19 February 2004

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FRANCE

Dear Fabrice

PROVISIONAL LEVEL 2 MANDATES ON FINANCIAL INSTRUMENTS MARKETS DIRECTIVE

Thank you for the opportunity to comment on the European Commission's provisional mandates, regarding possible Level 2 implementing measures for the proposed Financial Instruments Markets Directive ("ISD2"). This letter and its attachment constitute the Exchange's response.

We support the ongoing development of a single European market in financial services through the removal of barriers to trade. Current regulatory initiatives, including ISD2 which proposes a common EU framework for financial markets in the EU, are essential for ensuring the continued quality of our markets and enhancing investor confidence throughout Europe. The work that CESR now has to do to ensure the practical and consistent implementation of these directives will be fundamental to their chances of success.

While we believe that all of the areas touched on by the mandate are indeed vital to the success of the directive, and the attachment contains detailed comments, I draw your attention to three areas of particular concern.

Provision of transparency

The new directive will pose a number of challenges to regulators but the most significant of these will be in how they address the issue of access to, and comparability of trading data in a genuinely competitive market. The directive will facilitate trading on regulated markets, MTFs and by internalising investment firms. If the market is going to be able to make use of the trading information that is produced then it must have confidence in its quality.

We believe that, given the conflicts of interest and commercial pressures that transparency providers are likely to be subject to, all transparency providers, be they regulated markets, MTFs, internalising firms or third party data vendors, should be subject to minimum standards, including an obligation to ensure that all trading is subject to real time market monitoring.

Transaction and trade reporting

We feel that the directive provides CESR with a great opportunity to simplify reporting arrangements for investment firms and, as such, considerably reduce the costs passed on to end investors. Firms have an obligation to provide regulatory reports, trade reports for the purposes of transparency and, although not a requirement of the directive, also have to provide settlement instructions. There is considerable content in common required for each of these reports, and key among these is the security identifier. We would urge CESR not to mandate a demonstrably unsuitable standard such as ISIN in this field and instead to look at the considerable amount of work that has been undertaken by the industry to find a common standard that would be useful to all three types of report and hence facilitate consolidated reporting solutions.

Transparency - innovation and development

Finally we feel it is important that CESR gives due regard to the necessity for continued innovation to meet the needs of investors. The mandates give CESR flexibility in certain areas, for example in determining an <u>appropriate</u> transparency regime. This will require setting proportionate waivers in recognition of the fact that optimal transparency does not equate to maximum transparency. CESR should be as flexible as possible in this area unless it identifies a specific regulatory risk that must be addressed - any unnecessary additional regulation or onerous transparency obligations that CESR imposes will reduce the ability of markets, firms and other market participants to develop new products and services to meet investors' needs.

I hope that you find the attached paper useful in your deliberations and look forward to working with you to ensure that the legislation that the Commission produces works for European securities markets.

Yours sincerely

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Enclosure

Appendix – London Stock Exchange views on the mandate

3.4 Best execution obligation (Art. 21)

Given the removal of concentration rules from some markets we fully appreciate the importance of introducing a robust and practical best execution regime if CESR is to meet ISD2's twin objectives of protecting investors and promoting fair, competitive, transparent, efficient and integrated financial markets. There is an important balance to make between the two and we would urge CESR to ensure that it gives the latter objective sufficient consideration as its delivery will tend to promote the former.

To this end we fully support the Commission's assertion that there is a "need for a comprehensible set of criteria to be put in place to allow firms to determine whether they are complying with their obligations as well as to allow clients to understand execution policies" which is clearly a call for a best execution regime that provides certainty to both firms and investors.

3.4.1 Criteria for determining the relative importance of the different factors to be taken into account for best execution

CESR should pay particular regard to the Commission's call for certainty when considering its advice on these criteria. While price is certainly important to all investors, so is the need for certainty of execution and the need to minimise search costs for retail investors. We would therefore propose that CESR introduce a safe harbour for executions that achieve a benchmark price – this could be based on the price available on a liquid trading venue for that instrument – this will allow firms to concentrate on providing cost effective services that minimise search costs and therefore the total costs to end customers. This will allow competition between firms to flourish.

3.4.2 Trading venues to be included in the order execution policy

The annex calls for CESR to propose criteria for determining which venue is offering the best results on a consistent basis – we would urge CESR to be wary of taking too narrow a view of "best results" and to avoid judging performance on a trade by trade basis and instead focus on the development of a process by the firm that tends to produce better execution in all its facets, whilst looking after investor interests in each case.

