

**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**

**Second part of Response to CESR's June 2004 consultation paper
(CESR/04-261b) on advice on possible implementing measures of
the Directive 2004/39/EC on Markets in Financial Instruments
("MIFID")**

4th October 2004

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INTRODUCTION

This response is a compilation of the agreed views of the above associations. We respond jointly in order to assist CESR by providing one document rather than eleven. For the purposes of its analysis of responses, CESR should however count this response as coming from eleven respondents, representing a significant proportion of investment firms active in Europe's securities and derivatives markets, especially its wholesale markets, and weight it accordingly. See Annex 2 for a brief description of the associations.

We support MIFID's overall objective of creating a fair, competitive and efficient European securities market that serves the needs of all its users: especially investors and issuers both in Europe and from the rest of the world.

This is the second part of our response to CESR's 17th June 2004 consultation paper, and should be read with the first part which we sent to CESR on 17th September 2004. It covers Section II (best execution) and Section III (pre- and post-trade transparency).

We do not repeat, in this response, the comments on key general themes made in the introduction to our 17th September response. However, these key general themes apply equally to this response as they do to our 17th September response, namely:

- 1. Level 2 measures need to recognise and accommodate the needs of different types of market and market user, the distinctive characteristics of the wide range of financial products available, and the global nature of some markets, by adopting a less prescriptive approach than CESR currently proposes.**
 - (a) Distinguish appropriately between eligible counterparties, professional and retail clients.
 - (b) Distinguish between different markets and different levels of expertise, accommodate different market models, and enable market participants to provide the range of services that different types of market user demand.
 - (c) Be flexible enough to adapt to new market developments.
 - (d) Respect non-legislative means of achieving public policy objectives.
 - (e) Impose costs or administrative burdens only where market users clearly benefit.
 - (f) Not set unattainable or unrealistic standards, and not reverse the onus of proof.

- 2. Level 2 measures need to be developed in a way which is consistent with the intention of the Lamfalussy approach**

- (a) Measures should not be set at such a high level of prescription and detail that they negate the flexibility and adaptability that is the essence of the Lamfalussy approach.
- (b) CESR's standards should not be replicated at the same level of detail in European legislation.

3. Level 2 measures need to help to alleviate the practical problems caused by the timetable for implementing MIFID.

- (a) Measures should be at a general enough level of detail, consistent with the Level 1 text, to minimise the need for extensive changes in market participants' existing systems and procedures.
- (b) Transitional arrangements, phased implementation, grandfathering, and other means should be used to take account of the practical impossibility of making certain changes to systems and procedures by the implementation date.

4. Level 2 measures need to dovetail appropriately with MIFID Level 1 and also other Directives.

- (a) Level 2 measures must not exceed the scope of the Level 1 Directive provisions.
- (b) Measures under MIFID should not conflict with, add uncertainty to, or replicate provisions that are already covered by Level 1 or 2 measures under other Directives (e.g. Market Abuse Directive).

We also refer CESR to the Annex to our 17th September response, which explains in detail the system development implications of MIFID and its Level 2 measures, and the consequent need for transitional or other measures to allow more time than the 30th April 2006 deadline allows for market participants to comply with national provisions under the Directive. That Annex, and its conclusions, apply particularly forcefully to the matters dealt with in this part of our response.

We have not commented in this response on the question of whether Level 2 measures should take the form of Directives or Regulations. ISDA is preparing a separate paper for the Commission on this subject.

While we have endeavoured to provide as full a response as possible to CESR, it has become evident to us and our Members in preparing this response that, despite considerable efforts over the last three months, CESR's consultation paper contains too much detailed material to provide thorough input on all of it in the time available. This has the following procedural consequences:

- i. We may need to provide supplementary comment to CESR if important points emerge over the coming weeks which we have not so far identified.

- ii. CESR and the Commission must recognise that high-quality, evidence-based legislation cannot be generated at this level of detail, on this tight timescale, for markets as diverse and complex as Europe's financial markets, without giving rise to substantial systemic risk. The Lamfalussy Committee and other interested parties have repeatedly emphasised that quality of legislation is more important than speed. This has practical consequences not just for the timetable of this consultation, but also for the level of detail that legislation should contain at this stage of the development of a high-quality European securities law. We hope that CESR will pay particular attention to these two aspects, both in finalising its advice on the first set of mandates, and when it comes to the handling of the second set. At the very least, CESR should advise the Commission to consider a series of options for workable implementing measures at different levels of detail (see our comments on key general theme 2(a) in the Introduction of our 17 September response).
- iii. A second round of consultation will be essential on all of the areas covered by CESR's paper.

VIII. BEST EXECUTION

Overarching issues arising from CESR's consultation paper

The level 1 obligation to obtain best execution imposes detailed requirements on firms expressed in relatively straightforward language which requires little elaboration through further directives or regulations at Level 2. Most of the issues that CESR discusses in the consultation paper would be better suited to guidance at Level 3, and are not suitable for EU-level legislative requirements. CESR should at least point out in its advice as an option that relying on Level 1 alone would provide effective investor protection.

CESR notes (at page 71) that Article 21 covers all financial instruments and recognises that the markets for these instruments can vary widely. While it seeks comments about the applicability of best execution in various markets it is clear that its current views are formed from regulating exchange-based equity markets. Markets such as bonds and OTC derivatives – dealer driven and largely non-exchange - do not fit comfortably into its analysis. Nor do exchange-traded derivatives. This distinction between shares, bonds, and OTC and exchange-traded derivatives corresponds to a fourfold qualitative distinction which it is essential that CESR takes into account:

- i. Instruments which are mostly traded on a central venue, and where investors purchase because of the individual characteristics of the issuer (shares).
- ii. Instruments where the issuer's characteristics are less important to investors than the instrument's characteristics, such as yield, maturity, and credit rating, which are mostly traded in a principal dealer, over the counter, market (bonds).
- iii. Instruments whose valuation depends heavily on the perceived credit-worthiness of buyer and seller, which are typically bespoke (OTC derivatives).
- iv. Instruments developed by and tradable only on a particular exchange (exchange-traded derivatives)

We deal with these issues in greater detail in the description of the characteristics of these markets at pages 20 to 30 below. We hope that that description provides a helpful backdrop for CESR's work in turning its 'preliminary ideas' into 'definitive views'. It is essential to ensure that Europe does not end up with a 'one size fits all' equity-tailored approach for all markets.

Obtaining best execution for a client should be seen by regulators as a process that firms must follow which is reasonably designed to seek the best result achievable taking account of the venues accessible to the firm, not an outcome to be assessed on a trade by trade basis. The discussion in the explanatory text (page 72) usefully sets out the complexity of the best execution assessment: speed, price, market

impact, etc. CESR should draw the appropriate conclusions - there can be no guarantees that, trade by trade, the desired outcome will always be achieved. Instead, firms should have procedures which in good faith are designed and operated to enable the firm to meet its obligations to its clients.

CESR is right to give prominence to the client characteristics (in particular whether they are retail or professional, and the specific nature of the service the client requires) as a vital factor in firms' assessment of the quality of execution. The background material at pages 20 to 30 below identifies some of the salient considerations for different types of client. In equity markets, for retail clients, the absence of market impact and focus of liquidity means that on-exchange execution is likely to be the most predominant venue, unless cost or absence of immediacy prevent it. For professional clients, the possibility of market impact makes the judgement of how the best achievable result can be obtained more complex. Completely different considerations apply in fixed income and derivative markets.

CESR's objective of encouraging competition between execution venues is really only relevant to equity markets, since competition for order flow already exists between liquidity providers in OTC fixed income and derivative markets just as it does on individual RMs and MTFs which use liquidity providers to supplement and facilitate investor order flow. Even in equity markets, encouraging competition between venues has to be balanced against the costs of mandating expensive search and access requirements on firms (including the cost of keeping records of the search) – cost that would be ultimately borne by investors. CESR has established that in 95% of cases the most liquid market is least five times the size of the second biggest market (page 107 of CESR's consultation paper). Linkage to new venues is expensive. An obligation to mount extensive searches of multiple venues (which may include exchanges, MTFs and dealers) will take time that would frustrate clients' need for immediacy. Lack of immediacy can in turn mean that the price changes to the detriment of the client. Extensive disclosures to clients about firms' execution policy of the sort that CESR seems to be envisaging would not only be costly, but also overload clients (particularly retail clients) with information of little or no use to them. The best balance is to allow firms to choose the venues they access, in a way which is tailored to clients' characteristics and needs (in accordance with the Level 1 text, which does not mandate searching across a large number of venues), and to require adequate, but not excessive, disclosure of the firm's execution policy, so that investors can choose the service they demand and the costs they wish to incur. CESR should gather information about existing arrangements, and conduct cost-benefit analysis, before proposing advice that would give rise to substantial new costs.

CESR proposes to define 'orders' (Definition 23 on page 10) in a way that covers any order received for execution or transmission. It will

however be important to make clearer when a communication from a client to a firm constitutes an ‘order’ for the purposes of best execution. For example, counterparties and many professional clients will seek to negotiate with the firm all the terms of a transaction. CESR should recognise that in those circumstances the final negotiated terms of the transaction, including price, are the terms which satisfy both parties. Therefore, this should not constitute ‘executing of a client order’. For example, in the case of two firms dealing with each other, it makes no sense to seek to determine who is giving an order to whom and it would surely overstretch any natural meaning of the words ‘execution of client orders’ if it was concluded that in a transaction between two such parties both were engaged in order execution, each party executing the other's orders. On the other hand, if for example a client asks a firm to sell on its behalf a security for a certain limit price, the firm thereby assumes a fiduciary responsibility towards the client. This should regularly constitute the execution of a client order, even if the firm executes as principal for example by using discretion given to it by the client on how to execute by taking the other side of the trade. Only an activity which involves the assumption of some fiduciary responsibility should constitute order execution. This corresponds to the description of the range of application of the best execution provision in Recital 33.

In addition, it would be inappropriate, as CESR suggests on page 70 of its consultation paper, simply to apply, under article 19(1), the standards set out in Articles 21 and 22 to the business of ‘reception and transmission of orders’. As CESR states on page 70, the Level 1 text is clear that Article 21 applies to firms only ‘when executing orders’ (and Article 22 applies only to ‘execution of client orders’). For example, many corporate finance and venture capital firms are authorised as ‘investment firms’ because they are regarded as ‘bringing together investors’ and are thus within the definition of ‘reception and transmission of orders’ (see recital 20 to MFID). Also, firms offering order routing or introducing broker services may be regarded as ‘receiving and transmitting orders’ but do not have the degree of discretion that would make it appropriate to impose the duties contemplated by article 21. Similar issues will no doubt arise in relation to portfolio managers. The principles of Articles 21 and 22 may be a helpful guide in some cases, but their provisions cannot be simply applied across the board to other investment services and activities.

