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4 April 2005

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Dear Fabrice

MIFID - CESR'S SECOND CONSULTATION ON FIRST MANDATE

Thank you for the opportunity to comment on CESR's second consultation on its second mandate on possible implementing measures on MiFID. This letter and its attachment constitute the London Stock Exchange's response.

We believe that the subjects covered by this consultation are of critical importance to EU capital markets. We understand the difficulties CESR has had in reaching its draft advice however, we are concerned that some of the conclusions are not properly supported by reasoned arguments. Notwithstanding the careful negotiations that CESR members have undoubtedly undertaken, we urge CESR to carefully consider consultation responses and to amend its final advice where there is a clear call from the industry. Our detailed responses to the questions asked in the consultation paper are attached, but there are two points that we believe are of paramount importance and worthy of further comment here.

Negotiated trades

When considering the requirements for negotiated trades on regulated markets we would urge CESR to remember that use of regulated markets is entirely voluntary and that, if undue restrictions are placed upon them, firms will simply transact business OTC. While the freedom to do this is clearly an intended consequence of the directive, we do not believe it was the intention to prohibit firms who wish to secure for their clients the regulatory protections and enhanced transparency that regulated markets provide. Any undue restriction on the way negotiated trades are done on regulated markets will result in more trades being done OTC. To this end we urge CESR to clarify the price restriction contained in the waiver to ensure that, while supporting the principle of best execution, it does not inadvertently force business off the regulated market. The requirement should therefore be clarified that the trade matches or betters the available order book price for that size of trade.

Delayed publication

Whilst we congratulate CESR on the relatively simple approach for deferred publication of post-trade information we have some serious concerns over some of the thresholds.

Our concerns focus on both ends of the liquidity spectrum. Firstly, for those shares where firms provide the greatest quantities of capital and liquidity we believe the protections are insufficient and would suggest that the 60 minute delay is available for trades above the lower of €5m and 5% of ADV (rather than €10m and 10% as proposed).

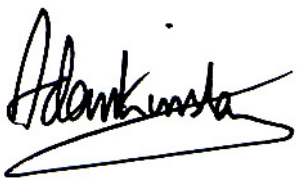
We are also very concerned at the proposals for most illiquid stocks where the provision of risk capital is critical to a viable secondary market. The issuers affected will be SMEs who need confidence that there is an orderly market for the trading of their securities. Whilst the majority of trading occurs in the shares of the most liquid issuers, the vast majority of the EU's 8,000 issuers may fall into this illiquid category.

The explanatory text questions whether or not it is appropriate to set these thresholds for these securities at CESR level, or whether it might be more appropriate to leave these to be set at member state level. We whole heartedly support such an approach: regulated markets and their competent authorities have a wealth of experience in tailoring these regimes to balance appropriate transparency with an environment conducive to encouraging liquidity provision.

If CESR insists on imposing a single solution for these securities, then the suggested thresholds for delayed publication in illiquid securities are extremely high when compared to current practice in most major European markets and we would ask CESR to re-examine them. In particular, we believe CESR has made an unintentional error in its requirement that trades need to be for a minimum of €1m in order to attract a 2 day delay as this will necessarily be in excess of the proposed 100% of ADV. We believe that many companies in this liquidity band will have an ADV of less than €100,000 and as liquidity provision at this end of the market is already extremely scarce we believe that the suggested regime could significantly raise the cost of capital for SME, and would urge CESR to reconsider the thresholds for the 2 day delay for illiquid stocks.

I hope that you find the attached comments useful in your deliberations and look forward to continuing to work with you on these issues.

Yours sincerely



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Appendix - London Stock Exchange response to detailed questions

Chapter 1
General obligation to act fairly, honestly and professionally in accordance with the best interests of the client (Article 19(1)) – lending to retail clients

Question 1: Do you agree with the proposed advice in this area, including the proposed limitations on the scope of the obligation?

