RMs and MTFs.
(b) Where MIFID provisions introduce new and untested requirements, Level 2 measures should err on the side of caution, and not seek to arrive in a single step at a comprehensive, fully-formed solution. Much of the uncertainty and compromise within CESR has been associated with the advice on measures under Article 27. It is particularly important in this area, in Boxes 1 and 2 in particular, that CESR and the Commission adopt a gradual approach, given the importance of avoiding the wrong balance between transparency and market efficiency.

Specific Comments on CESR's proposals:

SECTION 1 - Definition of Systematic Internaliser – (Article 4.1(7))

BOX 1 – 'organised, frequent and systematic basis'

CESR's draft advice on the definition of 'systematic internaliser' (SI) is now more developed than in the October 2004 consultation. It provides a reasonable starting point from which to develop the final advice. However, it still retains a number of important flaws, and fails to reflect all of the relevant issues covered in the Level 1 text. As drafted the advice is, in effect, circular. CESR still proposes to define the criteria in certain respects by reference to the entity that will carry out the systematic internalisation business (paragraph 6). The advice does not otherwise shed light on how the particular business of systematic internalisation would be identified within the firm. We suggest this leaves only half-answered the question asked by the Commission in its mandate. It also presents uncertainty for those firms which would be SIs as to how they would

arrange and differentiate between their on-exchange business, off-exchange non-SI business, and SI business. In particular, for example, it is important for firms to be able to distinguish their systematic internalisation from their discretionary management of client orders, and from their OTC business. It also creates difficulty for other parts of CESR's draft advice. We will flag these points as they arise.

We welcome the following elements of CESR's Explanatory Text and Box 1:

(a) The adoption of the 'indicator' approach.
(b) The move towards focusing the indicators on a separate activity that is conducted on an organised, systematic and frequent basis, not on the totality of a firm's off-exchange trading.
(c) The focus on a separately identifiable activity which is 'marketed' to clients as such
(d) The intention to recognise the implications of Recital 53 (paragraph 2, second bullet, but this is not reflected in Box 1)
(e) The intention that the criteria should apply only to an activity that relates to shares, and not other instruments (paragraph 5, but not reflected in Box 1).

Aspects of CESR's Box 1 that need further improvement

(a) All 'positive' indicators should be cumulative. The use of 'or' in paragraph 11(a) means that CESR's proposed indicators would still catch too broad a range of well-managed firms that use own-account dealing to facilitate customer orders.
(b) It should be made clearer that the indicators point to a separate, identifiable business activity to which Article 27 provisions would apply, not to the firm's off-exchange dealing against client orders as a whole.
(c) CESR should not refer in its indicators to 'internalisation', which is not a defined term and would therefore render the definition circular.
(d) 'Frequent' should preferably not be defined as a positive indicator by reference to specific quantitative thresholds. Any quantitative threshold should not be compared to the total value of trading in the market as a whole (which would anyway be very difficult to calculate accurately). Furthermore, 'frequent' should refer to the systematic internalisation activity itself, and not be measured against the total business of the firm. Own account dealing which is not systematic internalisation (for example because it is not order execution) is irrelevant in deciding whether or not the systematic internalisation activity itself is conducted on an organised, systematic and frequent basis.
(e) We remain of the view that specific negative indicators, over and above those which CESR proposes, are necessary to limit the definition appropriately. We suggest negative indicators, and the reasons for them, in our detailed comments below.

Paragraph 11. The problems identified above could be dealt with by making further amendments to the wording of paragraph 11 of the draft advice as follows (revised wording shown in bold):

'For the purposes of MIFID Article **4.1.7**, where an investment firm **conducts an activity which involves dealing** on own account by executing client orders **for shares** outside a regulated market or MTF, it should be considered as likely to be conducting **that** activity on an organised, frequent and systematic basis when**, excluding that part of the firm's**

business described in MIFID Recital 53 and all other principal business not covered by Article 27, that activity has all of the following **characteristics:**

(a) ***It is*** *a* separate business ***activity under which*** non-discriminatory rules, protocols, procedures and/or practices**, from which there can be no frequent variance,** ***routinely route client orders away from a RM or MTF to own account***, AND

(b) Personnel and/or an automated technical system **are** ***specifically assigned for that purpose***, AND

(c) The activity is marketed and made available to clients ***as such'***.

Paragraph 12. As explained above, we think that CESR should not define 'frequent' as a positive indicator in quantitative terms. Neither of CESR's proposed measures – the share of the firm's total executed orders, or the firm's share of the total value of trading on the most liquid market – provides a real measure of 'frequency'. The first measure could easily capture a small firm dealing infrequently. The second would capture large firms purely because of their size, regardless of the frequency of their systematic internalisation activity. If CESR decides to retain a quantitative measure, it should be a negative indicator and focus on entities that have a role in price formation. In this context, 12(a) is irrelevant, and 12(b) needs to be judged in the light of the leading execution venues in the market. In CESR/04-261b, page 107, paragraph 12, CESR observed that 'in 95% of all the cases, the most liquid market had at least five times the size of the second biggest market (using the criterion 'volume' as well as the criterion 'turnover'). In 90% it had even more than eleven times the size of the next biggest market'. In that context, other venues will affect price formation only if they have a share of the market which is significant in relation to the concentration of liquidity on the most liquid market, for example if they have at least 5% of the volume executed through the main venue. If a quantitative measure is retained, the figure in 12(b) should therefore be at least 5%. In addition to the above points, it would be important for any advice on this subject to specify the period over which 'frequency' is determined.

In paragraph 2 (4th bullet) CESR proposes that the only negative indicators should be quantitative ones. We continue to consider that negative qualitative indicators are necessary to ensure a balanced assessment, and to prevent various types of business from being inappropriately classified as systematic internalisation. Paragraph 2 (2nd bullet) implies that CESR shares this view. In judging the systematic, organised and frequent basis of an activity, it is particularly important, for the reasons given, to take the following into account as negative indicators:

(a) **Activity which is incidental to another business activity which itself does not constitute systematic internalisation.** In this case, the firm has not decided to deal in a systematic and organised way on own account.

(b) **Client orders for which the price is taken from an external source, such as the regulated market price.** Such dealing does not affect price formation. In effect, the firm has not decided to deal in an organised way outside a regulated market.

(c) **Dealing where the relationship between the firm and the client is characterised by transactions above Standard Market Size.** In this case, the dealing falls within the Recital 53 exemption

(d) **Dealing where the execution with respect to a specific share is closely linked to or forms part of an order encompassing other transactions, such as an**

order relating to a portfolio of securities. In this case, the firm has not made a decision to deal systematically on own account in the particular share.

(e) **Dealing which is not frequent**. In this case, the firm is not dealing frequently (see also our comments under 12 above on CESR's proposed quantitative approach).

(f) **Activity where the firm deals on own account to make good on a price guarantee provided to a customer.** In this case, the firm has not made the decision to deal systematically on own account.

(g) **Activity where the firm's commitment to deal on own account in relation to a specific order has been made based on a blind bid (i.e. without knowledge of the specific share or shares).** In this case, the firm has not made a decision to deal systematically on own account in the share.

(h) **Dealing where it is the client who specifically decides whether or not the transaction takes place on a regulated market**. In this case, the firm has not made the decision to deal systematically on own account.