Comments on specific issues discussed in CESR’s consultation

Criteria for determining the relative importance of the different factors to be taken into account for best execution (Article 21(1))

CESR proposes three categories of criteria that it suggests will be relevant to investment firms’ assessment of the relative importance of the factors set out in Article 21(1).

CESR's Questions for consultation

Q1: Are the criteria described above relevant in determining the relative importance of the factors in Article 21(1)? How do you think the advice should determine the relative importance of the factors included under Article 21(1)?

We agree that the criteria are relevant and helpful. However, they should not be treated as an exclusive list. For example, market conditions and the characteristics of the product itself will also be relevant factors, as will all the costs to a firm and its clients of access to a venue. It should also be noted under 'order characteristics' that there is a huge range of types of order, each of which will have different characteristics and consequences. Many will not relate to equity trading, and equity trading norms should therefore not automatically be treated as a standard model.

Because the relative importance of the criteria will vary from case to case, it should be left to the firm's own policy judgement to determine the best strategy, acting in accordance with its agreement with the client, and in the client's interest. This would be in compliance with the Level 1 text. Their relative importance should not be specified in legislation. This is vital for all types of business, but it is particularly the case for professional clients, where the criteria's relative importance will depend on all the circumstances and the firm/client relationship. Nor should there be an expectation that all the factors are relevant in all cases. In the case of retail clients' orders in particular, the relevant factors are likely to be fewer and their relative importance more predictable because of the more stable dynamic of the market, but the possibility that a wider range of factors may be relevant means that for retail clients also it is not appropriate to prescribe the relative importance of the factors in legislation. Because of the greater predictability of factors for retail orders, their execution is more likely to be automated: the execution policy will determine the venues used, and there should be no additional requirement to consider the relative importance of the factors case by case.

The advice should therefore not seek to determine the relative importance of the factors included under Article 21(1).

In some cases the appropriate criteria for best execution will conflict with CESR's proposed requirement under Box 11, paragraph 6 for 'sequential' execution of orders. For example, a firm's best execution policy will need to enable the firm to execute one client's order first (because that client values immediacy), while delaying another's (because that client is more concerned about price). This is a further argument against a strict 'sequential' requirement under Article 22. Best execution should clearly prevail. See also our comments on Box 11 paragraph 6 in our 17th September 2004 response.

CESR should note that speed of execution is relevant not only when prices are moving quickly (page 72). The risk of ‘missing the market’ exists regardless of the speed of movement of prices. Immediacy of execution is thus a relevant criterion whenever the client wishes to ensure that the trade is carried out at the currently available price.

It should also be noted that in highly illiquid markets, such as markets for most bonds, or any market in a security in which there is no regular two-way investor interest, or no market maker, obtaining any execution at all may constitute ‘best execution’.

Q2: Are there other criteria that firms might wish to consider in determining the relative importance of the factors? Do you think that the explanatory text clearly explains the meaning of all the different factors in respect of the different financial instruments?

See our response to Q1: the relative importance of any other criteria, if they occur, should be left to the firm’s judgement of the client’s needs. The explanatory text is satisfactory. One other area which may need to be taken into consideration when considering how an investment firm effects best execution, particularly for an OTC derivative or structured product, is confidentiality, either that of the client or of the firm where a product may be proprietary in nature and a requirement to establish best execution may mean that another firm may be able to gain a competitive advantage. See page 27 for a more detailed explanation.

Q3: How might appropriate criteria for determining the relative importance of the factors in Article 21(1) differ depending on the services, clients, instruments and markets in question? Please provide specific examples.

The appropriate criteria will vary considerably between markets and depending on the nature of the clients, financial instruments, trading strategy, and type and size of order, and over time, among other factors (see specific examples in the background description at pages 20 to 30 below). These variations and the number of possible permutations are not susceptible to regulatory specification.

Q.4: Please provide specific examples of how firms apply the factors in Article 21(1) to determine the best possible result for their clients.

See the specific examples in the background description at pages 20 to 30 below.

Trading venues to be included in the order execution policy (Article 21(2)); Obligation to monitor and update the order execution policy (Article 21(3))

1. Criteria for venue selection

It is self-evident that the factors that firms will consider in venue selection will parallel those which are relevant to the execution quality assessment in any particular case. (As noted in our response to Q1, in the case of automated retail order execution systems, the systematised venue selection will itself determine where the order is executed in any particular case.) CESR is right to propose that firms should take these factors into account where they are relevant to venue selection, but it should be for firms to judge which factors are appropriate in any particular case. CESR should take full account of the different market dynamics which are described in the background description at pages 20 to 30 below, including the way in which, in certain markets, there is a natural tendency for liquidity to focus on a single venue, and, by contrast, in certain dealer markets and in dealing in most illiquid securities (such as most bonds and OTC derivatives), the concept of a ‘venue’ ceases to be relevant. CESR should also note the extent to which national regulation has moved away from being over-prescriptive in the matter of venue selection, recognising the fact that firms should be able to choose execution venues based on non-prescribed criteria, taking customers’ requirements into account, for instance, to reflect the customer’s need for immediacy, or for a strategy that minimises the impact of arbitrageurs on a large institutional trade. Regulation should not seek to create or favour new venues artificially where no investor demand for them exists (such an attempt would fail anyway if it did not correspond to a market need).

It is essential that CESR gives full weight to the ‘on a consistent basis’ criterion so that firms are able to consider the most appropriate and relevant subset of possible venues.

CESR’s Questions for consultation

As well as our answers to these questions, CESR should also refer to the general description of how best execution is currently sought at pages 20 to 30 below.

Q.1: What investment services does your firm provide?

The firms whom we represent provide a full range of investment services relating to all products in all markets (see Annex 2 for a brief description of each Association).

Q.2: How many venues does your firm access now? Does your firm expect to access more venues after the Directive becomes effective?

All firms potentially have access to all relevant venues worldwide, either directly or through another broker. In bond markets, most corporate bonds trade over the counter. Firms judge whether to access venues directly (fixed costs) or rely on third party brokers (variable costs) depending on how costs will be minimised and other commercial factors such as the value of other services received from local brokers, such as local knowledge or research. The Directive should not affect their ability to do so, and it would be wrong for Level 2 measures to seek to force firms to obtain direct access in a way that would diminish the quality of execution by driving up costs, perhaps so prohibitively as to force firms to stop offering services altogether (this potential will be most acute for small and medium-sized firms, and would have the undesirable effect of reducing investors' access to non-domestic securities, limiting the benefit of the single market for those investors). Furthermore, such a move would require firms to become experts in all markets offered, rather than being able to place reasonable reliance on local expertise: this would further increase costs. Although it is not possible to predict what effect the Directive will have on the structure of the market in the EU, it is of course to be hoped that it does not have the effect of arbitrarily diminishing the choice of venues in Europe and the rest of the world that investors currently enjoy.

Q.3: What factors does your firm consider in selecting and reviewing venues?

See the background description at pages 20 to 30 below. For professional clients, the most important factor is likely to be avoiding market impact: this is also the factor which is most dependent on the skill of the firm, and least susceptible to empirical comparison of venues. Other factors may include liquidity, cost, client preference, the local legal environment, reliability of price formation, supervisory standards, and the strength of the clearing guarantee.

Q.4: Please provide specific examples of costs you consider in evaluating venues.

The system development required to link to a new venue directly is costly. The variable costs are also likely to be important, such as: order fees, execution fees, margins, costs of using a particular clearing and settlement system, cost of using another clearing firm to clear trades if direct clearing is not warranted, and regulatory costs such as trade or transaction reporting to local regulators. Staff costs are also incurred to support the use of a new venue, including dealers, back-office, and IT support costs. Furthermore, it takes some three months to join an exchange. Costs vary depending on the venue. Firms have estimated the following cost elements of linking to a new venue:

Joining fee: between Euro 10,000 and Euro 30,000, in some cases up to Euro 80,000;

Annual membership fee: between Euro 10,000 and Euro 25,000;

Initial IT and staff set-up costs: between Euro 100,000 and Euro 500,000;

Continuing IT and staff costs (which would need to be assessed against the cost of using a broker): Euro 120,000 per annum.

Firms do not need to be a member of a venue in order to obtain good prices, since they can do so through other brokers. Firms cannot justify the investment required unless they can be confident that the venue concerned will enable them consistently to achieve best execution to a degree that would justify the cost of direct access.

There should be no obligation, as CESR implies, for firms to be forward-looking in assessing the potential of new venues, nor should firms be required to link to a venue merely to 'test' it. There are other ways of tracking where best prices and liquidity lie, including through third party brokers and data purchase. Firms must obtain best execution for their clients in the present, not in the future. Furthermore, adding new venues which must be consulted as a matter of course would diminish the firm's ability to give the client immediacy, and increase the risk of the client's losing by missing the market. Even if there might be a better price out there, the time taken to find it could mean that the client obtains no better execution, or the firm could while searching 'miss the market', so that the client would receive worse execution. CESR's statement on page 75 that 'the business model of the firm must not be used to justify the exclusion of a venue that will enable the firm to achieve the best possible result on a consistent basis' should be interpreted and modified to take account of these considerations.

Q.5: How do costs affect your decisions about venue selection?

Costs will have to be either borne by the firm or passed on to investors. In either case, especially given the continuing need for careful cost control, firms assess costs rigorously to determine whether they will be justified by an additional benefit. As described in the background note at pages 20 to 30 below, saving clients (particularly retail clients) the avoidable costs of using particular systems is also a major consideration.

Q.6: Do you take account of implicit costs such as market impact? Is the question of implicit costs only relevant to firms that act as portfolio managers?

Implicit costs such as market impact are the predominant factor in execution decisions for all equity and fixed income trading in institutional size, in particular for large orders in illiquid securities (see background description at pages 20 to 30 below). It is not only relevant to portfolio managers.

Q.7: What specific events have led your firm to re-evaluate venues in the past? Please provide examples of how your firm has changed the venues that it accesses as the firm, its clients, or markets have changed.