CESR should also avoid prescribing a minimum number of venues to be accessed. Provided that customers are aware of a firm's arrangements and likely performance prior to dealing then a firm must be free to connect to as many or as few venues as it wishes – as long as it believes that it is offering a service that represents good value for the client. It might well be that a firm does not consistently achieve the best price available in the market but if, by minimising a private investor's search costs, it delivers a better overall result on a consistent basis then this should be encouraged.

3.4.3 Information to the clients on the execution policy of the firm

When providing information to clients on the execution policy of the firm, CESR should be aware that too much information is likely to confuse retail customers. The disclosure should be restricted to naming those venues to which a firm has access, in what circumstances and for what types of business it uses them along with a rationale. For example, where a firm has chosen not to connect to the central liquidity pool for a particular instrument or type of instrument then it should make sure that the client understands its reasons why and the likely implications.

3.4.4 Obligation to monitor and update the execution policy

There is obviously a need for firms to have arrangements to monitor their own performance on a periodic basis and to update their policies if it is clear that end customers are not receiving consistently acceptable results. We would advise against requiring periodic disclosure to the public and regulators on this matter as a similar requirement in the US leads to vast quantities of unintelligible data being published that serves little purpose other than to increase the costs incurred by firms which are directly passed on to customers. Rather, firms should be able to demonstrate to regulators, on request, that they have monitoring procedures in place. There are a number of IT applications commercially available that will allow firms to fulfil this obligation in a meaningful and cost effective way.

Clearly firms should also be required to inform their customers where there is a significant change to the execution policy in order that they continue to choose their service provider on an informed basis.

3.5 Client order handling rules

The client order handling rules, and in particular Article 22.2, are vital for ensuring that markets remain efficient, particularly given the conflicts of interest that are present when a firm that trades as principle is also asked to handle client orders. Accordingly, when considering the circumstances under which firms may depart from the obligation to expose orders we would, given these conflicts of interest and the need to protect the client's interest, be fairly restrictive. However, there are clearly circumstances where the general rule should be waived to protect the client's interests, the most obvious being when the immediate display of an order would result in significant market impact. The waiver should be restricted to large orders or where liquidity is so scarce that any type of display would have significant market impact.

3.6 Reporting of transactions (Art. 25 (3), (4), (5) and (5.a))

On the issue of regulatory reporting we would urge CESR to consider the practical difficulties involved in generating multiple reports for transactions and, while we appreciate the need for competent authorities to have access to regulatory reports in other member states, e.g. in the home state of the most liquid market for a security, we would ask that this access is facilitated through co-operation arrangements between competent authorities, rather than placing additional obligations on firms.

CESR should also aim to facilitate a "one stop shop" approach to reporting whereby market operators, MTFs and other transparency providers can act as reporting mechanisms, using the data collected to meet post trade transparency obligations to generate onward regulatory reports and settlement instructions on behalf of firms. If information is to be useful for all of these purposes then it is important that the issue of security identification is given due consideration.

CESR should pay particular regard to the range of securities identifiers that need to be specified within the trade and transaction reports and throughout the trade processing cycle. The area of unique securities identification is highly complex and has come under scrutiny of industry bodies such as the Reference Data Coalition[1] (REDAC) and the Reference Data Users Group (RDUG). If ISD2 is to facilitate genuine cross border trading the need to uniquely identify an instrument at the place of trade is of paramount importance.

For example, the ordinary shares of Daimler Chrysler AG have only one ISIN yet the shares are officially listed in 7 countries (with 1 SEDOL code per country of listing), traded on 22 exchanges and priced in 5 currencies. It is therefore essential that the security is identified correctly.

REDAC & RDUG believe that all instruments traded should have an instrument identifier that can meet the criteria of **uniqueness, timeliness and commonality**. They also contend that the identifier chosen needs to be relevant across the lifecycle of a transaction – from decision making to execution, through settlement, reporting, valuation and position keeping. In their discussion paper 'In Search of a Unique Instrument Identifier' (June 2003), they question the viability of the ISIN code as the standard as the global symbology for securities, stating that:

[1] REDAC is an international coordinating body of broker/dealers, investment managers, custodian banks and others designed to define the data elements and standards necessary to make global trade processing more efficient.