(i) **Activity that provides a dynamic and discretionary order-management service to clients, part of which may include the provision of risk capital.** In this case, the firm has not decided to deal in a systematic an organised way on own account.

Paragraph 13. Firms should not be required to maintain Article 27 quotes when they are not acting as a systematic internaliser in relation to a share. Such a requirement would not be consistent with the Level 1 text.

Q 1.1. *Do the revised criteria for assessing 'organised, systematic and frequent' better delineate the activity of systematic internalisation? If not, what further modifications would they propose?*

See all of our comments on this section above. Appropriate treatment of the criteria is also important to the discussion of other parts of CESR's draft advice, for example paragraph 84 and Q3.4, on which see our comments below.

Q 1.2. *Is the proposed use of a quantitative measure as an additional indicator useful?*

The use of quantitative measures could be helpful as a negative indicator, to exempt those firms that would fulfil the other conditions but fall below the quantitative measures. However, they should not be selected randomly, nor should they act to discriminate against particular firms. As mentioned above, the measure proposed in 12 (b), in particular, would discriminate against large firms simply because they are large. The net effect of imposing additional costs on such firms' trading in otherwise illiquid shares may be withdrawal of dealers from providing liquidity for these stocks, therefore reducing the amount of liquidity available for investors, particularly investors outside the home country of the issuer. Due to the higher costs of dealing for retail investors outside their home market, this would further discourage investment by EU investors outside their home market.

***Q. 1.3**. Has the quantitative test been appropriately structured? If not, how should it be improved?*

CESR has published no supporting analysis for selecting the figures put forward. In our comments on paragraph 12 above we suggest alternative approaches which would avoid the problems associated with a positive quantitative indicator. If the quantitative tests were intended to capture 'significant' execution venues, supporting analysis is crucial to determine the appropriateness of the means being suggested to the ends CESR is attempting to address. The significance of any one venue cannot be determined without taking into account the market share of the dominant execution venue with respect to shares, i.e. RMs.

SECTION 2 – Pre-trade transparency

SECTION 2.1 – Defining the scope of the quoting obligation for Systematic internalisers: Liquid shares (Article 27)

We have several reservations about CESR's overall approach to determining what is a liquid market in a share for the purposes of Article 27.1. Philosophically we are concerned that CESR has not described what it believes liquidity, in this context, to represent, though it is helpful that CESR has clarified in paragraph 20 that a liquid market should here be defined in the context of Art 27, and that this is distinct from defining liquid shares for other purposes. Furthermore, we consider that because of the risk to which SIs would be exposed by the requirements of Article 27, and the fact that SIs will need to be able to justify commercially the resources they devote to maintaining continuous quotes, the definition of 'liquid' for these purposes should be narrower than its general meaning. CESR recognises this point in paragraphs 17 and 20. Therefore, whilst we appreciate that CESR is trying to generate a practical outcome, we believe that it has jumped an important step in the process. Practically speaking we remain convinced that the best way to approach such a significant change to market practices is to run a test project as a first stage, using a small number of shares that are indisputably liquid. Once the results of the first stage have been examined, the definition of 'liquid market' could be extended to cover additional shares that are then, in the light of experience, deemed also to have a liquid enough market for these purposes.

In considering these issues we have found very helpful CESR's data on shares that would be deemed to have a liquid market under its proposals. It was unfortunate that the data were not available at an earlier stage of the consultation, or in a more organised form, which would have enabled us to analyse them more thoroughly. Nevertheless, we have the following general observations in the light of the data:

(a) The data underline the great variety of relationships between free float, frequency of trading, and trading volume in different European markets.

(b) It appears that CESR's criteria would result in between 350 and 500 shares (depending on which criteria competent authorities chose) being deemed to have a liquid market. This number is too large for the introduction of a new and untested regulatory structure. It includes many shares which would not normally be considered to have a liquid market, and more shares in which it is doubtful from a commercial and risk management point of view that firms would be able to maintain Article 27 quotes.

(c) The test approach that we advocate above, starting with a small number of indisputably liquid shares in the first stage, would cover a very large proportion of the total market. For example, on the basis of CESR's data and FESE's statistics on market capitalisation and turnover, the 50 most liquid shares would represent about 40% of total market capitalisation and about 30% of total trading volume. The 100 most liquid shares would represent about 55% of total market capitalisation and about 40% of total trading volume. Under this approach Article 27 would therefore be implemented from the outset on a very large scale across Europe, but without jeopardising liquidity provision in those mid-capitalisation shares that are likely to depend on it to a greater extent to grow and prosper. We observe that the next 300 most liquid shares (i.e. bringing the total up to CESR's proposed 400 or so) would represent only a further 20% of total market capitalisation.

If the data are available, it would also be wise to run the calculation for more than one year, to see how variable the results can be.

BOX 2 – Liquid shares for A27 purposes

Paragraph 22.

It is not clear exactly how the free float would be calculated. In terms of the interim 'proxy' approach CESR needs also to indicate which proxy is to be used.

We do not believe that there is any justification for offering member states a choice (in 22(c) and (d)) as to what constitutes liquidity, nor is this implied in the Level 1 text. We do not think this approach would support the objective to achieve a single market in European shares. Of the two criteria proposed, 22(c) is not unreasonable in principle, although based on an analysis of the data published by CESR we think that 500 trades per day is too low a threshold, and that 1000 trades per day would be more accurate.. However we do not think the criterion proposed in 22(d) provides a reasonable result, nor is CESR itself internally consistent in proposing 22(d) as a criterion for liquidity.

When (see page 73) CESR proposes thresholds for pre-trade waivers on exchange-traded transactions, low liquidity shares are described as those with ADV below €1 million, and Lower-mid liquidity shares are described as those with ADV between €1-25 million. On this (numerical) basis, CESR cannot therefore justify using a €2 million figure as an indicator of liquidity for Article 27 purposes where, as CESR acknowledges, the risks are higher. Any average daily value threshold would therefore need to be much higher than €2 million, and at least €5 million, or (c) and (d) would need to be cumulative rather than optional, or (d) would need to be deleted altogether.

CESR proposes in paragraph 105 that the customary retail size is €7,500. This implies that a share with Average Daily Volume of €2 million would have less than 300 retail trades a day, hardly a mark of liquidity. A further inconsistency in CESR's approach is that, taking 22(c) and (d) together would imply that the average size of trade for a liquid share is EUR4,000. It is counter-intuitive to imply that average trade size in a liquid share is considerably lower than the customary size at which retail trades occur.

***Q 2.1**. Does the proposed approach to identifying liquid shares establish a sound methodological approach in the context of Article 27? If not, please specify (in sufficient detail) a modified or alternative approach and explain why it would be superior.*

CESR's data show that European markets differ greatly in the relationship between free float, number of trades, and trading volume. CESR has tried to accommodate these differences by proposing that competent authorities should be able to choose the criteria which they think most appropriate. We do not consider that optional criteria are compatible with a single market. Furthermore, the judgement of participants in the market, taking account of other factors such as the average quantity of stock available at the best bid and offer, and the size of the spread, is that numerical thresholds as low as CESR proposes would lead to the inclusion of many shares which would not be considered liquid in the market, and which CESR itself does not consider liquid under its proposed thresholds for delayed trade reporting. Many firms would be unlikely to consider maintaining an Article 27 quote in such less liquid shares as either an acceptable risk or a commercially viable activity. We therefore commend to CESR our preferred approach of starting with a smaller number of indisputably liquid shares, as described above. This approach would be methodologically sound, would smooth out divergences between trading patterns in national markets (since it would focus on the most internationally traded shares), would align Article 27 regulatory requirements with the commercial priorities of firms, but would also mean that from the outset Article 27 covered a very large proportion of EU share markets.