We are surprised to find requirements relating to lending in the draft advice. We would ordinarily expect such requirements to be dealt with by means of retail credit legislation.

Chapter 2
The definition of investment advice (Article 4(1)(4)) – generic and specific advice

Question 1: Do you believe that investor protection considerations require the application of the above conduct of business requirements from the point at which generic advice is provided or do you believe that sufficient protection is provided in any event to allow the definition of investment advice to be limited to specific recommendations?

Whatever approach is adopted, it must be workable. This would seem to favour a more narrow approach. Generic advice doesn't always lead to specific advice and therefore it might prove burdensome to impose requirements at this stage in all circumstances.

Chapter 3
Best execution (Articles 19(1) and 21)

Generally, we believe that more thought should be given to the application of what is essentially an equity best execution regime to other asset classes. For example, it is important to distinguish between equity and bond markets. Bond markets do not price off a given "market price" but rather refer to fundamental interest rate, corporate and credit rating data.

56. Question for Comment: Please suggest situations and circumstances in which a firm might satisfy the requirements of Article 21 while using only one execution venue.

We believe that it is possible for a firm to satisfy Article 21 by virtue of using only one venue if (but only if) that venue provides access to multiple counterparties and is widely acknowledged as a central point of price discovery. For example, despite the absence of a concentration rule, many firms choose to trade solely on the London Stock Exchange's electronic order book (SETS). The order book is the central price formation and trading service for the securities comprising the FTSE 100 index, the most liquid FTSE 250 securities and equities that have a LIFFE traded equity option and provides access to the greatest number of actual buyers and sellers in those stocks. Market participants with a patient trading strategy use limit orders to achieve their desired price, acting as price makers rather than price takers. In addition to achieving superior prices, market participants incur only negligible explicit exchange fees by placing limit orders (£0.085 or €0.12 per trade).

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

Of all the factors considered in assessing execution venues, we believe that price is the paramount factor. Any discussion about cost should relate primarily to the end user, rather than the firm. If the firm's commission is the same for all venues, costs such as staff costs and execution fees should be irrelevant. When commissions differ, the net price is relevant. Therefore, we only believe that the distinction between internal and external costs is relevant to the extent that there is more chance that investors will incur external costs.

87. Question for comment: Are intermediaries likely to inform investment firms that manage portfolios or receive and transmit orders about material changes to their business?

Whilst we have no specific comments to make on this question the explanatory text that precedes it notes that the London Stock Exchange has developed new services which have led to greater data availability and transparency. We thought that it might assist CESR to describe these services. The "Execution Quality" service provides retail brokers and their liquidity providers with the ability to monitor, assess and compare execution performance for all trades reported to the Exchange in UK listed and AIM securities. It provides users with reports on how their execution performance compares with the rest of the market as well as how each of their liquidity providers is performing. Specifically, the service allows users to:

- Assess their execution quality by security, user-defined portfolio, FTSE index, FTSE business sector or market segment.
- Trend their execution quality over time, with data available back to January 2004.

- Compare their trades against similar trades transacted in the market. i.e. by dealing capacity (agency or principal business), security, size of trade or time of day.
- Assess their performance against a range of price parameters and best price benchmarks.
- Extract underlying trade data for bargains executed outside of the prevailing market price in order to identify and, where appropriate, correct any deficiencies. Information contained within this report includes trade code, settlement period, special conditions, etc.
- Assess their execution venues through the provision of a named ranking report which tracks the performance of liquidity providers.
- Rank themselves against their peer group through the provision of a nameless ranking report.

115. Question for Comment: With respect to the fourth disclosure suggested by respondents, CESR requests further comment on whether investment firms that execute client orders directly or indirectly should be required to disclose information about their error correction and order handling policies.