"the creation of the international standard ISIN (ISO 6166) essentially an embedded local identifier with a prefixed ISO country code, unified the format of a security identifier and paved the way for the communication of electronic securities messages generated for trading, settlement and registration. The underlying problem however is that the international standard (ISIN) alone is not sufficient for the automation requirements of STP. ISIN is a unique issue identifier, but is not always a unique security identifier. ISIN alone is not sufficient for unique identification because one ISIN can be shared among offerings in multiple locations where each offering may have slightly different characteristics that nonetheless have significant impact. Although the issue at the ISIN level is a fungible instrument the offerings across multiple locations are typically not immediately fungible – introducing real issues of risk and valuation."

In addition the Giovannini Group and G30 reports, highlighted that the lack of same day allocation and distribution of new instrument identifiers as one of the key barriers to creation of an adequate clearing and settlement infrastructure in global financial markets. Due to the number of National Numbering Agencies (NNAs), up to 65, it is felt unlikely that ISIN codes could be created and circulated with enough speed to prevent the need for dummy codes which cannot be used for the exchange of information between counter parties.

The ISITC[2] has set up a working group to consider the appropriate industry solution/framework for securities identification in a greater level of detail. It is suggested CESR considers the results of this review, with the roadmap due in June 2004, when making the decision with regards to the appropriate identifier.

3.7 Transparency obligations (Articles 28, 29, 30, 43 and 44)

Transparency has obviously been a key element of the negotiation of this directive and the level 2 implementing measures will be vital to ensuring its success. However, we would recommend that CESR avoids trying to dictate market structure. Instead, CESR should set common standards and principles that apply to a range of market structures with guidance as to how they should be implemented in specific structures.

[2] International Securities Association for Institutional Trade Communication

The mandate calls on CESR to take into account the necessity to "facilitate the consolidation of trading information so that all market participants could have an easy access to comprehensible and comparable information". This instruction places three clear demands on CESR:

- To create a framework whereby the market can develop products that will consolidate trading information but not to mandate any form of consolidated tape or particular messaging protocol;

- To ensure that trading information, whether originating from regulated markets, MTFs or investment firms that are subject to transparency obligations is comparable and made public on an equivalent basis; and

- To set minimum standards for the manner in which trading information is made public in a useful and understandable way.

3.7.1 Pre trade transparency obligations for Regulated Markets (Article 43) and MTFs (Article 29)

The mandate calls for CESR to opine on:

- the extent of the obligation placed on regulated markets and MTFs;

- where this obligation might be waived on the basis of type and size of orders; and

- where the obligation might be waived on the basis of market model.

However it is clear that this mandate does not ask CESR to consider the requirements that regulated markets or MTFs place on their participants with respect to the information that they must submit to the markets. This is properly left to the MTF or regulated market to determine when developing its trading services.

<u>Extent of obligation</u>

We see no reason for limiting the quote and order information, that a regulated market or MTF makes available for publication, to a minimum number or depth of quotes or orders. They should make all quote and order information for which transparency has not been waived available and market forces will determine how much or how little the wider market needs to see. This would likely include all firm quotes and non-executable limit orders. If regulated markets and MTFs provide all the data they have in their systems then onward vendors can determine how much or how little they choose to display on the basis of market demand.

Waiver of obligation for certain size and type of order

While there must be a general obligation to make order and quote information available for publication, there are clearly cases where, owing to size or type of order, regulated markets and MTFs must be free to delay from immediate publication. When considering this issue it must be remembered that all orders received by a regulated market or MTF are received on a voluntary basis. If inappropriate transparency is mandated for all regulated market or MTF order types, then firms will simply refrain from submitting them, potentially damaging overall market liquidity, reducing trading opportunities and driving firms to seek less transparent means for executing their business.

A good example of where this applies is the iceberg order, where only a predetermined 'peak' is displayed to the wider market. Clearly such an order is only entered on this basis (to avoid market impact). To demand that the whole order be displayed immediately would negate the value of the order type and firms would not enter their orders at all. Iceberg orders are used in a number of European markets and can be seen to enhance overall liquidity. Price formation is not damaged because firms that happen to execute against or through iceberg orders can only receive better prices than they were expecting.

As a more technical consideration, there is clearly no need to display immediately executable orders. The order being submitted is filled against those orders that are already on the order book on the basis of price-time priority. Any requirement to display these orders before execution could damage the interest of the investor as he would be subject to price risk.

Waiver of obligation for market models

When considering the basis on which pre trade transparency might be waived for certain types of market model we would ask CESR to consider the need for markets to be able to continue to innovate and develop trading services to meet the needs of all market participants.

While public limit order books have been extremely effective in European markets there may well be alternative trading methodologies that are more effective in certain circumstances, and that meet the objectives of efficient markets and investor protection that ISD2 is committed to delivering. Crossing networks are an example of an alternative market model that have functioned effectively alongside transparent central markets to facilitate trading in very large size with little or no market impact. CESR should ensure that national regulators have the flexibility to work with market participants to develop new market models that also meet these objectives.