SECTION 2.2 Content of pre-trade transparency

Paragraph 50. We note CESR's discussion of the question of whether 'orders executed' in Article 27.1 refers to the original orders that underlie transactions, or the executed transactions themselves. CESR states that some CESR members consider that the former interpretation 'will generate a Standard Market Size that more accurately reflects the role of large orders in the trading mix'. This statement ignores the significant aggregation in some markets of small orders before they are executed. Any use of an 'order' measure rather than a 'transaction' measure would therefore also need fully and accurately to reflect the role of small orders that have been aggregated into the 'trading mix'.

BOX 3 – Content of pre-trade transparency

Paragraph 73. We welcome CESR's proposal to pull back from the comprehensive publication requirements on which it previously consulted. This will go a very long way towards ensuring that RMs and MTFs have the flexibility to provide the necessary range of information to meet the differing needs of different market users. However, in paragraph 24 CESR explains that 'following consultation with the Commission', it now proposes to prescribe minimum pre-trade information that RMs/MTFs should advertise and make public. The effect could be a more rigid structure of what can and cannot be advertised, with regulators rather than exchanges making the decisions, despite CESR's reduced suggested minimum requirements. Furthermore, CESR's interpretation appears to be inconsistent with the Level 1 text of Articles 29 and 44, which require RMs and MTFs only to make public on reasonable commercial terms the pre-trade information that they choose to advertise. We therefore suggest that paragraph 73 should read '…they should publish for each share admitted to trading on an RM, at least the information, **where it is advertised through their systems**, set out in the paragraphs below'. This is necessary to 'provide sufficient leeway' for different market structures that CESR refers to in paragraph 37.

Paragraph 74. We consider that the appropriate level of published information is best determined by those who will use the information. For this reason flexibility should be

left to the producers of the information, in consultation with users, so that only information which is useful to its users is published. Specifying a minimum of five price levels for bids and offers gives more flexibility than CESR's original proposal. But it may not be possible to specify a minimum which is appropriate for all markets at the EU level.

Paragraph 75. Publication of an indicative auction volume should not be required by Level 2 measures, as this could cause market manipulation problems for some less liquid shares.

Paragraph 76. CESR proposes to require disclosure of best bid and offer overall, and for each market maker, in a montage for each share, in a quote driven system. Investors are usually most interested in the 'touch' (best bid and offer) and size in a quote driven system. We do not consider that routinely showing the quotes of market makers who are not at the 'touch' would provide useful information to investors. CESR should therefore not propose it as a minimum publication requirement.

Paragraph 77. We have no particular comments on CESR's proposal to require publication of all bids and offers of market personnel in a 'trading system with market members acting as market personnel', though we are not clear why publication of the best bid and offer should not be sufficient.

Paragraph 78. We agree with CESR's statement in paragraph 36 that 'MIFID accepts different market models with varying degrees of pre-trade transparency as being sufficiently pre-trade transparent'. We therefore suggest that the same approach that we advocate in our comments on paragraph 73, taking account of the characteristics of the trading system and the information that it advertises, should be applied across all types of trading system. The reference in paragraph 78 to a 'standard of pre-trade transparency comparable' to that in paragraphs 73-77 is not precise enough for Level 2 legislation, and the requirement that the 'trading mechanism shall be in the interest of fair and orderly trading and investor protection' is not appropriate for a measure on 'the range of bid and offers or designated market maker quotes, and the depth of trading interest at those prices, to be made public'. Furthermore, it is not clear what difference is intended between (a) 'standard' of pre-trade transparency' and (b) 'level' of pre-trade transparency.

Paragraph 79. CESR is right to propose that members and participants in an RM or MTF are entitled to update and withdraw their bids, offers, and quotes, subject to orderly market and market abuse provisions.

Paragraph 80. CESR is also right to specify that RMs and MTFs should have rules governing the conditions and circumstances in which market makers may withdraw their quotes.

Both **paragraphs 79 and 80** need however to be considered in the context of paragraph 99, which would allow SIs to withdraw quotes only when trading on a RM is suspended. The treatment of SIs in paragraph 99 is not only inconsistent with the treatment of market makers in paragraphs 79 and 80, but also fails to take account of the different commercial position of RMs and SIs. Unlike buyers and sellers in an order-driven market, who want to buy or sell a share at a certain price because they have a view on that share, market makers are intermediaries, who do not necessarily have a view on the share but are willing to provide liquidity by committing their capital for a fee. The primary motivation of a RM is to keep a share trading, because it does not want to harm its market makers. It

will therefore prefer to allow its market makers to protect their capital by withdrawing firm quotes and providing indicative quotes than to suspend trading, and will develop its rules accordingly. A SI similarly would need to be able to withdraw its firm quote to protect its capital, very probably in a wider range of circumstances since it would not enjoy the protection of the central counterparty. SIs should therefore have at least the same privileges under Paragraph 99 as market makers under Paragraphs 79 and 80, and be able to withdraw firm quotes subject to orderly market and market abuse provisions. A properly competitive market could not otherwise be maintained without imposing undesirable restrictions and conditions on RMs' and MTFs' rules under Paragraph 80.

Paragraph 81. In Paragraph 39 CESR argues rightly that iceberg facilities: 'help intermediaries and their clients in executing their orders in the most efficient way'. Investment firms similarly help their clients to execute their orders in the most efficient way by managing the exposure of the client's trading interests on RMs and MTFs.

Paragraphs 83, 84, 85. In Paragraph 42 CESR argues rightly that a regime for 'negotiated trades' is necessary where 'it would not be in the interest of the client to enter the order into the order book because a better quality of execution might sometimes be achieved outside the order book…thus negotiated trades may be necessary for intermediaries to achieve best execution'. We agree that quality of execution should override transparency in such circumstances, which should include situations such as those cited in paragraph 42 where posting small retail trades on the order book would be too costly to give the client best execution, or where the terms applying to the transaction do not correspond to the terms on which the quote is made or the order is entered.

It is however important that the condition which requires the transaction to be made at or within the current spread on the RM/MTF refers to the weighted spread to the extent that liquidity is available on the order book, not indiscriminately to the best bid and offer. Firms entering into negotiated trades should not be restricted in their pricing decisions if there is not sufficient liquidity on the order book.

