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CESR'S DRAFT TECHNICAL ADVICE ON POSSIBLE IMPLEMENTING MEASURES OF THE DIRECTIVE 2004/39/EC ON MARKETS IN FINANCIAL INSTRUMENTS
2ND SET OF MANDATES
CONSULTATION PAPER - OCTOBER 2004
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RESPONSE OF EURONEXT

EXECUTIVE SUMMARY

Euronext is grateful for the opportunity given to reply to CESR's Consultation relative to the second mandate received from the European Commission on the Markets in Financial Instruments Directive. However, it is difficult to offer definite views on several issues since important elements to be taken into account are still being considered by CESR separately.

Determination of level II measures is indeed essential, as those measures must remain in line with the level I text "spirit" on the one hand, and specify the framework Directive so to render it practicable on the other hand. The challenge and general objective of creating an efficient and competitive European integrated financial market allowing for a level playing field for all operators must be kept in mind at every moment when determining implementing measures.
Therefore, the framework determined at level II should not be over-prescriptive, but to the extent possible simple, practicable and flexible. In addition, simplicity and clarity will be crucial in order to avoid divergent implementations at a national level.

Consequently, Euronext's reply to CESR focuses on the following issues:

First, as concerns the definition of the "systematic internaliser", we would be more favorable to a qualitative definition, notably based on the "availability" and "consistency" of the service offered by the investment firms to its clients. Quantitative criteria would indeed be too inflexible and might not be representative in all cases, especially as concerns the determination of the "frequency" of this activity. Moreover, the approach of CESR has to be properly calibrated since several of the requirements established by CESR in that respect could be met in the case of both "systematic" and "non systematic" activities.

Considering the activity of the systematic internaliser, we consider it is important to find at that stage a right balance between the necessity of ensuring a fair price formation as well as an appropriate level of market information, and the need to provide a practical approach. In that respect, we believe that regulation in the field of transparency for both investment firms and regulated markets should remain flexible in order to allow for future evolutions and for innovation; this consideration should be taken into account in CESR's advice.

With respect to the notion of "liquid shares", our opinion is that the definition of "liquidity" should once more be rather simple and practical, for the benefit of all market participants. Moreover, the related calculations should be based on objective and representative data, on an EU-wide basis, and include as much as possible data from all types of execution venues and OTC trading to be relevant. We would suggest to retain absolute criteria to characterize such "liquidity", the turnover (in value) being the most representative one, potentially combined with other parameters (e.g. freefloat, number of trades). A proxy such as the inclusion in an independent index may also be a useful indication of liquidity in case of doubt or lack of data.

Finally, we would also advocate that sufficient time should be foreseen and allocated between the adoption of the specifications of the level II measures and implementation of such texts, in order to allow the industry to prepare and settle, in a practicable delay, the necessary arrangements required by the provisions of the level I & II texts.

DETAILED COMMENTS

INTERMEDIARIES

Execution only (Article 19.6) - p.48

All derivatives instruments should not be excluded *a priori* from the definition of "non-complex instruments" for the purpose of Article 19.6 of the Directive, i.e. in order to allow firms to provide execution and/or reception and transmission of clients' orders without the need to obtain further information regarding their knowledge and experience in the investment field relevant to these products. Indeed, certain derivative instruments may be considered as non-complex at present and the perception of complexity is likely to evolve over time. Flexibility is therefore needed.

Transactions executed with eligible counterparties (Article 24) - p.53

As concerns the transactions executed by investment firms with eligible counterparties, we consider the advice proposed by CESR regarding the opt-in and opt-out regimes as appropriate. The defined "opt-in" regime does not call for any specific comments, as it offers the eligible counterparty "per se" a complementary protection foreseen by the Directive, giving this entity the benefit of the conduct of business, handling of clients orders and best execution rules if it wishes to be treated as a client.
CESR's proposals for the "opt-out" regime seem to offer a fair level of protection to the undertakings not being "eligible counterparties" *per se*, but willing to be treated as such, either on a general basis or for a specific transaction or type of service.

Regarding the quantitative thresholds fixed by CESR as a requirement to be considered as an eligible counterparty, we believe they should be equivalent to those used to define the "professional clients".