Firms are constantly looking for newly emerging opportunities to save their clients costs and improve the quality of execution of their orders. For retail clients this tends to take the form of developing systems that reduce clients' execution costs by avoiding existing, costly venues. For wholesale clients, firms are alert to the potential for MTFs and OTC dealers to provide more tailored services, or existing services at lower costs, to meet clients' needs. But as described under Q5, firms must also assess how costly to use the venue itself will be: one factor in this assessment is what commitment to using the venue the firm will need to make for the decision to be commercially viable and in the interests of its clients. Since there has been little competition to date among exchanges, it has rarely happened that a firm needs to reevaluate where it conducts the great majority of its business. Examples where a shift in liquidity would typically lead to a reevaluation of venues include the shift of the Bund contract from LIFFE to Eurex, and the shift away from SEAQ International when local markets moved to order books. Competitive initiatives such as LSE's Dutch Trading Service will tend to drive down costs, to the benefit of clients. New venues such as MTFs tend to offer new trading strategies or services to new types of clients (such as hedge funds): they tend not to be in head to head competition with exchanges, but represent a refinement or specialisation which targets specific areas of the professional market.

Q.8: Has CESR identified the key criteria?

Yes, but as described elsewhere in this section, the criteria are not susceptible to 'one size fits all' regulatory prescription because of the wide diversity of possible circumstances.

Q.9: What data is available to carry out these reviews? If no data is available, are market solutions likely to provide it?

Information about direct costs explicitly charged by the venue is available from venues themselves. It is also necessary to take into account the other costs of establishing and maintaining connectivity to the venue. See our comments on the next section for information about prices and other execution quality factors. See also our comments under Q4 above.

2. Criteria for on-going monitoring

CESR's Questions for consultation

As well as our answers to these questions, CESR should also refer to the general description of how best execution is currently sought at pages 20 to 30 below.

Q.1: What kinds of monitoring arrangements do firms use now?

Firms are able to monitor the prices they obtain against time and price information which is available from the venues they use. Given the fact that in equity markets in 95% of cases the vast bulk of executions take place on-exchange, the information provided by exchanges is typically all that is needed. In fixed income markets, execution quality can be monitored by reference to benchmark yields, published credit ratings (or, when credit ratings are not published, the firm's own estimate of what the credit rating would be), and other factors such as, in the case of smaller issues and issues which are tightly held by investors, illiquidity premiums. Some dimensions of execution quality, such as market impact, are possible to assess only after the trade has occurred, and are not possible to predict accurately on the basis of past experience.

Q.2: How frequently do firms monitor execution quality?

Firms do not routinely monitor execution quality on a trade by trade basis, and any monitoring would be focused on retail clients' business. However, institutional clients are increasingly requesting analysis of execution quality on an overall basis over time, to allow comparison of their brokers' performance. Provision of this kind of information is therefore driven by commercial rather than regulatory factors. Such comparisons typically take into account other elements of the broker's service, such as settlement quality and market skills. In many cases the number and intangibility of criteria and their application to a range of financial instruments makes system-based monitoring of execution quality difficult, and misleading if all criteria cannot be reflected.

*Q.3: What data is available to aid firms in their monitoring obligations?
What does the data cost?*

Firms can obtain data without further expenditure only from the venues which they use. Data may also be obtained from other venues, but at a cost. Broader surveys of the type which exist in the US are not widespread. In the US, liquidity is shared between exchanges and ECNs, and at any moment the most liquid market might be one of several alternative venues. These circumstances, which provide a market for third-party analysts in the US, are not present in Europe. In any case, as explained in the background material at pages 20 to 30, to the extent that different venues have different characteristics and focus

on different user groups, any comparison would be invalid and the data of limited or no value. In those market areas where there is competition between venues, it is typically the case in Europe that orders require bespoke execution strategies, which diminishes the relevance of comparing execution venues.

Q.4: In what respects does the frequency with which firms monitor execution quality depend on the types of instruments, clients, markets and investment services in question? Please provide specific examples.

Currently monitoring tools exist for equities and some fixed income instruments. Constraints are imposed by the number of currencies that the system functionality can handle. Other instruments are being considered for future development.

Q.5: What, if any, market data do firms consult in order to monitor execution quality?

See our response to Q3 above.

Q.6: What additional data do firms expect to use after the Directive's transparency requirements become effective? (This question relates in particular to expanded pre-trade obligations for MTFs (ATSEs) and 'systematic internalisers', and to more comprehensive trade reporting, possibly through multiple mechanisms.)

See our response to Q3 above. All sources of information – exchanges, firms, MTFs and data vendors, are constantly increasing the volume and type of information on market activity. Firms must continue to assess whether the cost of obtaining access to additional data is justified by its usefulness.

3. Timing of venue assessments

CESR's Questions for consultation

As well as our answers to these questions, CESR should also refer to the general description of how best execution is currently sought at pages 20 to 30 below.

Q.1: How frequently do firms review the venues to which they direct orders on behalf of clients?

In practice, the timing of venue assessments will vary depending on the nature of the market, clients, and instruments. As explained elsewhere in this section, choice of venues will be more stable in the retail market, more dynamic in wholesale markets, less relevant and more tailored to specific client needs in fixed income and OTC derivative markets. Changes to the firm's business model may require a reassessment of

venues. While an annual reassessment could be appropriate, provided that its method and content was not over-burdensomely and rigorously prescribed, and that there was no expectation of change for change's sake, it is better to rely on firms' own arrangements (whose frequency will vary depending on the firm's services): in practice firms will review venues as and when market conditions or developments make it appropriate to do so (for example if there is a new entrant in the market).

Q.2: Do firms re-evaluate their trading venues:

whenever there is a material change at any of the trading venues?

whenever there is a material change at the firm that affects its execution arrangements?

whenever the firm's monitoring indicates that it is not obtaining the best possible result for clients on a consistent basis?

Firms will consider the implications of any of the above events. Because of the cost implications described elsewhere in this section of our response, in practice a firm's ability to be aware of material changes to trading venues that it does not currently use, or 'better possible results on a consistent basis' that might be obtainable from venues that it does not currently use, is limited by the difficulty of obtaining consistent and reliable information from such venues. Even if the firm were aware of such a situation, it would still need to gauge the consistency and quality of execution available from that venue against the costs of gaining access to it. In any case, it is not realistic to think that different prices will exist for the same instrument for any period of time without being arbitrated out by market professionals.

Q.3: What difficulties would firms face in reviewing their execution arrangements in response to each of the foregoing events?

See our response to Q2 above.

Q.4: Do venues make firms aware of material changes in their business?

For almost all exchanges and MTFs, marketing their venue as a good place to do business is a key element in their business strategy, which obviously includes any changes to their systems that they believe improve the quality of their market place.

Q.5: Please provide examples of instances in which firms have changed the venues that they use.

See examples (e.g. MTFs in wholesale markets; cost-saving services in retail markets) in the background description at pages 20 to 30 below.

In equity markets, there are some examples of competition emerging, for example the competition between Euronext and LSE's Dutch Trading Service led to some reduction in trading costs, though there has been little effect so far on the location of liquidity. Other examples include the transfer of the Bund contract from LIFFE to Eurex, and the competition between Frankfurt and Helsinki in trading Nokia.

Firms typically cease direct membership of venues if the low volume of their trading makes per trade costs prohibitive, or if it is cheaper to use a local broker.

Information to clients on the execution policy of the firm (Article 21(3))

CESR's questions, and its statement of what it is 'considering requiring', suggest that CESR favours very extensive, detailed, complex and frequent disclosures. The costs would appear to be substantial and the benefits highly debatable. Experience over many years shows that professional clients typically have the expertise to assess the quality of the firm's execution without extensive disclosures. Retail clients need straightforward information about the policy that helps them to make any necessary decisions: excessive disclosure to them of the type which CESR is proposing is likely to be either unhelpful or confusing to them, or to go unread. It is also necessary to bear in mind that for retail clients venue selection is a more straightforward and stable exercise, a major consideration being the domicile and base currency of the retail client (see background description at pages 20 to 30 below). Furthermore, the publication of too much information about the firm's execution policy may distort competition by giving other market participants an information advantage.

Furthermore, it will be important to ensure that requirements for client consent under Article 21(3) are applied in a way which does not harm clients. The process by which agreements become binding varies widely between Member States depending on national law. CESR should recognise this by allowing for alternative mechanisms under national law by which client consent can be effected, including consent by conduct.

Q.1: At present, how many venues do firms access directly? Indirectly?

As described under Q2 on page 10 above, firms effectively are able to access, directly or indirectly through another broker, any venue in the world. The choice of direct or indirect access will vary depending on a range of factors, including the benefits and costs to the firm and its clients. CESR's proposed required disclosure in paragraph 1 on page 78 would thus overload clients with unnecessary information. We believe that professional clients themselves would argue that they do not need this disclosure. See our introductory remarks on this section, and our

response to Q6 below, for what we consider to be the appropriate approach to retail clients.

Q.2: Should an investment firm be required to provide clients and potential clients with information on the percentage of a firm's orders that have been directed to each venue?

No. Such information would be very costly to disseminate, and would provide no benefit to clients, overloading them with information of little value. This would be especially the case for small and medium-sized firms that use another broker to execute their orders. Furthermore, aggregate information about the firm's overall executions will not necessarily bear any relation to how the firm has executed the client's own orders¹. CESR should take account of the fact that, as mentioned both earlier and again in the background section below, it is liquidity in a particular security that primarily drives the choice of a particular venue, not the relationship that the firm has with the venue. And in the case of markets where liquidity is limited (such as most bond markets) and a duty of best execution is owed to the client, it is the ability to provide best quotes on a consistent basis that primarily drives the choice of a particular dealer for the purposes of achieving best execution, not of itself the relationship with the dealer.

Q.3: For example, should an investment firm be required to disclose to clients and potential clients what percentage of its client orders were executed in the trading venues to which the firm directed most of its client orders (to cover, at least 75% of the transactions executed)?

No. See our answer to Q2 above.

Q.4: How frequently should investment firms make this information available to clients? On a quarterly basis, for example?

They should not. See our answers to Q2 and Q3 above.

Q.5: Should firms be required to update the information to reflect recent usage? How frequently?

No. See our answers to Q2, Q3, and Q4 above.

Q.6: Are there any other categories of information that a client or potential client needs to be adequately informed about the execution services provided by firms?

¹ It should be noted that these proposals considerably exceed disclosure requirements (particularly for brokers) for this type of information recently introduced in the US. The greater cost burden would put EU firms at a competitive disadvantage internationally.

What CESR is ‘considering requiring’ would greatly exceed what we think any client would find useful. Our experiences is that clients need to know no more than a high-level description of the firm’s general approach towards seeking best execution, and how the firm goes about it. CESR’s advice should reflect this approach, tailoring disclosure to clients’ needs.

Q.7: Should the information provided by portfolio managers and firms that receive and transmit orders be different from that provided by brokers? What are the key differences?

There is no need for any more elaborate disclosure from any intermediary than what we recommend under Q6 above.