CESR proposes in the final sentence of paragraph 84 that the waiver of pre-trade transparency should not be available to SIs for transactions smaller than SMS, except where the transaction involves crossing client orders. It would be wrong for Level 2 measures to discriminate against the clients of SIs in this way, denying them the opportunity for best execution. The reason for the waiver of pre-trade transparency, as described in paragraph 42, is the same regardless of whether the intermediary is a SI or not. Provided that the conditions, which include compliance with the rules of the RM or MTF, are satisfied, the nature of the intermediary should be irrelevant. Furthermore, it is precisely to transactions below SMS that paragraphs 83 to 85 are most relevant, since except for systematic internalisation MIFID imposes no restrictions on firms' ability to execute client orders by dealing on own account outside a RM or MTF. Under CESR's proposal, a SI would be obliged:

(a) either to enter the client's order onto the order book if it was possible to do so (even though it might not be able there to obtain best execution, and regardless of any other harmful effect on the client's interests);
(b) or to execute the order on own account subject to Article 27 (regardless of the fact that restrictions on price improvement or negotiation might prevent best execution, or otherwise harm the client's interest);
(c) or, if it was possible to do so, to execute the order on own account without Article 27 restrictions.

Under CESR's proposals, only in the last case would SIs' clients not be disadvantaged by comparison with the clients of non-SIs. The effect would be to limit the options of SIs' clients anticompetitively and inconsistently with firms' best execution obligations. Furthermore, while rightly giving RMs and MTFs discretion to limit excessive transparency in the client's interests, CESR's proposal would deny that opportunity to SIs in similar circumstances. The clients of SIs which are not a member of the relevant RM or MTF should also not be discriminated against. Furthermore, paragraphs 83 and 84 would require negotiated trades to be 'made' on the RM or MTF. There is therefore a great danger that the last sentence of paragraph 84, combined with other elements of paragraphs 83 and 84, and the too broad application of the 'systematic organised and frequent' criteria which CESR proposes in Box 1, would effectively reintroduce a 'concentration rule' by inappropriately favouring on-exchange execution and limiting or preventing off-exchange execution in similar circumstances.

Provided that CESR's advice on 'systematic, organised and frequent basis' is appropriately developed in Box 1, so that it excludes situations in which the firm manages orders on behalf of clients by dealing on own account without full transparency for similar reasons to those which justify paragraph 84, the fears of a 'loophole' which underlie Q3.4 and presumably gave rise to the final sentence of paragraph 84 are unfounded.

For all these reasons, the final sentence of paragraph 84 should be deleted.

Paragraph 86. CESR is right to propose waiving the pre-trade transparency obligation for a RM/MTF where prices are referenced to another trading mechanism whose reference price is reliable and widely published. In order to maintain a 'level playing field', firms' execution systems which are referenced to a RM's or MTF's trading mechanisms whose reference price is reliable and widely published should be excluded from the definition of 'systematic internaliser' – see our comments on negative indicators under Box 1 above.

Paragraph 88. CESR is right to use different criteria for establishing the figures to be used for pre and post-trade calculations.

Paragraph 91. We believe that a 3 year review is too long a period, in particular because the Article 27 provisions are new to the market and might, in the light of experience, benefit from earlier adjustment. A review at 12 months would be more appropriate. Moreover, we suggest that CESR should anyway allow latitude for an earlier review if market circumstances overall suggest this is desirable. This could be couched in the language used in paragraph 94.

Paragraph 95. We do not think that CESR's proposals on new issues are sensible. We suggest that new issues should be assessed once they have been trading for a minimum period of 3 months, before when Article 27 provisions should not apply. Even after the first three months, CESR should apply an approach using peer stocks as a proxy until the first annual reevaluation, given the distortion that could result from basing SMS on the share's first three months of trading history. Almost without exception, new stocks trade much more frequently and in greater size in the period immediately after issue than subsequently. This early pattern of trading will, after some months, settle into a less volatile trend, and it is at this time that the shares should be assessed to see if they meet the criteria for liquidity. A short period of volatility is not a measure of liquidity. In paragraph 60 CESR comments that the transparency requirements should be driven by the

high level of trading in the early period of a new issue. However it is in this period that the issue may be subject to stabilization provisions which are available only up to 30 days after pricing. Stabilization is carried out only on a Regulated Market, and investment firms which are part of the underwriting syndicate will not usually make markets until the issue is fully sold.

Paragraph 99. We strongly oppose this provision. Of the two options it describes in paragraph 70, CESR has chosen the one which is anti-competitive and not properly justified in the supporting text. The treatment of SIs in paragraph 99 is inconsistent with the treatment of on-exchange market makers in paragraphs 79 and 80. It also fails to take account of the different commercial position of RMs and SIs. The regulation of SIs should not be based on the commercial judgements of their competitors. The primary motivation of a RM is to keep a share trading, because it does not want to harm its market makers. It will therefore prefer to allow its market makers to protect their capital by withdrawing firm quotes and providing indicative quotes than to suspend trading, and will develop its rules accordingly. A SI similarly would need to be able to withdraw its firm quote to protect its capital, very probably in a wider range of circumstances since it would not enjoy the protection of the central counterparty. If paragraph 99 prevented it from doing so, the SI would have no option but to quote in the minimum number of shares or enter a one-way quote, which would be far less useful to market participants than an indicative quote, and might not sufficiently protect the firm or its clients. Paragraph 99 would thus go against the fundamentals of proper risk management, prudential rules, and orderly markets. SIs should have the same privileges under Paragraph 99 as market makers under Paragraphs 79 and 80, and be able to withdraw firm quotes subject to orderly market and market abuse provisions. A properly competitive market could not otherwise be maintained without imposing undesirable restrictions and conditions on RMs' and MTFs' rules under Paragraph 80.

At the 23rd March hearing, a commentator suggested that SIs should be prevented from quoting in shares in which a RM had suspended trading. It would be inappropriate for the actions of RMs to inhibit and restrict the activities of SIs in this way, and would effectively award quasi-regulatory powers to RMs. It is important to maintain a balance between orderly markets and investors' rights to be able to deal. Otherwise when an RM suspended a share, investors could be prevented from obtaining legitimate dealing services which only SIs could provide. Such a ban would also be anticompetitive in that it would not apply to brokers who crossed client orders or other types of non-Article 27 business. Any such suspension of SI activity should apply only when the competent authority has suspended trading.

Paragraphs 100, 101, 102. It should be sufficient for a firm's policy to be that it is prepared to deal at its quoted price only until it has dealt in the number of shares for which it is quoting, and that once it has dealt up to the quoted amount it is entitled to update the quote. This is in line with standard practice for market makers. We consider that paragraphs 100, 101, and 102 provide for it.

Paragraph 103. CESR has added in a minimum size condition of €3 million for portfolio transactions, without providing any justification in the explanatory text. We do not think that this is justifiable and oppose it. The whole point and purpose of portfolio transactions is that they are a means, for fund managers and other institutions, of trading a basket of securities in one lot. The basket itself is given a price, not necessarily the individual shares in the basket. The efficiency, for the fund manager, is that he can sell a package of stocks without either revealing his position on each stock or having to work

out a strategy for disposing of the component parts. The value therefore lies in bundling up a number of stocks, not in the value of the individual stocks in the overall bundle. Nevertheless, there would be no point for the fund manager in bundling up lots of small portions of stock – it would be simpler, for best execution purposes at least, to place these small orders on exchange. Therefore adding a minimum figure for portfolio trades adds complication but no value.

Furthermore, the figure proposed is not internally consistent with CESR's other proposals. The average size of a transaction in such a 10-share basket would be €300,000. The average size in a 100-share basket would be €30,000. According to CESR's data, even with a Box 6 Table 1 'large in scale' threshold as high as €500,000 for a liquid share, SMS is never higher than €75,000, and usually much smaller. CESR's proposal would therefore have the effect of nullifying the exemption for any basket containing fewer than 100 shares, which we assume was not CESR's intention.