In summary:

- Regulated markets and MTFs should make available all quote and order information that is eligible for publication on a non-discriminatory, commercial basis for onward dissemination and consolidation by data vendors and directly to market participants that wish to receive it;

- Regulated markets and MTFs should be free to waive pre trade transparency for specific, non-transparent order types that encourage liquidity and do not harm investor protection; and

- Regulated markets and MTFs should be free to operate and develop market models without pre trade transparency where those market models can be seen to improve the efficiency of markets without damaging the interests of investors, although CESR should set standards to ensure that this is not abused.

3.7.2 Post trade transparency requirements for Regulated Markets (Article 44) and MTFs (Article 30)

Post trade transparency has, we believe, a far more significant role in price formation and market efficiency than pre-trade, providing as it does the prices at which business that has actually been transacted, a far more reliable indicator of the actual market value of a security than any quote or order. Accordingly we fully support the transparency provisions in Articles 28, 30 and 44, albeit with a waiver for large risk trades.

The mandate calls for CESR to determine the scope and content of the information to be made public and the conditions under which publication might be delayed.

<u>Scope and content of information to be made public</u>

The scope and content should include:

- price
- size
- currency indicator
- date and time
- security identifier

This information must be made public in a manner that allows consolidation with information from other trading venues and, as described earlier, a common security identifier must be decided upon which is a genuinely unique identifier – this will be of real significance for the consolidation of data where it is traded on multiple markets and potentially in multiple currencies.

Conditions under which deferred publication of trades may be allowed

Delayed publication must be allowed for trades that are uncharacteristically large or risky for a particular instrument if firms are going to be prepared to commit risk capital. The challenge is to choose a level at which the investment firm will still be prepared to give the customer a good execution, whilst not depriving the market of too much information for too long a period. The threshold must be determined on the basis of the liquidity of the share. Clearly what is appropriate for an irregularly traded SME will obviously not be suitable for a constituent of the DAX or the FTSE 100. We would urge CESR to leave the precise determination of thresholds to national regulators, in conjunction with market operators and investment firms.

It is important that once a threshold has been set for a class of instrument, that threshold is applied uniformly across all venues within the EU in which it is traded. We would suggest that responsibility for setting the threshold could reside with the most liquid trading venue for that security, in conjunction with its home state regulator. That minimum threshold could then be applied consistently to all trading venues be they MTFs, regulated markets or investment firms – this is key if we are to avoid regulatory arbitrage.

If this is deemed too complex an arrangement then CESR should consider a framework whereby all European securities are assigned to a band based on their liquidity (e.g. liquid, semi-liquid, illiquid), with a different consideration threshold for each band. These bands could be set by CESR.

In summary:

- regulated markets and MTFs must make trading information public in a manner that is capable of comprehension and consolidation; and

- differing liquidity of securities may prevent a ´one size fits all´ approach, but once a threshold has been applied to a security it must then apply equally to all execution venues that trade it.

3.7.3 Post trade Transparency requirements for Investment Firms (Article 28)

The Commission's mandate under this heading calls for advice on the means by which investment firms meet their post-trade transparency obligations and the post trade transparency that is to be applied to types of transactions which are undertaken for reasons other than the current market valuation of the instrument.

Means by which firms might meet their post trade transparency obligations

ISD2 introduces choice of reporting venue for investment firms, allowing publication through regulated markets or MTFs, through the offices of a third party or by proprietary means. However, this choice introduces a number of significant regulatory risks that CESR must address.

Where firms choose to meet their obligation through regulated markets or MTFs that have admitted those shares to trading, those MTFs or regulated markets must make the details of those transactions public in the same manner as transactions conducted under their own rules and systems. Given the rigorous regulatory standards applied to regulated markets and MTFs, regulators can have the confidence that the information will be disseminated in a manner that is accessible by market participants and is received in a comprehensible and comparable manner. Regulated markets and MTFs also perform real time market monitoring, ensuring that the data they publish is reliable. Given the significance of trading data for price formation it is vital that market participants have confidence that the prices they – or their systems – see on the screen are correct.

The issues of access and data integrity become more important when considering the conditions whereby firms may make details of transactions public by means of the offices of a third party or by proprietary systems. It seems reasonably obvious that where a firm is publishing its own data there is a clear conflict of interest when it comes to making sure that data is accurate and widely available. Equally, where a firm is publishing through the offices of a third party there is no clear commercial imperative for it to apply the same exacting standards of monitoring to that data as that performed by regulated markets and MTFs.