Q.8: Have all of the key conflicts of interest been identified?

Conflicts of interest should be dealt with under Article 13(3) and 18.

Q.9: When should firms be required to provide required disclosure to clients and potential clients?

Disclosure should be made only at the outset and when any material changes occur, as set out in Level 1. There is no need for more detailed Level 2 measures.

Q.10: Is there any reason to impose different timing requirements for disclosure under Article 21?

See our response to Q9.

Background: How share, fixed income, and OTC derivative markets operate, and the implications for Level 2 measures on best execution

The following is a brief description of financial markets for shares (pages 20-23), fixed income (pages 23-28), OTC derivatives (pages 28-29), and exchange-traded derivatives (page 29-30) as they exist today in Europe. It responds to CESR's request on page 71 for information about specific services that firms perform. CESR states on page 71 that it presented this section of its paper as a 'concept paper' as a basis for discussion with market participants. We hope that the following description provides a helpful backdrop for CESR's work in turning its 'preliminary ideas' into 'definitive views'.

SHARES

This description reflects the working of the London-based cash markets in particular. It is our understanding that most regulated markets in Europe, particularly the larger ones, have similarly segmented their market to meet the varying needs of issuers and investors. We think, therefore, that the broad features of cash market trading, and the implications for best execution that we draw from them, are broadly comparable across Europe (though there are some differences: see the example in the last paragraph of the 'How shares are traded' section below).

How shares are traded

Equity trading today reflects the very substantial use of automated trading systems. One of the consequences of automation is that order flows for the retail, institutional and arbitrage sectors have tended to converge. In effect, average trade size has reduced, when compared to average trade size in the equity market of, say, 5 years ago. Although the choice of how to execute (whether client- or broker-directed) may differ at the outset, the price at which execution occurs varies little across clients, in part because trade size has converged. The exception is volume weighted average price (VWAP) trading.

Share trading can occur in a variety of ways. A substantial amount of trading, by number of trades, occurs on exchange and the exchange's data is integral to price formation. It should, however, be noted that the exchange neither owns nor provides all the information available on share trading, and non-exchange owned data also contributes to price formation.

The London Stock Exchange offers several platforms for trading shares. The platforms are designed, in particular, to deal with the different liquidity of the shares traded. The nature of each platform may be summarised as:

SETS – an electronic order matching system for the most liquid shares. Although much of the value of shares traded on the exchange is traded through SETS, the number of issuers represented on SETS is small compared to the total number of issuers traded on exchange.

SETSm – a system which uses a combination of client orders and continuous liquidity provision by market makers to provide pre-trade transparency. Post-trade transparency rules are the same as for the rest of the exchange. This platform is used for shares which trade with some regularity, but would not be described as liquid.

SEAQ – a bulletin board which provides a simple mechanism to advertise indications of interest. This covers illiquid shares.

Investors who are not members of the exchange (i.e. almost all investors) may choose to trade through a broker who is a member. Trading may occur through an order management system linked to the broker's systems or by other means, such as telephone or fax. The broker in turn may post the order on the exchange. Alternatively, and more usually, for orders placed electronically, the broker may offer secure arrangements for the trade to be routed electronically to the exchange (direct market access, or DMA). If the order is a large one it will be unsuitable for DMA. The client may then either ask the broker to take the market risk and deal immediately or to 'work' the order over time, perhaps splitting it into a series of smaller-sized orders. However this would only occur in respect of an order that is large compared to normal daily trading volumes.

Certain members of the exchange, called RSPs (Retail Service Providers) provide services to brokers for retail-size orders. RSPs offer trade execution services which guarantee to match or improve on the best price posted on SETS. They are able to offer improvement because, while most brokers calculate commission as a proportion of the amount involved in the transaction, most exchanges charge brokers a fixed amount per trade, regardless of the trade size. So the RSP's aggregated execution can save investors cost. Additionally, where there is a central counterparty involved as there is in SETS, the amount of settlement costs involved as a percentage of the value of transaction can be prohibitively high for smaller retail transactions. Here too, aggregated execution saves costs (see also our comments on Article 22.1). RSP trades are, of course, on exchange but in practice use the liquidity offered by the RSP. The additional benefit offered by the RSPs is that, for small investors who still hold physical shares, they can extend the settlement period beyond that which is accepted for the SETS order book.

Investors may also choose to deal direct with a dealer at a firm. Dealing directly with a firm's dealer does not usually invite any fiduciary responsibility on the part of the dealer (who of course only looks after

his own book) and thus only a very experienced investor would find this route attractive.

In some other Member States where the concentration rule has not been applied, orders from retail clients and institutional clients who have sought retail protection are frequently executed against a firm's proprietary trading account. The regulatory treatment of these transactions will vary, but firms are generally obliged at least to match the best bid or offer on the relevant RM's order book.

Implications for best execution

Markets have a natural tendency to consolidate rather than fragment. That is, if there were two platforms vying for the same types of orders and investors in the same shares, in a very short period of time one would obtain an advantage which would then drive the other out of business: liquidity begets liquidity. The most important factors for an investor are execution price and immediacy (i.e. liquidity).

Consequently what exists today in all jurisdictions is a central pool of liquidity which provides immediacy for all retail orders and is thus the benchmark by which best execution in equities is measured.

The costs of fees charged by an exchange to execute, clear and settle a transaction are likely to be widely relevant. Even where there is competition based on those costs, competition on execution price (that is the price at which a share is bought or sold) will not be a major consideration since market professionals will arbitrage out any price discrepancies very quickly. Thus for purposes of best execution the price will not differ significantly between venues. Nor will immediacy be a factor, because a venue that cannot provide a minimum level of liquidity (the ability to absorb all retail sized orders) will simply not get off the ground.

Whereas retail orders generally have little or no market impact, for institutional orders market impact can be the predominant concern in a trading decision. Market impact measurement methodology is an inexact science, at best, and a topic of intense debate. According to the statistics in the UK Financial Services Authority's Consultation Paper 154 (Best Execution) market impact and implementation shortfall amount to more than twice the explicit transaction costs in the form of spread and commissions.

In seeking to minimise market impact, institutions dealing in large size may ask a dealer to provide a risk price. But a dealer will effectively charge the institution for assuming risk to provide immediacy by trading at a discount (sales) or premium (purchases) to the market price. A large trade which is worked by a dealer over a period may achieve the objective of lower market impact and a better price for the client. However, a worked trade will be subject to a higher commission charge

than an immediate execution because of the time and expertise the dealer devotes to it. In seeking to minimise both market impact and dealer costs institutional investors have sought to bypass the cost of dealer intermediation by using alternative trading systems (MTFs) to execute their orders.

Technological advance has enabled competition among alternative market architectures catering for different securities, investors and trading strategies. Thus institutional investors will have a number of choices in execution venues.

It is important to note the distinction stated above that segmentation has occurred not only by securities but also by investors and trading strategies. In the exchange sphere, for example, the shares traded on the London Stock Exchange have a larger institutional bias than on Euronext. This is demonstrated by the fact that SETS generally displays greater liquidity (size x price) than comparable securities on other European exchanges.

The segmentation is more pronounced in alternative trading systems (MTFs). While many will have no particular restrictions, some have focused their eligibility on a limited class of participants (buy side only) or types of trading strategies (crossing networks).

In considering requiring brokers to undertake a comparative exercise for the purposes of best execution as envisioned in the CESR advice, these distinctions have to be borne in mind. While an exchange may be compared to another trading venue which has a similar profile, it would not be helpful to compare execution for retail orders between an exchange and, for example, an MTF which is used for institutional orders.

Similarly, while large traders are very sensitive to market impact and diligently monitor it on a trade by trade basis, the usefulness of comparisons among trading venues which target different factors (type of investor, type of order) may not be of great relevance.

FIXED INCOME

Characteristics of bonds, and their relevance to retail and institutional investors' needs

The structure of fixed income markets differs greatly from that of equity markets because of the investment characteristics of these instruments.

The objective of investors in shares is primarily capital gains (while dividend income is relevant, it is not the primary consideration). Additionally, while issuers sell shares directly to investors from time to time, this tends to be rare. An investor usually buys or sells a share in the secondary market.

In contrast a retail purchaser of a bond buys that instrument for income and rarely for capital gains. Issuers are frequently in the market raising fresh funds and thus offer investors the opportunity to buy at issue rather than in the secondary market. Similarly, governments provide facilities for retail investors to buy bonds directly from the government or its representatives such as a central bank. Because bonds are bought for income much of the time, they tend to be held by the investor until maturity, when the investor realises his principal invested.

Consequently, there is less activity for bonds in the secondary market. In fact, apart from an initial burst of activity while a new issue is placed with investors, many issues trade infrequently if at all. As a business custom the main underwriter of a bond will provide liquidity to the investors in that bond. Usually, there is no legal obligation for them to do so. Bonds listed on an exchange also have these characteristics of illiquidity and also rarely trade on the exchange. The listing is usually undertaken because of requirements for certain institutions (pension funds, mutual funds) that they only invest in exchange listed instruments.

While the majority of outstanding bonds are not traded actively, or in some cases not at all once a new issue has been firmly placed with investors who intend to hold the bonds to maturity, there are occasions when an investor may wish to buy or, more frequently to sell a bond in the secondary market. As stated above, in order to do this, the investor will turn to a dealer, usually the investment firm that brought the bond to market. MTFs in bond markets cater largely or exclusively for professionals, so they are not a realistic alternative for retail investors.

There is a group of bonds that are traded actively. These are government bonds and government agencies' bonds, bonds of supranational organisations (e.g. World Bank, EIB) and large issues of multi-national corporations, particularly the most recent issues at any particular time ("on the run" issues). While some institutions have an investment profile similar to retail in that they usually buy and hold bonds to maturity, others actively trade bonds. Some of the trading is due to a firm's view of where interest rates are going, while others use bonds as a hedge (e.g. lender's mortgage portfolio) and actively trade as the hedged portfolio changes. A third category seeks to take advantage of very small pricing differences created by fluctuating dealer inventories. Most secondary trading in bonds consists of these "yield curve pick-ups". For example, a typical 'pick-up' of 5 basis points equates to €500 per €million, out of which costs such as clearing and settlement have to come. Such trades are therefore economic only when undertaken in very large size. This is why retail involvement in the secondary market is very low. As explained above, the instruments involved in this active trading are usually government bonds, highly rated supra-national organisations and large multi-national corporations which issue "jumbo" bonds.