At the 23rd March hearing, CESR asked whether its draft advice on this point could be deleted. We think that it could, and that the Level 1 reference to 'several' is clear enough.

Paragraph 104. The reference to limit orders remains problematic. Limit orders cannot be grouped with buy and sell orders as 'orders subject to current market price' because the order types are not synonymous A limit order is subject to a condition other than current market price and therefore by its very nature is not capable of being equated with buy and sell orders. Article 27 requires SIs only to quote for immediate execution, up to the stated size, at the quoted current market price. If CESR's intention were to capture a limit order when it is **executed**, rather than when it is **received**, the following revised wording would help to clarify the issue: add the words '**at the point at which they are executed**' at the end of paragraph 104.

Paragraph 105. The 'customary retail size' figures that we cited in our response to CESR's earlier consultation were lower than CESR's proposed €7,500. Furthermore, the worked examples of average trades in CESR's Data Annexes show that for some shares, SMS would be lower than €7,500, whereas the purpose of the provision in Article 27.3 is to give SIs' professional clients price flexibility below SMS. For these reasons, and also based on the commercial judgement of dealers, we consider that 'customary retail size' should be lower than €7,500, at most €5,000. We believe that CESR should be more transparent in showing how it reached this figure. In the absence of transparency we cannot tell whether CESR has included outlying figures or whether adjustments have been made to figures, and for what reason.

We have also noted some internal inconsistencies in the figures proposed by CESR. In particular we note that the customary retail size figure of EUR7,500 compares oddly to the threshold for liquid shares in Box 2, where the implied average size transaction for a liquid share in paragraphs 22(c) and (d) is €4,000. We would expect CESR to provide a reconciliation and justification of this result.

***Q 3.1**. Do consultees agree with the specific proposals as presented or would they prefer to see more general proposals?*

We would prefer more general proposals. See our comments on CESR's proposals above.

***Q 3.2**. Is the content of the pre-trade transparency information appropriate?*

Though there are many improvements over CESR's previous proposals, some problems remain. See our comments on CESR's proposals above.

***Q 3.3**. Do consultees agree on the proposed exemptions to pre-trade transparency? Are there other types or order/transaction or market models which should be exempted?*

We consider that exemptions should be consistently available to all order execution venues. Exemptions corresponding to those for RMs should therefore be available to SIs. This could be achieved by an appropriate interpretation of the Article 4.1.7 criteria (see our comments on Box 1 above).

***Q 3.4**. Do consultees agree on the proposal in the second subparagraph of paragraph 84? Would it cause difficulties for firms trading in several capacity (systematic internalisation, crossing client orders etc.)? Are there alternative ways to address the potential loophole between Article 27 and Article 44?*

We do not agree with CESR's proposal. See our comments on paragraph 84 above. It would cause difficulties not only for firms, but more importantly their clients. How far the paragraph would cause difficulties for firms trading in several capacities, and their clients, depends partly on whether CESR adopts an appropriate approach to its advice on the criteria for 'organised, frequent and systematic basis' in the definition of 'systematic internaliser'. There is no 'potential loophole', provided that the 'systematic internaliser' definition is properly interpreted as applying only to a particular activity within a firm, in accordance with our comments on Box 1 above. As CESR's draft stands, however, it has significant discriminatory and anti-competitive implications. 'Negotiated trades' would by definition be made on a regulated market, and are therefore under Article 4.1.7 irrelevant to the firm's status as a SI. There is therefore no justification for excluding SIs from paragraph 84 because they would not be acting as SIs in doing this business. Nor would there be any mischief in their doing so.

***Q 3.5**. Do you agree with CESR's approach of proposing a unified block regime for the relevant provisions in the Directive or do you see reasons why a differentiation between Art.27 MiFID on the one hand and Art.29, 44 MiFID on the other hand would be advisable?*

Provided that an appropriate methodology is used, in particular a lower threshold than that for block sizes for post-trade reporting, and calculation of the threshold taking full account of our comments on paragraphs 171, 173, Table 1 and Annex 1, we agree that Article 27 and Articles 29 and 44 could use the same threshold.

***Q 3.6**. Would you consider a large number of SMSs in order to reflect a large number of classes each comprising a relatively small bandwidth of arithmetic average value of orders executed as problematic for systematic internalisers?*

Provided that under Box 1 systematic internalisation is appropriately defined as a separate activity within the firm, and it is therefore relatively easy for firms to automate SMSs for a relatively large number of bands, in the light of the indicative sizes set out in CESR's Data Annexes, it would appear that CESR's proposal to calculate SMSs in bands of €10,000 up to €100,000 would be appropriate.

***Q 3.7**. In your opinion, would it be more appropriate to fix the SMS as monetary value or convert it into number of shares?*

As explained in our response to CESR's previous consultation, investment firms may prefer to manage Article 27 obligations either by reference to a monetary value or a number of shares. Accordingly, we repeat our request that the monetary values for SMS be converted into a fixed number of shares at the given annual date, and for firms to be allowed to use either one or the other for the year, subject to any necessary adjustments to take account of significant share price movements.

***Q 3.8**. Do you consider subsequent annual revisions of the grouping of shares as sufficient or would you prefer them to be more frequent? Should CESR make more concrete proposals on revision, especially, should the time of revision be fixed at level 2?*

Annual revisions should be sufficient, subject to provisions to have an intra-year review in the light of extreme movements in the market or in the value of an individual share.

***Q 3.9**. Do you support the determination of an initial SMS by grouping the share into a class, once a newly issued share is traded for three months or do you consider it reasonable to fix an initial SMS from the first day of trading of a share by using a proxy based on peer stocks to determine which class the share should belong to?*

SMS should not be determined until after 3 months' trading. See our more detailed comments above under paragraph 95.

ARTICLE 2.3: Display of client limit orders

BOX 4

CESR's advice is largely unchanged from its October consultation. Subject to our comments on paragraph 130 below, we consider that it is proportionate and workable.

Paragraph 128. CESR proposes a new obligation to use a venue where publication of information 'does not impede consolidation' in accordance with paragraph 201(e). See our comments on paragraph 201(e) below, in which we explain why such a provision should not prevent the use of a proprietary system, including a website.

Paragraph 129. We agree that firms should be able to route unexecuted limit orders via another firm. Indeed, this is a requisite when a broker is not itself a member of a RM or MTF, and it must use a broker that is a member.

Paragraph 130. As we have noted before, there is no sanction in the Level 1 text for CESR's proposal to require disclosure of the firm's arrangements for limit order display in the order execution policy. Furthermore, as provided for in Article 22.2, it is essential that the client is able to opt out of Article 22.2 arrangements by giving a specific instruction.

SECTION 3: Post trade transparency requirements for RMs, MTFs, and firms

Paragraph 132. We agree with CESR's decision not to proceed with its proposal to require publication of aggregated data.

BOX 5

Paragraph 139. As we noted in our response to CESR's July consultation, effective provision of post-trade information that serves the needs of investors in a cost-effective way is essential to the quality of European markets. RMs' and MTFs' current arrangements, including different information provided on different timescales to different market users at different prices, have evolved to meet the needs of their users. Arrangements for direct publication of OTC trades should similarly provide for users' needs. It is essential that Level 2 measures support, and do not obstruct, this objective.