We believe that that if these conflicts are to be addressed and if the market is to have confidence in the accuracy and comparability of the trading data that it receives then there is a clear need for a set of minimum standards that must be met by any organisation that wishes to provide transparency to trading information, be they regulated markets, MTFs, investment firms or data vendors.

These standards would determine the means by which these organisations make the information public - clearly publication of data on investment firms' websites would not be acceptable as this would be difficult and expensive to consolidate - and would require that firms (where market monitoring is not being performed by another entity, such as a regulated market or MTF) have that business monitored. This monitoring could be performed by a third party but we don't believe that an investment firm would be able to monitor its own business, given the potentially huge conflicts of interest.

Transactions involving the exchange of shares for reasons other than current market value

The purpose of the post trade transparency obligations imposed by the directive are to ensure fair pricing of the instrument concerned by allowing the wider market to see the price which other investors have been prepared to pay for a specific quantity at a specific time. Accordingly, where there has been no change in economic exposure following share transfer – e.g. stock loans, collateral trades and delivery by value – the obligation serves no purpose with respect to price formation.

3.8. Admission of financial markets to trading (Art.39)

The directive places some obligations on what instruments regulated markets may admit to trading, most of which are enshrined in the other FSAP directives that deal with securities. The mandate calls on the CESR to advise on:

- The characteristics to be taken into account when assessing whether a security has been issued in a manner that allows it to be traded in a fair orderly and efficient manner and, in the case transferable securities, the conditions under which financial instruments are freely negotiable;

- The arrangements that a regulated market has in place to verify that the issuer complies with its obligations under the other FSAP directives; and

- The arrangements a regulated market has in place to facilitate access by participants to information that has been published under the directives.

Capable of being traded in a fair and orderly manner

The principle requirements on issuers of instruments on regulated markets are to be found in the FSAP directives. Therefore, while regulated markets may well wish to impose additional requirements on issuers in order to differentiate their offerings, they should not be concerned with duplicating the requirements of the directives.

Regulated markets should focus on ensuring that the instruments are capable of being traded in a fair and orderly manner. This would include a requirement that the instrument be admitted to trading on a platform that is appropriate for the particular instrument and that the instrument is capable of settlement, although regulated markets should be given flexibility as to how they meet these obligations.

Arrangements to ensure that issuer complies with obligations under the directives

The Prospectus, Transparency and Market Abuse Directives, all place responsibility for ensuring that issuers meet their obligations with the competent authority. Accordingly regulated markets, prior to admitting a security to trading, must notify the relevant competent authority of its intention to do so and receive confirmation that that issuer has met its obligations under the prospectus directive and is in ongoing compliance with the other two, or is capable of being so.

The competent authority, having been notified that a regulated market has admitted the security in question, should then notify the regulated market where it believes that the issuer is no longer in compliance with any of the directives. The competent authority can then co-ordinate suspensions across all regulated markets trading the security, if it feels that it is appropriate. Responsibility for ongoing monitoring and enforcement remains with the competent authority.

Access to information made public under the directives

When a regulated market admits a security to trading it should receive details of where the prospectus can be accessed from the competent authority. It should then provide details on its website.

The means by which the ongoing disclosures to be made under the Transparency and Market Abuse Directives are made public have yet to be determined and it is therefore difficult to frame the obligation to be placed on regulated markets. If the Council and Parliament are able to agree on the undoubted benefits of fast, simultaneous, pan-European dissemination of regulatory information it will be relatively straightforward for regulated markets to provide links to the relevant information on their websites. Should a lesser standard be agreed on, then regulated markets should direct interested parties to the websites of the relevant competent authorities and the companies' websites for details of where the information can be found.

In the case where an issuer's securities are traded on multiple markets ('parallel trading') the role of the competent authority is even more significant. The home competent authority must ensure that investors in multiple markets have access to the same information. This will, of course, be made easier if the Transparency Directive imposes an adequate obligation on issuers.

3.9 Obligation to co-operate (Art.56) and 3.10 Exchange of information (Art.58)

A genuinely integrated market will require co-operation between regulators if it is to be effectively supervised. A key element of this will be the exchange of transaction information. We would urge CESR once again to consider the issue of security identification codes and the amount of information that can be conveyed in this field. If competent authorities can agree to standards that include issue, register and market identifiers the data that is provided is likely to more meaningful to the interested competent authority.