We note the reference to error correction and in particular the relevance to this consultation of IOSCO's February 2005 paper on the subject. We believe that, while this is a fundamental issue, and disclosure of firms' policies in this area will be useful, it must be cross referred to Paragraph 201 of Chapter 4, which deals with the publication of pre and post trade information and in particular the requirement that, at the point of all publication, all trading data is subject to real time market monitoring, whether it is done on a regulated market, MTF or OTC. Without a meaningful monitoring requirement error correction policies are unlikely to be effective.

Order handling policies are important and investment firms should be required to disclose information about them. This would appear to be closely linked to Art 22(2) of MiFID.

Chapter 4
Market Transparency

1. Definition of Systematic Internaliser (Article 4)

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

Yes. In particular we support the focus on the specific activity within the firm, rather than the wider organisation. However we believe that the criteria should be cumulative and that all must be met before a firm is so classified.

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

No. If the advice is attempting to identify those firms that are engaged in a certain activity then quantitative measures are irrelevant.

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

N/a.

2. Pre-trade Transparency requirements for Regulated Markets (Article 44), MTFs (Article 29) and Systematic Internalisers (Article 27)

2.1 Defining the scope of the quoting obligation for Systematic internalisers

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

We believe that CESR should be pragmatic and cautious in arriving at the number of shares that are to be determined as liquid for the purposes of Article 27. An approach that results in an excessive number of shares being caught could be irreversible whereas a more conservative, initial approach can be expanded later, once the effectiveness of what will be a brand new regime has been tested.

The measures proposed seem broadly sensible, although the allowance of optionality will prove counterproductive in efforts to create a single regime across the EU. Experience suggests that the Commission may reject advice that allows any member state optionality as failing to answer the requirements of the mandate. To the extent that it is possible we urge CESR to arrive at an approach that is acceptable to all members.

We believe that the Transparency Directive definition of free float is too restrictive and inappropriate. While index providers do exclude strategic holdings of over 5% from free float they do not exclude holdings by institutional investors. Institutional investors will generally actively trade their holdings and these holdings should be considered as free float, regardless of size.

2.2. Content of pre-trade transparency

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

The proposals are a dramatic improvement over previous texts and we now agree with the thrust of the proposals. However, we believe that some minor amendments are required if the proposals are to work.

- Paragraph 74 - should read “up to at least five price levels where available”. Regulated markets should not be prevented from displaying more than five price levels if they wish to and, if insufficient orders have been entered, there may not always be five price levels to display.

- Paragraph 76 - the words “in a montage” should be deleted. Regulated markets are wholesalers of data and do not have control over how that data is displayed by third party data vendors. The requirement that all quote data is made available should be sufficient. Data vendors will display the data in a way which is useful to their customers.

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

For regulated markets we believe that, provided the amendments mentioned above are made, then the content is appropriate.

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

The principle of the exemption is a good one but the wording requires some clarification if it is not to have the perverse effect of forcing firms to transact business outside regulated markets.

The text that requires amending is paragraph 84(a) which requires that the transaction be made within the current spread. Our reading of the text would indicate that “spread” should be taken to mean the weighted spread for that size of trade. However, if it were narrowly interpreted to mean the simple, unweighted best bid and offer, then transactions that were done at prices better than available on the order book for that size could not be done under the rules of a regulated market.

By way of illustration, consider an order book that contained two sell orders, one for 100,000 shares at €100 and one for 100,000 shares at €120. In this example the SMS is 50,000 shares so Article 27 is not relevant. A simple interpretation of “spread” would argue that a firm could report a negotiated trade for 200,000 shares at €100 or buy 200,000 shares off the order book for an average price of €110. However, it could not do a negotiated trade for 200,000 shares at €110 (or say €108) on the regulated market. It could of course transact the business OTC and be subject to no pre trade rules anyway. Given that there is absolutely no compulsion to use the regulated market it seems likely that the majority of negotiated business would be forced off the regulated market with potentially negative regulatory consequences.