Unless it allowed scope for publication of more limited information to certain market users, CESR's approach could over-regulate matters which should be dealt with under RM/MTF rules and national regulation taking account of local market circumstances. They could also give rise to significant costs where they required RMs, MTFs, and firms to modify existing trade reporting and publication arrangements to bring them into line with CESR's specific proposals, for example to add new information fields, and new systems to identify who has the reporting obligation.

A requirement to make public all of the proposed information for every trade to every market user would be excessively prescriptive. RMs, MTFs and investment firms should have discretion to provide reported post-trade information to different market users in ways which are relevant to their information needs. CESR must take account of the fact that every additional required piece of published information will add costs to the system, and that exchanges charge fees for every trade report – costs which will ultimately be borne by investors. A provision at a more principled level, requiring the reporting and publication of enough data to provide a reasonably reliable sequence of date-stamped trades, with the outliers marked, would satisfy the information needs of the market while not inappropriately constraining post-trade data publishers.

(a) A market or other source identification is of questionable value as a marker for each trade. Furthermore, a requirement to publish the name of the firm in the case of trades executed outside RMs or MTFs is inappropriate because it would provide information which other market users could use to move the market against the firm concerned. It would thereby also raise competition concerns by making it more difficult for firms to provide liquidity off-exchange. Many RMs throughout Europe have recognised this, and have already introduced a greater degree of pre- and post-trade anonymity, or are in the process of doing so.

(c) Although the Level 1 Directive requires publication of the time of each trade, practical mechanisms will need to be found to control the sheer magnitude of data that could be published. In particular, given that CESR wishes to impose tight time constraints on publication, CESR should consider whether there is an appropriate proxy for the disclosure of date and time for each and every trade. In some circumstances the date and time of trade may well be redundant information, particularly if there is a requirement to report within a very short time period of the trade's taking place, or where the publication of trades consists of a real-time sequence of trades. In the latter case, a more useful provision, and one which would

involve less redundant information, would be a requirement to identify the trade as non-sequential if that was the case.

(h) A 'non-sequential' marker would also cover trades that were eligible for delayed publication, and trades for non-standard settlement that cannot be reported within the normal time period.

(g) We agree that transactions, such as VWAP and 'non-market price' trades, which are relevant to the information needs of the market, should be reported with an 'other than current market price' indicator of the type CESR proposes. However, a requirement to make public every trade subject to current market prices is also not appropriate in all circumstances. Often trades are executed for reasons associated with settlement, not price (for example, stock trades that are the result of options exercised in physical or physically unwound swaps, or a large trade executed for a money manager split into a series of riskless principal trades for settlement purposes). The exclusion of such trades would be consistent with paragraph 140's provision that every trade should be published only once.

The new provision on a single report for multiple trades at same time and same price is helpful.

Paragraph 140. We support the objective of ensuring that each trade is required to be published only once. CESR will be aware of the different rules of different exchanges, and different definitions of 'trade', and would need to ensure that the rules were consistent across Europe, to minimise duplicate reporting, although the magnitude of this task would suggest that Level 2 measures are not the appropriate mechanism for it. It will also be important to enable firms to report the two legs of a riskless principal transaction as a single trade report, reflecting the fact that economically it is a single transaction.

On the reporting of OTC trades, while it is acceptable that the default rule should be that the seller reports, CESR's advice should make it possible (as is the case under the rules of certain RMs and MTFs) for the buyer to assume the reporting responsibility, if the parties to the transaction agree. This is particularly important for a buyer that acquires a risk position in block size, where the accidental immediate reporting of the transaction by the seller would inappropriately expose the buyer's position to the market, and therefore the buyer needs to be able to control its risk. Also, it would not be possible for the seller to gauge whether or not the buyer had offset its risk in advance of the reporting deadline in a way which would enable earlier reporting of the trade.

CESR should also take into account the system implications of requiring firms to maintain a database of non-EU institutions to comply with the proposed obligation on the buyer to report in these circumstances.

Paragraph 141. We agree with CESR's proposal not to require trade reporting where the price is based on factors other than current market valuation. However, there is no need for an 'indicator explaining the reason for deviation from the current market price'. Such an explanation could not be accommodated in a succinct trade report in a way that would take account of all possible reasons, and would be inconsistent with paragraph 139(g), which would provide sufficient information.

Paragraph 142. We agree that deferred trade reporting should be available for block size trades whenever a firm acts as a principal to facilitate third party business.

Q5.1. *Do consultees support the method of publishing post-trade information (either trade by trade information or on the basis of one price determination)?*

See our comments on paragraph 139 above.

Q5.2. *Do consultees agree that the responsibility for publishing the post-trade information lies on the seller in case of trades made outside RMs and MTFs?*

As a default position, yes. But the parties should be able to agree to transfer the responsibility, as explained in our comments on paragraph 140 above.

SECTION 4 Transactions large in scale compared to normal market size

Paragraph 146. In general we agree with CESR's "main considerations". However, as regards the second bullet point ('address the potential for regulatory arbitrage in the single market'), it is important to remember that there would be nothing to prevent an institutional investor from transacting with an investment firm outside the EU if it considered rules within the EU inappropriate.

Paragraph 147. We agree with CESR's proposal that pre-trade thresholds should be smaller than post-trade block size thresholds, for the reasons which CESR sets out. But Boxes 1 and 2 do not always deliver this objective: e.g. ADV €2 million would yield pre-trade threshold of €250,000 but post-trade threshold of €200,000, because of absence of a sliding scale in Box 1.

BOX 6

Paragraph 171, Table 1, Annex 1, Paragraph 173. In the explanatory text (paragraph 150) CESR acknowledges the advantages of basing pre-trade thresholds on average trade size, and the disadvantages of basing them on average daily volume, but in Table 1 and Annex 1 chooses structures based on the latter. There is no real explanation in paragraph 168 of why CESR dismisses the average trade size approach. Also, in Paragraphs 157 – 159, CESR does not explain how it arrived at its proposed monetary thresholds for 'large in scale compared to normal market size'. CESR simply refers in paragraph 170 to a 'simplified approach'. The absence of explanation is very surprising given the importance to the operation of EU markets of the resulting numbers.

Of the three remaining methods which CESR outlines in Table 1 and Annex 1, we have a strong preference for determining 'large in scale' by reference to a percentage of the number of trades (Option 2, second method), though the relevant percentage should be lower than 95%.

The Fixed threshold method (Table 1, Annex 1 Option 1), although it has the merit of simplicity, is too crude , and its bands are too broad, to provide a consistent measure of either 'large in scale' or 'standard market size' compared to either average daily volume or average trade size (as demonstrated, for example, by the UK statistics in Data Annex II, which show that it yields multiples between 4 and 31 of average trade size). Furthermore, the proposed €100,000 threshold for low liquidity shares, representing at least 10% of ADV, is too high, and inconsistent with the general 1% of ADV principle of the rest of Table 1.