Best execution obligations and fixed income markets

Best execution as defined in Article 21(1) is a standard with which investment firms active in bonds markets are effectively complying now. Problems arise only as regards elements of the detailed ideas for Level 2 provisions on which CESR is consulting, such as how the price is arrived at to comply with the obligation, and the choice of venue.

As explained in the previous section, secondary market trading in bonds in Europe has developed outside regulated market structures. We estimate that the total on exchange trading of bonds on RMs in the EU amounts to less (possibly considerably less) than 2% of the total trading volume (by value) in the market as a whole. The dominant means by which client orders are executed is via dealer-provided liquidity in the OTC market.

Within that market, a small group of MTFs have successfully provided trading platforms for trading government debt. A significant amount of order flow between participating dealers and institutional investors now uses these systems.

Apart from the MTFs, in the last two years several large dealers have begun to provide access to their bond inventories for their professional clients on an automated 'execution only' basis in sizes varying from €1 million to €5 million. The process of consolidating some of those prices and making them public has recently begun as a cooperative project between the interested dealers and a data vendor. (See also our recommendations regarding the issue of consolidatability of trade and quote information in equity markets on pages 42 to 43 below.)

However, continuous day today liquidity as the term is normally understood in the equity market (firm bid and offer quotes, primarily investor provided) remains limited to a small subset of the total universe of outstanding bonds (except that the managers of bonds that have been recently issued and not yet fully placed with long term investors usually make prices to their customers on demand for a short period).

There is a somewhat larger group of bonds (although well short of a majority of the bonds outstanding) in which some dealers will make a price on request from a client even though the bonds may rarely trade. For example, ISMA's 42 Reporting Dealers (liquidity providers) undertake to make prices on request from clients who are also members of ISMA in some 11,000 bonds. On average, each of those bonds has around 2 to 3 Reporting Dealers. However, there are more than 40,000 bond issues outstanding in Europe, so approximately three quarters of them have no formal liquidity provider. They can therefore be priced only on a formula basis which relates the bonds to the risk-free government bond or swap rate (this equates, in many respects, to the long tail of rarely traded small capitalisation shares admitted to trading

on most stock exchanges), or, as is currently permitted in some Member States (e.g. Denmark) by comparison with comparable issues, for which there is a current and reliable public price.

As regards post-trade transparency, while some MTFs provide post-trade data during the trading day in the small sub-set of liquid bonds for which they provide a trading platform, for the remainder of the market trade data are available on a next day basis from ISMA for those bonds which traded and are reported to ISMA via its TRAX trade matching and regulatory reporting system. Although ISMA estimates that this system captures 75% of inter-professional trades, on a recent day chosen at random no trades were reported for 85% of the 40,000 bonds outstanding in Europe. Of the 15% of bonds where at least one trade was reported, less than half traded more than twice. In some domestic bond markets (e.g. the Danish mortgage bond market) OTC transactions are required to be rapidly reported to the RM for publication.

It is apparent from this description of the market as it works today that for most bonds there is no readily available price in the market on which to base a trade which requires best execution, and search costs for a dealer willing to execute the trade at any price are high. Looking at last trade information for a bond in order to assess 'best execution' is unreliable, because the bond may not have traded for days or weeks, or even longer. Even if it has traded, say a few days ago, prices can move in a very volatile way, not because of developments peculiar to the issuer, but because interest rates have moved due to actions by a central bank.

These market structure elements impinge in different ways on the three types of investment firms which seek to execute client business in the bond market.

1. Firm acting solely as a broker

In order to execute a client order a broker has to find a counterparty prepared to execute the trade. The question is therefore what actions on the part of the broker are reasonable to solicit interest in filling the customer's buy or sell order.

A broker whose customer wishes to buy or sell a bond in the secondary market has several options. If several dealers are prepared to quote a price for the bond the broker should solicit prices from those he has a business relationship with. Alternatively he might employ a specialist broker ('brokers' broker') who may be able to poll a larger number of dealers but who will of course charge for the service. Given the high search costs in this market, and the need to meet the tests of speed and likelihood of execution and settlement, it is important that, as CESR recognizes generally, brokers should not be obliged to poll all possible dealers. To minimise costs, a broker's judgment as to which dealer will provide the best quote 'on a consistent basis' is also relevant.

Depending on the quality of his relationship, and the nature of the order, it may be that a dealer who does not hold himself out as being prepared to quote a price on request in that bond will, on a consistent basis, provide the best price. Each transaction will require different treatment. For example, if a client of a London-based broker gives an order to sell a bond of a corporate issuer in the Czech Republic, polling only dealers in London may not be sufficient given that dealers in or around the Czech Republic may be able to provide better bids based on local knowledge.

2. Firm acting solely as a dealer

When a customer (typically an institutional client) places an order for a debt security with a firm acting solely as a dealer, a best execution responsibility should not apply. Institutional customers (including eligible counterparties) understand that a dealer is acting for its own account and not as an agent for the customer. Were retail customers to deal on an execution only basis the client agreement must make it clear that due to the structure of the bond market the dealer cannot ensure that the client would not obtain a better price if he opened an account with other dealers or employed a broker to act for him.

3. Firm acting as dealer but also providing advice or owing similar duties to customers

Where firms provide advice on bond market investments to customers on which those customers rely, or where firms owe other fiduciary duties to customers, such as retail clients and professional investors who have sought retail client protections in this regard, it is right that there is an obligation to obtain best execution when executing an order against the firm's own account. What is reasonable conduct should depend, on a case by case basis, on the degree of reliance the client has placed on that advice, the range of options available to the firm to establish the best price, and the relative importance the firm, on a best efforts basis, places on the factors set out in Article 21(1) and the characteristics concerning clients and orders set out by CESR in its consultation paper. 'Venue' for this purpose will be the firm itself. Where there is no public quote (three quarters of outstanding bonds), CESR should accept that a price compliant with the best execution obligation is one calculated on the basis of the current spread over the risk free or swap rate rate of bonds with comparable characteristics such as maturity, coupon, credit rating, etc, plus any illiquidity premium or discount where relevant. This last point is important since a firm may have to go short to make the sale only to find that it can obtain the bonds for settlement only by either borrowing them or purchasing them from another dealer at a premium. Similarly, if the firm buys bonds for which there is no ready market, it may have to keep them in inventory for an extended period, consuming capital which could be more profitably used elsewhere.

An alternative way of dealing with illiquidity premiums arises from a characteristic of bond markets which is not found in equity markets, namely that bonds with a high credit rating are extremely good substitutes for each other. The shares of a chemical company, for example, are not equivalent to the shares of another chemical company, since investors buy shares to benefit from future price changes which will depend on the profitability of the specific company. Bonds issued by different companies with the same maturity, coupon credit rating and other terms will, however, provide very similar investment returns in terms of income and likelihood of repayment at maturity - the objectives of bond investors. Unless a client insists on purchasing a specific bond, which may have a high illiquidity premium, a dealer is usually able to offer an equivalent bond from his inventory at a better price. CESR's advice should recognise this important difference.

OTC DERIVATIVES AND STRUCTURED PRODUCTS

The OTC derivatives market is almost entirely a professional market where investment firms enter into individually negotiated transactions with their clients. OTC derivatives are bilateral contracts between parties acting as principal and so are not listed or traded on exchanges. In most cases, the firms in this market will act as principal in dealing with their clients (or will arrange transactions to be entered into by another group company, for example, where another group company has a higher credit rating or can maximise the benefit of netting). In this context, the concept of venue does not have the same meaning as in the context of other markets.

Because of the nature and complexity of OTC derivatives, it is not easy for investment firms to obtain independent prices from other sources to establish a fair valuation or price (as would be the case for an off-exchange transaction in equities). Information from published price sources may be of limited direct relevance even where it is available, since transaction terms are individually negotiated and the terms on which a party is willing actually to enter into trades may also depend on, for example, the creditworthiness of the parties and the collateralisation, netting or other credit risk mitigation techniques that are in place between them (unlike a cash market transaction in equities, where these factors will normally not be relevant).

It is also often not easy for a firm to obtain a comparable price or valuations from another investment firm. Many OTC derivatives are designed specifically for an individual client and consequently often confidential to that client; it may be difficult to maintain client confidentiality if the price of the product had to be independently verified through another investment firm to prove best execution. Also, a firm may not wish, for competitive reasons, to give another investment firm all of the components to the transaction if it is proprietary in nature, which may make it difficult to establish a comparable price. In addition, some of the parameters required to value complex products may be

subjective in nature and the models used to calculate the price or valuation may vary between firms causing pricing anomalies, which mean that prices may not be directly comparable. In any event, other firms may be reluctant to provide valuations for transactions which they will not execute.

Structured products may involve the issue of a bond or other security, but in many respects raise many of the same issues as described above. These products are normally tailored to meet specific client requirements and the pricing and terms of different transactions are not comparable. Even where there is a bond or other security which is to be listed on exchange, the initial transaction will normally be made with the client to purchase the security on its creation and given the proprietary nature of the structures it will normally be difficult to obtain information on comparable prices or valuations. There will also normally be very little after-market trading in the security and to the extent that the firm does trade the security it may be difficult to obtain comparable prices or valuations for similar reasons to those described above.

In these markets, it may also often be difficult to distinguish anything which is comparable to a conventional 'order' to which best execution duties would apply. The client may request a quote for or seek to negotiate a particular transaction with the firm (or a member of its group) as a principal but the firm should not be regarded as having the same duties to the client as it would where it accepts an order for execution and has discretion as to the manner of its execution. Of course, the position may be different for inter-dealer brokers or other brokers which expressly assume an agency obligation for their clients (although these will very often be eligible counterparties). In relation to the initial issuance and sale of structured securities, Article 22(1) may not apply in any event as the activity may be the 'placement' of securities rather than the execution of orders.

EXCHANGE-TRADED DERIVATIVES

Exchange-traded derivatives are, by contrast to OTC derivatives, both liquid and fungible within the listing exchange. However, they are mostly specific to a particular exchange, and while derivative contracts on the same underlying financial asset or commodity may be listed on more than one exchange (e.g. individual equity options on EuroStoxx 50 equities are traded on both Eurex and Euronext, and crude oil futures are traded on the International Petroleum Exchange in the UK and NYMEX in the USA), the actual specifications of these contracts will differ (e.g. different contract sizes, delivery timetable or deliverable commodity grades). This means that, although these contracts are fungible on the exchange on which they are listed, there is almost always no fungibility across exchanges. Therefore a contract cannot be 'opened' on one exchange and then 'closed out' on another, and there is only one venue on which the product can be traded. Professional investors will decide

which contract they wish to trade by assessing factors such as liquidity, trading hours, costs, and suitability for hedging price risk of a particular asset.