To avoid uncertainty and the potential for such a perverse outcome we propose that the wording of 84(a) is amended accordingly:

“the transaction is made within or at the current weighted spread for that size of trade on the RM/MTF, if applicable …”

In our previous example this would allow the firm to bring its trade for 200,000 shares at €110 onto the regulated market and secure for its client the regulatory protections and transparency that regulated markets provide.

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

The issue of multiple capacity firms must be addressed if the clients of firms that engage in systematic internalisation business elsewhere in their business are not to be disadvantaged. An additional qualifier such as "where it is acting in its capacity as a systematic internaliser" should be added to make it clear that only a certain element of the firms' business is to be excluded from the waiver.

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

A unified block trade regime will create certainty for firms operating cross border and cross-market.

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

The bands proposed seem sensible.

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

The SMS should be fixed as a monetary value as share prices can fluctuate quite dramatically over time. Firms will be able to convert it into a share figure as and when they need to.

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

Revisions should be at least annual and there must be a procedure for ad hoc revisions to deal with dramatic changes in share price. More concrete proposals are not necessary.

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

It is reasonable to fix an initial SMS from the first day of trading based on peer stocks as it would be inappropriate to wait for three months before determining SMS.

Q 3.10: Do you consider a two week period from publication as sufficient for systematic internalisers to adapt to new SMSs?

Yes.

Q 3.11: Do you agree on the proposal on publication of the classification of shares, would you prefer establishing a single contact point (at level 2)?

Yes. Each competent authority should publish the classification for those securities for which it is competent. CESR should consider the usefulness of publishing a consolidated list on its website at level 3.

Q 3.12: Do you have further comments on the proposals for the obligations of systematic internalisers?

No.

2.3 DISPLAY OF CLIENT LIMIT ORDERS (Article 22.2)

We support the requirements for the display of client limit orders, in particular the requirement that they must be visible to the wider market and immediately executable against.

3. Post-Trade Transparency requirements for Regulated Markets (Article 45) and MTFs (Article 30) and for Investment Firms (Article 28)

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

Post trade information should be published on a trade by trade basis or, in the case of trades resulting from auctions or uncrossings, then by one price determination. While the list looks quite long, it is all vital for effective display and consolidation of information and CESR should bear in mind that most of these fields will be automated at firm, market or MTF level and will not result in traders individually having to key in lots of data after every trade.

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

It is a useful default but firms must not be prevented from coming to alternative arrangements by contract.

4. Transactions large in scale compared to normal market size

We have a general concern that this whole section is very order book-centric. While we note that this is irrelevant for calculation of pre trade thresholds as there is a general waiver for quote markets, the approach will pose problems when calculating thresholds for post trade delays. The calculations are all supposed to be based upon order book data and yet, for the majority of stocks on the Exchange's market, for which we operate a quote based market, there is no order book data available. We would appreciate clarification as to whether, for these securities, we will remain free, in conjunction with our regulator, to establish our own transparency regime.

We would also like to dispute the assertion in paragraph 166 that competent authorities do not have access to relevant data for making calculations. All competent authorities will have full transaction report data for those securities for which they act as the regulator of the most liquid market. These reports contain all the data necessary for these calculations, including whether or not those transactions were done on order books and what capacity they were done in.

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

The categoric approach proposed is too simplistic and would result in huge swings in percentage terms across the different constituents of each category. The alternative approach as proposed in Annex 1 Option 2 would provide much better outcomes as it would be stock sensitive. This is particularly important given the other uses that this number must be put to, including calculation of SMS. The threshold should be calculated on the basis of number of trades, rather than volume as the latter approach would create unrealistically high thresholds and, in turn, unworkably large SMSs.

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

We agree with the suggested approach.

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

The proposals would result in a considerable increase in transparency across most markets that currently apply a block trade regime and CESR must be wary of the potential damage that might be done to liquidity provision in Europe. Whilst we agree with the general methodology, we believe there are some problems with some of the parameters. For example, while the regime for liquid shares seems to produce acceptable outcomes, the threshold for the first delay should be reduced to 5% of ADV (or €5m if lower) if it is to be in any way useful to market participants.