The percentage of total order book trading value method (Annex 1 Option 2, first method) would risk inappropriate pre-trade disclosure, and inclusion within the 'standard market size' computation, of inappropriately large trades, simply because larger trades had 'used up' the 5% 'allowance'. The result could be significant discrepancies, although less wide than under Table 1, in the treatment of otherwise similar shares.

The percentage of number of trades method (Option 2, second method) is likely to provide a more consistent and proportionate threshold than the other two methods, properly excluding transactions which are genuinely 'large in scale'. However, CESR's data show that the 'standard market sizes' resulting from this method would even so be high enough to impose Article 27 restrictions at a level that could risk disrupting liquidity provision, and also too high for the exemption from pre-trade transparency on RMs and MTFs. We would therefore prefer the 'large in scale' threshold to be lower than the size at 95% of the total number of trades, for example 90%, and it should certainly be no higher than 95%.

Paragraph 174, Table 2. In general, CESR's proposals do not allow enough time for firms to unwind large risk positions, particularly in the case of 'high liquidity shares'. In particular:

(a) 2 hours is not always long enough to unwind a risk position, particularly when the market is slack in the middle of the day. Furthermore, it takes longer to unwind the second 10% of a large risk position than to unwind the first 10%. Therefore at least 3 hours, not 2 hours, should be allowed for trades of this size.

(b) Consistently with the principle that it becomes increasingly hard to lay off risk as the transaction size increases (see previous point), when a firm trades above 100% of average daily value, it will need longer than the end of the next trading day to unwind its position. Firms should therefore have until the end of the second trading day whenever the trade represents more than 100% of ADV. We also suggest that firms should have until the end of the next trading day to unwind trades representing more than 50% of ADV.

(c) We agree with CESR that monetary ceilings need to be provided, to provide a workable regime for the most liquid shares. However, the 'High liquidity shares' ceilings are too high and should be lower. In order to provide enough time for firms to unwind large risk positions, we propose that the ceilings should be, simply: 10% of €50 million, i.e. €5 million (60 minutes); 20% of €50 million, i.e. €10 million (180 minutes); 30% of €50 million, i.e. €15 million (end of day + roll-over in the final 3 hours); 50% of €50 million, i.e. €25 million (end of next day) and 100% of €50 million (end of second day).

(d) For trades in mid-liquidity and less liquid shares, firms should have a longer period, 5 days following the trade, to unwind positions above 250% of ADV.

CESR proposes that firms should have until the end of the second trading day following the trade for trades in less liquid shares (less than €1 million average daily volume) which are 'more than 100% of ADV but at least €1 million'. This would mean that the block size would always be €1 million, whereas the trend of CESR's proposals for shorter delays for trades in less liquid suggests that CESR means in this context 'more than 100% of ADV but at least **€100,000'**.

The risk to firms of losing money on these high-risk trades would increase if they were obliged to publish them too early. Requirements to publish before the position can be unwound could force firms to behave more risk aversely towards clients, decreasing liquidity provision in a way which would not be consistent with the intention of the Directive. This result would be good neither for firms nor end investors..

Under our proposed amendments Table 2 would therefore appear as follows:

Maximum permitted delay for trade publication	**Minimum qualifying size of trade (and cash ceilings)**		
	High liquidity shares e.g. Eur 50 m+	**Mid-liquidity shares e.g. Eur 1-50m**	**Less liquid shares e.g. less than Eur 1m**
60 minutes	More than Eur 5m	More than 10% of ADV or more than Eur 3.5m	More than 5% of ADV or more than Eur 10.000
180 minutes	More than Eur 10m	More than 15% of ADV or more than Eur 5m	More than 15% of ADV or more than Eur 30.000
End of day (+roll-over to close of next trading day if undertaken in final 3 hours of trading	More than Eur 15m	More than 25% of ADV or more than Eur 10m	More than 25% of ADV but at least Eur 50.000
End of next trading day	More than Eur 25m	More than 50% of ADV	More than 50% of ADV
End of second trading day following trade	More than Eur 50m	More than 100% of ADV	More than 100% of ADV but at least Eur 100,000
End of fifth trading day following trade		More than 250% of ADV	More than 250% of ADV

Paragraph 177: CESR proposes that delayed reporting be available for 'principal portfolio trades' only when the portfolio 'includes at least one security in the 'top liquidity band' in excess of the threshold for that share. This restriction would not provide enough time for firms to offset and in some instances even to report many portfolio transactions. Portfolio trades done on risk should be accorded delayed publication on the basis of the size of basket and the risk which attaches to it, not on basis of its constituents. Whether one of stocks is in the top liquidity band is irrelevant. What matters is that portfolios are priced as one unit, and delayed publication should be available whenever the total value by comparison with liquidity means that unwinding it will take some time.

As we explained in our response to CESR's June 2004 consultation, it is important to provide appropriately for deferred reporting of any transactions where particular executions are part of a much larger transaction that exposes the firm to risk, such as portfolio transactions. Portfolio transactions are driven by factors such as an increased focus on asset allocation and indexation, lower transaction costs and the growth of stock index futures and options market. Investors ask the firm to execute buy and/or sell transactions in a portfolio of stocks. Clients can ask for different trading techniques, including agency transactions, agency-type transactions with some form of implied or

explicit price guarantee (for example relative to the volume weighted average price in the relevant period) and therefore an element of risk, or principal transactions.

Typically, where some form of protection is given, portfolio transactions are agreed based on only very limited information about the relevant securities (such as the size of the portfolio and its liquidity characteristics) given by the client to the firm, or to a range of firms in a competitive bidding process. Information about whether the transaction concerns buys or sells or both, and the specific securities in the portfolio, is typically not disclosed until after the client has given the relevant order and, for transactions with a principal element, until after the transaction has been agreed.

After the firm has executed the transaction in the market, and booked the client-side transaction taking into account any price protections given, it would theoretically be possible to break down the pricing for the whole portfolio to yield prices for individual securities, and to report a resulting trade for each security. It is unclear whether this is what MIFID requires, since Article 28 presumes transactions in a particular share, not transactions in portfolios of shares. Since there is no agreement between the firm and the client about such sub-prices, there is a danger that the inclusion of such trades in normal trade reporting might give misleading signals to the market. They should therefore fall under paragraphs 139(g) and 141 of CESR's draft advice.

Appropriate treatment of portfolio transactions will be required to avoid disrupting firms' ability to service clients' needs. They are a special type of transaction (Article 45(2)) whose price is determined by factors other than the current market valuation of the share (Article 28(3)(b), and which are usually of significant size (Article 45(3)(b)). As a portfolio transaction is a single trade, consisting of many securities, regard should be had under Article 45 to the total size of the trade, not to the size of each component. By accelerating their trade reporting in many circumstances, the 'top liquidity band' constraint in paragraph 177 would deter firms from servicing client needs in this way. Firms need the protection of the deferred reporting regime to lay off the often significant risk they assume by providing liquidity for the whole portfolio.

Furthermore, portfolio transactions, regardless of the risk that the firm assumes, often consist of hundreds, or sometimes thousands of different constituent shares. For such large baskets, regardless of the other considerations explained above, it would be physically impossible to compute the relevant price information and report all of the lines within three minutes of the trade.