IX. PRE-TRADE TRANSPARENCY

General comments

Effective publicity for the trading interests that investors choose to disclose to the market is essential to the quality of European markets in shares. RMs and MTFs continuously evolve new or modified transparency arrangements as the demands of their users change. It is essential that Level 2 measures should enable them to continue to do so.

CESR's proposals for pre-trade transparency obligations for RMs and MTFs seem to be based on a particular perception of how equity markets should operate, and do not allow for the diversity of means by which such markets do, or may choose to, advertise trading interests. The proposals are likely to be inflexible, and damage the competitiveness of European markets.

First, CESR proposes a level of detail and prescription in Level 2 measures that would risk setting in stone certain current market structures. Even though Level 2 can be updated more quickly than Level 1, it will not at this level of detail be able to react quickly enough to market infrastructure developments which are likely to occur. We therefore caution CESR against giving preference through EU legislation to markets as they happen to operate today.

Second, CESR's approach would over-regulate matters which should be dealt with under RMs' and MTFs' own rules. Too much prescription of the details of RMs' and MTFs' market models would limit their ability to adapt the services they provide to their users' needs. CESR's proposals appear in some respects to go beyond the Level 1 text, whose starting point is the trading interests that RMs and MTFs decide to advertise. CESR should advise the Commission to adopt a more principle-based approach that can regulate pre-trade transparency without distorting existing markets or deterring innovation. Any attempt to regulate too prescriptively would merely reduce the attractiveness of European markets for European and international investors.

Third, CESR's proposals in several respects fail to recognise the balance of costs and benefits which has governed the evolution of market structures and their regulation, and continues to do so. CESR's approach would drive up the costs for users of using RMs and MTFs, without demonstrable benefits, and in some instances cause a demonstrable diminution in the utility of the current market structure. The result would be less liquidity and, perversely, less transparency.

This section of CESR's paper lacks thorough cost-benefit analysis. CESR's proposals could be particularly harmful for illiquid market sectors.

CESR should therefore instead adopt a more principled and less intrusive or prescriptive approach. We have made several suggestions designed to achieve this in our comments below on CESR's specific proposals in Box 12.

Following the Level 1 text, CESR should explicitly limit Level 2 measure to shares admitted to trading on a regulated market (not just shares, as implied by paragraph 3 on page 85).

Comments on CESR's specific proposals in Box 12

1.

CESR proposes to regulate in excessive prescriptive detail how an exchange or MTF decides to operate its pre-auction algorithm. This is inappropriately restrictive for Level 2 legislation, and does not allow for future developments.

2.

The Level 1 text requires publication of current bid and offer prices which are advertised through RMs' and MTFs' systems. While for most orders advertisement of the security identifier and number of shares bid or offered will be appropriate, this will not necessarily be the case. CESR's proposals do not take account of the range of facilities offered by electronic trading systems, and risk obstructing possible new developments in markets. For example, the type of quote/order might be an indicative bid or offer, at an indicative price. Any such provisions should therefore be cited as examples, and should apply only 'where such information is part of the advertised order'.

Furthermore, we presume that the 'number of shares the market participant is ready to buy or sell' element refers to the number of shares that the client immediately bids for or offers to the market, and not the client's full trading interest, otherwise it would not appear to be compatible with the exemption for 'iceberg' orders in paragraph 14.

3.

Again, CESR proposes excessively prescriptive requirements. It is entirely possible, for example in a small market, that there is no need for electronic display.

1, 2, 3

Instead of paragraphs 1 to 3, CESR should adopt a more principled approach, providing that whatever structure the RM or MTF operates to advertise information about prices to different classes of market users, that information should be made available fairly to those classes of market users who are prepared to pay for it.

4.

As it stands, 4 does not reflect the intention in paragraph 18 on page 89 that ‘trading facilities which publish only indicative prices are not covered by the proposal’. Indeed as they stand, paragraphs 2 and 4 read together would prohibit a RM or MTF from operating an electronic trading system that allowed for indicative quotes.

We assume that the proposed limitation to firm bids and offers arises because of CESR’s intention to exclude systems that display indicative prices from the Level 2 provisions. CESR should make this statement explicitly in the text, and make clear that the measures would not apply to such systems.

CESR should take account of the fact that, to the extent that the bids and offers reflect client orders, any restrictions would apply also to clients. It would be inappropriate and wrong to apply an ‘orderly market’ constraint in a way which prevented a client from withdrawing its order at any time.

5.

The ‘limited exemptions’ condition is an inappropriate intrusion in the RM’s or MTF’s ability to tailor its requirements to the risks which it asks designated market makers to take on. There is a range of circumstances, for example volatility in derivative markets, in which RMs and MTFs will need to tailor their requirements to encourage firms to provide liquidity. A requirement for clearly defined conditions and circumstances is sufficient.

6.

The ‘not so frequent as to intentionally deprive market participants of trading against the quotes displayed’ condition is an inappropriate intrusion in the RM’s or MTF’s ability to tailor its rules to the needs of market participants. There should be no regulatory constraint on RMs’ and MTFs’ ability to allow market makers to update their quotes at any time. In particular, often a market maker’s quote reflects its client’s order. If the client withdraws the order, the market maker will need to change its quote. The Level 2 provisions must not constrain clients’ freedom of action: see our comments under paragraph 15 below about the need to avoid disrupting the interaction between a client and his broker. It is sufficient to hold firms to the price displayed at the time that the order is received.

7.

RMs and MTFs determine the amount of information about bids and offers that they make available on the basis of the needs of various

users, and the costs involved. One of the costs of requiring too much information to be displayed may be, paradoxically, a reduction in the quality of pre-trade transparency. This is because, depending on the volume of orders and the amount of processing power in the system, new order information may be entered more quickly than the system can absorb it. RMs and MTFs need to be able to ensure that the amount of pre-trade transparency offered does not disrupt the order flow. The regulatory focus should be on the relevance to market users and quality of the published information, not its quantity. An example of problems that arise when a system contains too much information arose during the development of LSE's SETS system, when it became apparent that providing too much or full information about bids and offers would mean that it would be physically impossible to trade as fast as the actual market moved. RMs and MTFs calibrate the information displayed to order-book users carefully to balance the benefits of transparency against the costs of excessive information. Some exchanges charge for orders to be entered, specifically to control the amount of static information contained in their systems. CESR should also take account of the fact that current computerised trading programmes used by many large investors make a very very large number of minor changes to orders entered into trading books on a continuous basis. The optimum amount of information displayed will tend to vary depending on market conditions, the demands of different types of market user, and technological developments. It would be wrong, and unnecessary, to legislate for it. If market users need more information for any reason, they can ask exchanges to make time and price information available.

Furthermore, a requirement to 'make available' all bids and offers may not be consistent with the Level 1 text, which requires Member States to require RMs and MTFs to make public 'current bid and offer prices and the depth of trading interests at those prices *which are advertised through their systems*'. 'Which are advertised through their systems' clearly leaves the discretion to the operator of the system to decide the depth of trading interests displayed. This is consistent with commercial reality.

In view of the considerations discussed above, CESR cannot sustain its assertion in paragraph 20 on page 89: "It has been pointed out that at present pre-trade transparency in many markets is not as wide as proposed, which could have cost implications. It was proposed to limit pre-trade transparency to 5 best bids/offers maximum. However, that was not widely supported. CESR is therefore proposing that there should be wide pre-trade transparency." This statement is not consistent with the principles of proportionality and subsidiarity.

8.

CESR's proposal is that RMs and MTFs should make quotes 'available' electronically. Paragraph 10 implies that CESR interprets 'available' as meaning 'to the public'. For the reasons discussed elsewhere in our

comments on paragraphs 7 to 10, it is vital that RMs and MTFs retain the discretion to make different information available on variable terms: to the public, to market participants, or on request.

9.

CESR's proposal is that RMs and MTFs should make bids and offers on a floor-based system 'available' electronically. Paragraph 10 implies that CESR interprets 'available' as meaning 'to the public'. For the reasons discussed elsewhere in our comments on paragraphs 7 to 10, it is vital that RMs and MTFs retain the discretion to make different information available on variable terms: to the public, to market participants, or on request.

10.

Such a requirement would require RMs and MTFs to build a system that everyone could access. The system changes would be immensely costly, and the charges that RMs and MTFs would need to make for information would be prohibitive for most users. The result would be less transparency, not more: CESR's vision of pre-trade information which is 'free to all' is simply impractical. In practice, real-time prices are useful only to market users who are able to trade close to real-time. Real-time prices are not useful to investors and 'other interested parties' (whoever they may be) who must access the market through intermediaries. At present, RMs and MTFs offer a range of information at different prices, governed by demand for the information. This should continue to be the case.

Such a requirement would also inappropriately deprive RMs and MTFs of discretion, and limit their ability to incentivise liquidity provision. In paragraph 19 on page 89 of the CP, CESR opines that the same information should be available to all 'to allow investors to benefit from enhanced pre-trade transparency'. CESR asserts, without any justification, that incentivisation of liquidity 'should be done by other means', without suggesting practical alternatives which are both practical and consistent with high standards of integrity in the market. It is not appropriate for CESR to make such assertions without citing evidence to justify them.

Such a requirement would also impose unnecessary cost on MTFs that might limit access to certain classes of investors

11.

As we explain under paragraph 10 above, real-time prices are useful only to market users who trade close to real-time. Real-time prices are not usually useful to members of the public who are not members of a RM or MTF, who must contact a broker in order to be able to trade. RMs and MTFs must be able to retain discretion to offer access to

information on different timescales, at different prices, to different classes of user.

7, 8, 9, 10, 11

For the reasons explained above, a wide-ranging cost/benefit analysis would clearly be essential before CESR could justify any of its proposals in paragraphs 7 to 11, even if it was compatible with Level 1 to specify what information RMs and MTFs advertise in the ways that CESR proposes.

12.

‘Designed to ensure’ is a more realistic standard than ‘ensure’. Operators of RMs or MTFs should have procedures to minimise inaccuracies, but it is vital that they have no liability for wrong data. If wrong data is not picked up by the system’s controls and results in a trade, that is a real trade.

13.

CESR is right to exempt from the obligation to make information public RMs and MTFs that determine their prices by reference to those displayed on another trading venue.

14.

Such a provision is self-evidently consistent with the ‘advertised through their systems’ criterion of the Level 1 text. However, since the unrevealed part of ‘iceberg orders’ is contingent on the execution of the revealed part, strictly speaking there is no need to make provision for them under this heading. See also our comments above on the need to make paragraph 2 consistent with the exclusion of iceberg orders. There are also other types of order which RMs and MTFs need to be able not to advertise through their systems, such as ‘close orders’ (which are specified to be executed at the close of trading).