The proposals for less liquid shares are wholly inappropriate - see answer to Q6.7

The advice is also silent on the issue of rolling "medium" sized block trades over into subsequent trading days - where a trade would attract a two hour delay and there is not sufficient time left in the trading day, firms should be able to "roll over" whatever period is left of the delay into the start of the next trading day. For example, if a firm took on a block that would attract a two hour delay at 15:30 and the market closed at 16:30, it should also be given the first hour of the next trading day to complete the trade.

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

We note that there is a discrepancy between paragraph 154, which asserts that trades should be published as soon as risk is offset, and the final advice, which includes no such requirement. On a practical level, requirements based on unwinding would be too complex to be set and administered at CESR level and the current approach, while not perfect, has the advantage of simplicity.

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

No. If the intent is to create a pan European regime then there must be a single regime per stock. Otherwise, multinational firms that trade a single stock on a pan European basis will have to be aware of 25 separate regimes to know what their obligations are. Accordingly, all member states should observe the thresholds set by the competent authority of the lead market.

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

We note the short-term arrangements to use order book data and, aside from the reservations about non-order books stocks that we have put at the start of this section, this seems acceptable. However, the text makes no mention of what the long term arrangements will be. CESR should clarify that, following this initial period, competent authorities will calculate thresholds on the basis of all trading data that that they receive via transaction reports.

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

Shares in the lowest liquidity band will often be extremely illiquid and CESR should seek to facilitate liquidity provision as much as possible. CESR should be mindful of the knock on effects for SMEs with respect to cost of capital. We believe that the deferred publication regimes for shares in this band should be left to individual markets, with their competent authorities, to determine.

The proposed regime is considerably higher than is current UK practice. In particular the requirement that trades are at least €1,000,000 to attract a 2 day delay would act as a severe disincentive to liquidity provision on illiquid securities. This may well be a mistake as the requirement that trades are 100% ADV but at least €1m in a category of stocks with a maximum of €1m ADV doesn't make sense. However, if the intention was to impose a minimum of €100,000 then this might produce much more acceptable outcomes although we still have doubts about the desirability of a regime for these stocks being set at CESR level.

It should be noted that the shorter one and two hour delays for these stocks are less useful in this liquidity band as liquidity providers typically need longer periods to unwind positions in less frequently traded stocks.

Furthermore, the proposed calculation relies on order book data which, as previously mentioned, is not available for these shares. Given the lack of workable CESR proposals and that existing national regimes have been developed over time to balance the needs of transparency and liquidity at this level, we would urge CESR to allow this to persist.

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

No. There should not be a requirement that any share be in the top liquidity band, rather the regime for the most liquid share in the portfolio, whatever band that may be, should be applied.

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

We are extremely nervous about the way in which these figures and thresholds have been arrived at. These figures could have huge significance for liquidity and competition in EU markets and yet they are not based upon any scientific study or consideration. We believe that it would have been a worthwhile exercise to commission a substantial economic analysis of the issues.

5. Publication of transparency information (and consolidation)

We disagree with the assertion in paragraph 196 that firms should have arrangements to publish trade outside the operating hours of regulated markets and MTFs. Such a requirement could have the effect of actually reducing transparency as reports published outside market hours are likely to get "lost" overnight. Given that most regulated markets that trade equity operate a common trading day we believe that firms should be able to observe the operating hours of the markets which they use with respect to publishing post trade data.

We welcome the requirement in paragraph 201 (a) that all pre and post trade information is subject to monitoring to ensure its reliability and integrity. However we believe the paragraph must be amended slightly to ensure that the monitoring is done in real time. Off-line monitoring would not be sufficient to ensure that market quality is preserved. Accordingly the sub paragraph should read:

"a. ensure that the information published is reliable by monitoring <u>in real time</u> the correctness of the information, alerting of obvious mistakes and correction wrong data when necessary;"