***Q6.1**. Do consultees agree with the approach to establishing a threshold for a waiver from pre-trade transparency? Would the categoric approach cause difficulties or market distortion for shares with different trading patterns? Would the alternative proposal described in annex I option 2 (footnote 19), as more stock sensitive, provide better outcome? If that approach would be taken, would the proposed threshold (95 %) be appropriate and should it be calculated on the basis of trading volume or number of trades? Are there other alternative proposals that you would put forward, bearing in mind the objective of finding an easily understood and easily implemented solution?*

See our comments on paragraphs 171, 173, Table 1, and Annex 1 above. Of CESR's proposals, we strongly prefer the second method in Annex 1 Option 2, but the threshold should be lower, for example 90%.

Q6.2. *For purposes of calculating the average trade size for Article 27 shares, do consultees agree that trades larger than the pre-trade threshold should be those that are excluded when calculating the average size? If not, which trades large in scale compared with normal market size should be excluded? It would be helpful if any suggestions could be illustrated with resultant figures.*

See our comments on paragraphs 171, 173, Table 1, and Annex 1 above. Of CESR's proposals, we strongly prefer the second method in Annex 1 Option 2, but the threshold should be lower, for example 90%.

Q6.3. *Do consultees agree with the proposals for determining thresholds for deferred publication arrangements? Is the balance of proposed threshold sizes and time delays appropriate? If you consider that they should be modified, please suggest how and why.*

Some of the thresholds are too high, and the delays too short. See our comments on paragraph 174 and Table 2 above.

Q6.4. *Do consultees consider that intermediaries should benefit from the maximum delay proposed, regardless of whether they have unwound their position? If not, on what basis should CESR recommend a rule aimed at requiring immediate disclosure once all, or the major part, of the position have been unwound?*

While on risk grounds there is no reason why firms should not report a trade once the risk position is fully unwound, for systems and cost reasons the full delay should be available because it would make it easier for firms to automate the process.

Q6.5. *Do consultees agree with the proposal that Competent authorities should be able to grant pre-trade waivers and/or approve deferred publication arrangements that comply with the minimum thresholds regardless of whether or not the competent authority of the lead market adopts higher standards? Would it be better to require all member states to follow the transparency arrangements adopted by the competent authority of the lead market, whether by the competent authority or the lead market operator? CESR would like to receive comments that throw more light on the pros and cons of each option?*

We agree with CESR's proposal that competent authorities should be able to grant waivers that comply with minimum thresholds regardless of the position of the competent authority of the 'lead market'. The latter option would not be compatible with the single market, and could result in the imposition across Europe of thresholds which are too high for some market users to find workable.

Q6.6. *Do consultees have any comments on the proposed short-term arrangements?*

We are not clear which aspect of its advice CESR is asking about in this question.

Q6.7. *Do the proposals adequately address issues relating to less liquid shares? If not , what arrangements would be preferable?*

No. See our comments on paragraph 174 and Table 2 above.

Q6.8. *Is the suggestion in respect of portfolio trades suitable?*

No. See our comments on paragraph 177 above.

***Q6.9**. Do consultees have any other comments on the proposals in this section?*

See our comments on Box 6 above.

SECTION 5: Publication of transparency information (and consolidation)

BOX 7

Paragraph 193: We have no difficulties with CESR's proposals for pre-trade publication by RMs and MTFs in real time during trading hours.

Paragraph 194: CESR's proposal that a systematic internaliser should publish its Article 27 quotes 'during its normal trading hours as a systematic internaliser' is consistent with the interpretation of 'systematic internalisation' as a separate activity within a firm. We urge CESR to recognise this interpretation fully in its proposed advice in Box 1 (see our comments above).

Paragraph 195: Subject to appropriate arrangements for deferred reporting, in particular as regards paragraph 174/Table 2 and paragraph 177 (see our comments above), we agree with CESR's proposal for a three minute deadline for trade reporting. However, CESR should note our comments on paragraph 139 above regarding the need for a differentiated approach to publishing the reported information. It is appropriate for last trade tape information to be published subject to a 3 minute deadline, but there may be a need to allow more time for the publication of more detailed information which is not necessary for the last trade tape. Because of the data retention implications, and the fact that firms are less likely to be asked for the information the longer after the trade date, CESR should propose a time limit (for example 14 days) for the availability of post-trade information on request

Paragraph 196: As we explained in our response to CESR's June 2004 consultation, it is not practical or commercially viable to expect firms' proprietary reporting arrangements to remain available all the time the firm is actively trading. The system development and operational costs could make out-of-market-hours trading unviable, to the detriment of clients. Furthermore, other market participants would be able to identify from the trades reported out of market hours what the firm's overnight position was, and move the market against the firm. It should be sufficient (as in the case of reporting through the facilities of a regulated market) for the system to be available during normal trading hours for the instrument concerned, and for out-of-hours trades to be reported within a short period of the opening of the RM which has the highest liquidity for the security in question, as is the norm at present. In paragraph 181 CESR refers to advice from the Commission that the Level 1 text has no provision allowing trades taking place outside market hours to defer post-trade publication to the next day. However, as explained above, for out-of-hours trades, 'as close to real time as possible' effectively means, because of commercial constraints, at the beginning of trading on the following day. CESR states that immediate publication is required, though it does acknowledge that firms do not have to publish incidental trades that fall outside the business hours of the firm. CESR should at least include the 'incidental trades' exception in paragraph 196. Furthermore, it would be essential to interpret 'normal business hours' sensibly to correspond broadly to the period during which the main market was open, and to interpret 'incidental trades' broadly to include any out-of-hours trade in size by which the firm provided liquidity to its client, so that firms would not need to arrange for out-of hours business to be conducted in markets

outside the EU. In effect, firms should be able, in a similar manner to paragraph 194, to predetermine their 'normal market hours' and work in tandem with the incidental trade exemption. Any more restrictive interpretation could significantly harm the international competitiveness of EU markets.

Paragraph 200: This paragraph repeats the provisions of the Level 1 text (Article 28.3).

Paragraph 201:

(a) 'Ensure' is too high a standard, as the reference to 'obvious mistakes' impliedly acknowledges. Any obligation should be to take 'reasonable steps to ensure' reliability of information.

(c) On the proposed obligation that the publication mechanism must function all the time the firm's publication obligations apply, see our comments on paragraph 196, which also apply here.

(d) CESR proposes that publication arrangements must be 'accessible to all interested parties on a reasonable commercial basis'. It is important that this provision is interpreted in a way which allows data publishers to provide different levels of information at different prices to different market users according to their needs.

(e) CESR proposes to require information to be published 'in a manner that does not impede its consolidation'. We very much welcome CESR's commitment in paragraphs 185 and 186, which is consistent with Recital 34, to work with the market to reduce barriers to the consolidation of information, though there is no guarantee that this work will yield fruit by the time the Directive comes into force. The requirement to publish data in a manner that does not impede its consolidation therefore needs to be interpreted broadly, recognising for example that information which a firm makes available on its website on a reasonable commercial basis can be accessed by market users who have paid for it, or by their representatives to whom they have provided the access password, and therefore that those market users or their representatives are able to consolidate it with other information as they see fit. However, further analysis of the consolidation of information would not be possible before information is available about how the market reacts and adapts to MIFID. We welcome the fact that CESR has accepted that the Level 1 text, including Recital 34,does not provide a basis for a stronger interpretation of provisions relating to consolidation of information.