15.

In practice, participants in the market will decide what size of trading interest is inappropriate for advertisement through the RM’s or MTF’s systems, since market users use RMs and MTFs specifically in order to advertise their trading interest. So provided that CESR and the Commission adopt a practical approach as described in our comments on paragraphs 1 to 12, allowing RMs and MTFs themselves to provide the range of transparency that market users themselves demand in the most cost-efficient way, prescriptive Level 2 measures on this point should be unnecessary.

Furthermore, the size at which a client will be unwilling to display an order to the market cannot be defined with precision in advance, and will vary from day to day depending on market conditions. Clients depend on the advice of their broker to judge in any particular market circumstances where the threshold lies. Any attempt to define by regulation the size below which clients' orders 'must', and above which they 'may not' be advertised and published to the general public would have the undesirable effect of regulating and constraining clients' behaviour. It would stultify the ability of firms to serve their clients' interests, and undermine the open relationship between the broker and his client on which the provision of liquidity to the market depends. CESR and the Commission need not be concerned about 'collusion' between the broker and client to 'withhold information from the market', since as a general rule the cheapest and most efficient way of handling the client's order will be to enter it into the order book. It is generally only when there is concern that the size of the order will move the market against the client's interests that the broker will commit its own capital or otherwise work the order into the market on an agency basis.

We comment further on CESR's proposals on determining large trades in the context of post-trade reporting, in our comments on paragraph 32 in Box 13.

Answers to CESR's Questions

Q12.1. Do consultees agree with the specific proposals as presented or would they prefer to see more general proposals?

See our comments on each paragraph above. In many cases CESR's proposals would be inappropriate and costly. In several cases they would damage the market and the interests of investors, sometimes by diminishing the transparency of the market. CESR should instead respect the autonomy of RMs and MTFs by proposing Level 2 measures which adopt a more general level of principles applying to the publication of advertised trading interests.

Q12.2. Is the content of the pre-trade transparency information appropriate?

No. See our comments on paragraphs 1 to 3 above.

Q12.3. Do consultees agree on the proposal regarding the depth of trading interest and access to pre-trade information?

No. See our comments on paragraphs 7 to 10 above.

Q12.4. Do consultees agree on the proposed exemptions to pre-trade transparency? Are there other market models which should be exempted?

See our comments on paragraphs 13 to 15 above. This is an area where CESR should generally give more discretion to users of RMs and MTFs.

Q12.5. Do consultees support the waiver for "crossing systems" as defined in paragraph 13? Could pre-trade transparency for crossing systems have a negative impact on liquidity or create the potential for abusive behaviour?

We support the general application of a waiver for RMs and MTFs that derive their prices from other systems. We are not aware of any evidence that such systems have a negative impact on liquidity or create the potential for abusive behaviour, nor would we expect them to do so. Indeed, given the efficiencies and cost-savings that such systems procure for investors, their overall effect on liquidity should be entirely positive.

Q12.6. Do consultees support the same minimum size of trade for the waiver to transparency pre-trade and delayed publication post-trade? Are there circumstances in which the two should be different?

See our comments on paragraph 15 above and paragraph 32 in Box 13. It is not appropriate to use the same size for pre-trade exemptions (if they are necessary or desirable at all, which is very questionable: see our comments on paragraph 15) and post-trade exemptions. The value of transparency is different in the different contexts: the need to avoid disclosing the scale of a trading interest in the case of pre-trade transparency; the need to reduce a position taken on in the case of post-trade transparency.

Q12.7: Do consultees have a preference for one of the options proposed for defining the block size, are there other methods which should be evaluated?

Block sizes should not be relevant to pre-trade transparency. See our comments on paragraph 32 in Box 13 for their application to post-trade transparency .

X. POST-TRADE TRANSPARENCY

General comments

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 have evolved to meet the needs of their users. Arrangements for direct publication of OTC trades should also provide for users' needs. It is essential that Level 2 measures support, and do not obstruct, this objective.

CESR's approach would over-regulate matters which should be dealt with under exchange/MTF rules and national regulation to take account of local market circumstances. They would also give rise to significant costs where they required RMs, MTFs, and firms to modify existing trade reporting arrangements to bring them into line with CESR's specific proposals, for example to add new information fields, new systems to identify who has the reporting obligation, changes to reporting timescales, or the provision of data in a 'consolidatable' form. CESR should instead adopt a more principled and less intrusive or prescriptive approach. We have made several suggestions in our comments below on CESR's specific proposals in Box 13 designed to achieve this.

Following the Level 1 text, CESR should explicitly limit Level 2 measures to shares admitted to trading on a regulated market (not all shares, as implied by paragraph 3 on page 85).

CESR's specific proposals in Box 13

21.

A requirement to make public all of this information for every trade is excessively prescriptive for several reasons. RMs, MTFs and investment firms should have more discretion to provide 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 information will add costs to the system, and that exchanges charge fees for every trade report – costs which will ultimately be borne by users of the market.

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.

As regards CESR's specific proposals for minimum information:

- (a) 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 reported. 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.
- (b) 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.
- (c) A market or other source identification is of questionable value as a marker for each trade.
- (d) CESR should distinguish between (1) transactions, such as VWAP and 'non-market price' transactions, which are relevant to the information needs of the market, albeit they need to be reported with an 'other than current market price' indicator of the type CESR proposes, and (2) transactions where the price is based on factors other than current market valuation (see our comments under paragraph 29 below). We question the value of including the latter category in the trade reporting regime.

A requirement to make public every trade is also not appropriate in all circumstances. Often trades are executed for reasons associated with settlement, not price (for example, a large trade executed for a money manager may need to be split into a series of riskless principal trades for settlement purposes).

22.

The proposal to require aggregated information goes beyond what is provided for in the Level 1 text (volume, price, and time of concluded transactions). It is therefore inappropriate for a Level 2 measure and should be deleted.

23.

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 are consistent across Europe, to minimise duplicate reporting.

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.

There are circumstances in which CESR’s proposed requirement for the seller to report an OTC transaction would be inappropriate. For example, if the buyer acquires a risk position in block size, the accidental immediate reporting of the transaction by the seller would inappropriately expose that position to the market. As is the case under the rules of certain RMs and MTFs, the parties to an OTC transaction need to be able to agree that the reporting responsibility lies with the buyer, to enable better control of the parties’ risk. CESR should provide that the default position is that the report should be made by the seller, but that the parties may agree otherwise.

CESR should 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.

24.

The one minute deadline which CESR proposes is unrealistic and does not reflect current practice. Reporting within one minute may be possible for trades that are executed via a fully automated electronic platform. But in other circumstances publication within a minute is very likely to be unachievable – for example where trades executed by other means, such as over the telephone, need to be separately entered into the trading system; where the trading system itself is not automated or not integrated with the trade reporting system; if the trade is non-standard; or if very active markets prevent immediate reporting. Imposing an unrealistically short deadline is also likely to damage data reliability (see paragraph 27 below). It would be better for CESR to allow national regulators discretion to specify the precise delay allowed, taking into account market-specific factors, as well as the Level 1 requirement for publication as close to real-time as possible. If CESR is to propose a maximum delay whatever the circumstances, it should take into account current reporting practice, which has evolved under regulatory control to provide the most rapid technically feasible publication. Current practice ranges between a delay of 3 and 5 minutes.

The 14 day availability criterion is also likely to be impractical for investment firms that use proprietary arrangements. Any such period is not warranted by the Level 1 text. CESR has provided no evidence of a market failure that would justify the associated system development

costs. Exchanges' time and price information will provide sufficient evidence to correct a bad execution.

25.

It is not practical or commercially viable to expect firms' proprietary reporting arrangements to remain available all the time the firm is actively trading. 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.

26.

We agree that consolidation of trade data is a very important goal to maximise the efficiency of market users' access to post-trade information. We support CESR's proposal, as envisaged in paragraph 39 on page 94 of CESR's paper, and Question 13.9, to work with firms, RMs, MTFs, and data vendors to develop a mechanism which best serves the needs of investors. This exercise will require a thorough evaluation of various factors, including the most appropriate data formats for providing information to the market, and the most appropriate means by which revenues from market data can most fairly be attributed to market participants, reconciling an open and competitive market in data with easy accessibility. We suggest that CESR should grasp the opportunity by setting up an expert group now, involving representatives of exchanges, MTFs, data vendors, and firms, to consider how these issues should best be resolved.

Consistent with CESR's view that it should work with the industry to develop proposals, and our support of this position, we fear that prejudging the issue by moving now to an 'easily consolidatable' condition in Level 2 measures would be too crude a means to provide, within the 30th April 2006 deadline, for the most efficient publicity and easy accessibility of all trade information. It will be important to ensure that Level 2 measures provide for practical methods for firms to publish trade reports through proprietary arrangements, and that a 'consolidatability' criterion does not distort competition by forcing firms to publish, from 2006, through a RM, MTF, or third party information vendor, merely because of insufficient time before then to establish competing proprietary publication mechanisms. To do so would negate a right which the Directive specifically provides for. While it is important for trade data to be available to market users in a form which is readily usable, it is also important for firms to have a choice of reporting channels, including the possibility of competitive

industry-owned reporting channels. Level 2 provisions on a tight timescale are not the best place to do achieve this. In effect, transitional measures are necessary to provide time for this debate. CESR should not seek to cut off the proprietary arrangements route, whatever arrangements firms may use. CESR should advise that interim measures are required which ensure that firms' arrangements meet the Level 1 criteria of publicity and easy accessibility, but do not mandate arbitrary 'consolidatability' conditions. We discuss this issue further in our response to Question 13.9 below.

As the Level 1 text of Articles 28, 30, and 45 recognises, firms, MTFs, and RMs are entitled to receive reasonable compensation for publishing the data that they respectively own. Any solution would need to incorporate appropriate arrangements for charges, rebates, and revenue sharing to ensure a properly functioning competitive environment in which the providers of data derive appropriate revenue from it, while market users also have access to data at an acceptable cost.

27.

CESR's proposal should be modified to read 'designed to ensure' and 'designed to be capable'. This is a more realistic standard than 'shall ensure' and 'shall be capable'.

28.

CESR is right to propose exemptions for transactions that do not include the transfer of economic risk. Exempted transactions should include repos, stock loans, and trades entered into exclusively for settlement purposes (see our comments on paragraph 21 above).

29.

Transfers of shares where the price is based on factors other than current market valuation should not be included in the trade reporting regime, since they do not include information which contributes to price formation. Such transactions include, for example, the exercise of an option, trades relating to security issuance, and trades related to exchange traded funds business..

30, 31, 32.

CESR is right to propose exemptions from immediate trade reporting where a firm takes on a large risk position on behalf of a third party. This is vital to encourage firms to take on risk positions on behalf of clients, so that firms will continue to be able to provide liquidity to clients at good prices. We therefore agree with the conditions set out in paragraph 31.

CESR does not set out a formula for eligibility of trades for delayed reporting, though it proposes to investigate the definition of block size along the lines described in paragraph 15 of Box 12. In that paragraph, CESR proposes three possible measures, based on:

- (a) Average daily volume
- (b) Average size of orders
- (c) Market impact

We have considered these possibilities as they would apply to deferred reporting of trades (post-trade transparency). See also our comments under paragraph 15 in Box 12 on the lack of need for a block trade regime for RMs' and MTFs' pre-trade transparency.

In order to be consistent with the conditions set out in paragraph 31, the regime for delayed reporting of block trades would need to:

- (a) Allow sufficient time for the firm to offset its risk;
- (b) Support a uniform methodology across Europe for calculating the size of block trades for delayed reporting as regards any particular share;
- (c) Support a methodology that was simple to calculate and apply, and well understood across the market;
- (d) Be robust over time, so that little change was needed once the regime was established (this is important both to ensure that dealers are able to work with the regime, and to minimise systems changes that firms need to make);
- (e) Allow some flexibility for national regulators to deal with exceptions, for example in the treatment of portfolio or programme trades and in the handling of small capitalisation shares.

A market impact measure would not easily meet these criteria. Furthermore, the purpose of deferred reporting is to enable the firm to unwind a risk position before the rest of the market has an opportunity to exploit knowledge of it to the detriment of the risk-taker, not directly to limit the impact of the trade on the market price. The 'market impact method' is also likely to be the most difficult to develop into a consistent and predictable block trade regime. For example, it would not measure the impact of such a trade to look only at the effect on exchange order books at the time the large trade was published, as one of the major effects of publishing block transactions is to trigger aggressive short-selling by opportunistic investors, whose orders would only be triggered by the relevant trade and would not be present on the order book in its absence.

Of the other two methods CESR proposes, we prefer the use of a formula based on average daily volume, since it bears more relation to the purpose of deferred reporting than a measure based on average trade size.

In addition, CESR should have regard to the liquidity of the share, as liquidity (or lack of it) plays a large part in the success an investment firm may have in laying off its risk. For certain very liquid shares a limit based on the same percentage of average daily volume as for less liquid shares could mean that very large risk trades in those very liquid shares could be inappropriately exposed to immediate trade publication. To ensure that trading in very liquid shares was not damaged by excessive transparency, we suggest that it would be necessary to specify a monetary limit per transaction, beyond which the trade could benefit from deferred reporting.

CESR should consider the following factors as regards the calculation of block size:

- (a) Which data set should be used for each share, or group of shares, to establish the average daily value, and what transitional measures might be needed to take account of the current availability of data on executed trades in different European markets.
- (b) The need to allow some latitude to accommodate price changes in busy markets that might affect the status of a trade which was close to the block trade threshold.
- (c) Setting different reporting delays to reflect different levels of liquidity and allow reasonable time for positions to be unwound. The regime should allow a considerable amount of time, up to several days, for less liquid shares. The regime should also take into account the fact that for more liquid shares at certain busy times of the day firms need more time so that the management of their newly-acquired risk does not undermine their ability to provide the services that investors demand.
- (d) Setting different reporting delays to reflect the size of the risk position relative to the average daily volume, so that the greater the size, the longer the firm would have to unwind the trade.

CESR is right to propose grouping shares for the purposes of determining block sizes. This approach is easier for firms to administer.

As a matter of good practice, CESR should base its analysis on a survey of existing block trade deferred reporting regimes across Europe.

When considering exemptions from immediate trade reporting based on the size of the trade, CESR should also take account of the type of the

transaction, as specified in Article 45. In particular, it will be important to provide appropriately for deferred reporting of transactions where particular executions are part of a much larger transaction that exposes the firm to risk, such as portfolio transactions, which form a significant percentage (one firm estimates 20 or 25 per cent) of total trading activity. 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 markets. 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 transactions with some form of implied or explicit price guarantee (for example relative to the volume weighted average price in the relevant period), 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.

The treatment of such transactions under MIFID is not entirely clear. 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.

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. Firms will need the protection of the deferred reporting regime to lay off the often significant risk they assume by providing liquidity for the whole portfolio. CESR should ensure that the mismatch between Article 45(2) – deferred reporting based on type of transaction – and Article 45(3) comitology – deferred reporting based on type of share – does not result in Level 2 legislation

blocking deferred reporting of portfolio transactions. In these circumstances, Article 45(2) should prevail.

CESR's Questions

Q13.1: Do consultees support the method of post-trade transparency (trade by trade information), should some other method be chosen (which)?

CESR should adopt a more high-level principled approach that is appropriate to any market model. See our comments on paragraph 21 above.

Q13.2: Do consultees support the inclusion of "aggregated information" in paragraph 22 or should it be left for market forces to provide on the basis of the information disclosed under paragraph 21. If it is included what should the content be?

This should not be legislative measure, and should be left to market forces. See our comments on paragraph 22 above.

Q13.3: Do consultees support the two week period for which the post-trade information should be available?

No. See our comments on paragraph 24 above.

Q13.4: Should some minor trades be excluded from publication (and if so, what should be the determining factor)?

There appears to be no legal authority to exclude minor trades. However, such trades give little useful price information, although firms incur reporting fees in making them. On the other hand, from a systems perspective, it is undesirable to include an additional minor trade identifier. It is more important to exclude trades that do not contain important pricing information, and to ensure that firms are not required to report a trade more than once.

Q13.5: Do consultees agree on the method of defining the time limit in paragraph 24 and is the one minute limit capable of meeting the needs of occasional off-market trades?

No. See our comments on paragraph 24 above.

Q13.6: Do consultees support the view that only intermediaries who have created a risk position to facilitate the trade of a third party should benefit from deferred publication or should all trades which are above the block size be eligible for deferred publication?

Yes. See also, however, our comments on block size under paragraph 32 above.

Q13.7: Should the identifier of a security be harmonised and if so to what extent? What should be the applicable standard (ISIN code, other)?

Harmonisation of static information is desirable, but the problem needs to be addressed at a global level. For Europe to maintain its international competitiveness it will be important not to try to develop a 'European' solution which takes no account of the rest of the world. See also our comments on CESR's proposals on transaction reporting. Any standard would need to take account of the result of current work to improve security identifiers. For the purposes of providing information about most recent trading, it will also be important to find solutions which identify the relevant share in a way which is actually useful to market users. As far as publication of transaction reports is concerned, reliance on any code, ISIN or other, will provide no useful information for anyone other than a tiny handful of investors who can match the code with a company name.

Q13.8: Should more information be available on stock lending? If so, which should be the content? Are there other similar types of activities which should be covered?

See our comments under paragraphs 28 and 29 above. Trade reporting should not be required where there is no transfer of economic risk, or where market price is not the main factor in the transaction.

Q13.9: Should CESR initiate work, in collaboration with the industry and data publishers, to determine how best to ensure that post-trade transparency data be disseminated on a pan-European basis?

As we explain in our comments on paragraph 26 of Box 13 above, consolidation of trade data is a very important goal. We are keen to engage in debate with regulators and other interested parties about appropriate methods of collation and dissemination of trade data, recognising the fact that opinions differ as to the most appropriate methods. However, for the reasons set out in our comments on paragraph 26, this work should be carried out separately from the development of Level 2 measures under MIFID, and on a longer timescale to avoid imposing inappropriate restrictions on rights provided by the Level 1 text. We suggest that CESR should grasp the opportunity by setting up an expert group now, involving representatives of exchanges, MTFs, data vendors, and firms, to consider how these issues should best be resolved.

ANNEX 1 : Supplementary comments on the sections of CESR's paper to which we responded on 17th September

As foreshadowed in the first part of our response, we have the following supplementary comments on the parts of CESR's consultation paper which we commented on on 17th September:

Box 11, Paragraph 9

It is not always practical to maintain a record of the intended basis of allocation on a trade by trade basis. Such a requirement could actually delay the prompt execution of the order, should such a record of allocation have to be documented by a salesperson or trader before execution. This matter should be managed by Firms by having appropriate documented policies and procedures for the allocation process.

ANNEX 2

Brief description of the participating associations

International Swaps and Derivatives Association

ISDA is an international trade association representing participants in the privately negotiated derivatives industry, a business covering swaps and options across all asset classes. ISDA numbers over 600 of the world's largest commercial, universal and investment banks as well as other companies and institutions with extensive activities in the area of swaps and other individually negotiated derivatives from 46 countries. Since its inception, ISDA has pioneered efforts to promoting the adoption of sound conduct of business and regulatory capital rules, and advancing the understanding of derivatives from a public policy perspective.

International Securities Market Association

ISMA is the self-regulatory and trade association for the international securities market. Its 440 members are located in 48 countries including all the original EU Member States and half of the new Members. Associate members include central banks, government debt management agencies and stock exchanges.

International Primary Market Association

IPMA is the trade association which represents the interests of the international banks and securities firms which underwrite and distribute international debt and equity securities in the primary market. It has 51 members from 12 countries representing the leading underwriters in all of the world's major financial centres.

Association of Norwegian Stockbroking Companies

ANSC represents 20 investment services companies, including the Norwegian banks.

Bankers and Securities Dealers Association of Iceland

BSDAI represents 13 Icelandic banks and securities dealing firms.

Bond Market Association

BMA is an international trade association with offices in London, New York and Washington representing approximately 200 securities firms and banks that trade, underwrite and distribute fixed income securities

Danish Securities Dealers Association

DSDA represents about 20 Danish/Nordic banks and investment banks with activities in the Danish wholesale market covering equities, fixed income instruments and derivatives.

Finnish Association of Securities Dealers

The FASD is the trade association and self-regulatory organisation of the Finnish investment services industry, representing about 40 broker/dealers and other licenced financial services firms engaged in public securities business.

Futures and Options Association

FOA represents 155 international and European investment banks, brokerage houses, oil and energy companies and exchanges engaged in business in derivatives, particularly futures and options.

London Investment Banking Association

LIBA represents about 50 European and international investment banks and securities firms which have major European wholesale market operations in London, covering all major securities and derivatives markets.

Swedish Securities Dealers Association

SSDA comprises about 40 members carrying out securities business in Sweden and representing a market share of roughly 90 percent of the Swedish securities market in equities, bonds, derivatives and other financial instruments.