MARKETS

Display of client limit orders (Article 22.2) - p.58

We agree with CESR's advice as regards the criteria to be fulfilled to comply with the obligation of article 22.2 of the Directive, i.e. to make public a client limit order which is not immediately executed. This type of orders should indeed not only be visible to other market participants, but also easily and rapidly executable once market conditions allow.

In that perspective, order driven Regulated Markets and MTFs running a public order book would be appropriate means of publishing such orders, given that they ensure the necessary visibility and capability of execution; indeed, orders are both visible and directly accessible on those systems. As for quote-driven systems, they should demonstrate that they fulfill these obligations in an additional manner as they may not *a priori* offer adequate arrangements. Other types of venues would also be appropriate, as long as they offer the same compliance with the principles determined by CESR (i.e. visibility, “executability”).

Finally, it is essential that the choice of the venue and moment to display a non-executed client limit order should be done by investment firms following the “best execution” obligation principle, i.e. on the most favourable terms for their clients; therefore, it would be useful that the arrangements used by the firm in that respect be included in its order execution policy.

Pre-trade transparency - Definition of Systematic Internaliser - p.61

We consider that the proposed advice and the criteria set out by CESR regarding the definition of “systematic internaliser” are globally appropriate.

Should indeed be considered a “systematic internaliser” an investment firm that engage in internalization as a matter of “deliberate and regular policy”.

We agree that an indication that the firm is a systematic internaliser would be given by:

- the use of a business model in which internalization has a commercial role, what we understand as meaning that it is identified as a specific service which is part of the offer of services to the firm’s clients;
- the existence of rules, protocols, procedures and/or practices governing the internalization process;
- the assignment or use of personnel and/or automated technical system for carrying out internalization, whether or not exclusively for that purpose.

Moreover, in our view those criteria should definitely be considered collectively in order to characterize a systematic internaliser. However, we are not certain that this approach would leave sufficient room for investment firms to act on their own account in a non-systematic way since several of the requirements established by CESR in that respect are likely to be met in both cases, “systematic” and “non-systematic” activities. This approach has therefore to be properly calibrated.

We also feel that qualitative criteria would be more appropriate than quantitative ones to define the notion of “frequency”, as we believe figures would be quite difficult to determine and inflexible. In that respect, we would think useful that CESR’s advice specifies that the frequency would be characterized by the “availability” and “consistency” of the service provided by the investment firm.

Pre-trade transparency - Scope of the rule (Article 27.1) - p.64

Considering the question of the pre-trade transparency required from systematic internalisers by Article 27.1 of the Directive, we fully share the opinion that CESR’s prescriptions should respect a balance between the necessity to ensure efficient pre-trade transparency and the need to take into account the risks borne by internalisers. It is important that the proposed framework does not undermine the provision of liquidity by market participants.

Defining the “liquid shares” to which the quote disclosure obligation will be applicable is definitely not an easy task, taking into account the variety of securities markets and systems/models in Europe. For us, it appears key that the definition of the “liquidity of shares” that will be used for the purposes of Article 27.1 should be simple, practicable and representative on a EU-wide basis.

As regards the method to determine what is a “liquid” share for which quotes need to be disclosed, our preferred option is a combination of absolute criteria, such as for example the daily average turnover (in value), number of transactions and freefloat. Among the other criteria suggested by CESR, proxies such as the inclusion in an independent and diversified index could make sense and have the advantage of simplicity; alternatively, it would even be possible to apply the calculation methods of such index. This type of proxy could be used as a temporary solution in case of doubt/lack of data.

Consideration of market capitalization for each share would also be an easy criterion; however, we feel it is too approximate, as free float should also be taken into account to provide a fair idea of real liquidity (which would be too complicated as there are several methods for calculating the free float). A selection of shares based on accumulate turnover wouldn’t be relevant, as the existence of a single strong share in certain markets could distort the results.

We believe that the data in relation to those calculations should be collected on an EU-wide basis, in order to remain in the Directive “state-of-mind” i.e. creating an integrated European financial market and a level playing field for all participants. We share CESR’s view that all shares, once determined to be liquid, should then be considered as such in all Member States.
In any case, and whatever the method chosen to characterize liquidity in the context of Article 27.1, it is important that the resulting number of liquid shares in Europe is sufficient to fulfill the objective of pre-trade transparency (i.e. ensure a competitive price formation, imply lower search costs for participants, help integrate separate pools of liquidity), but only captures truly liquid shares and remains practicable for investment firms.

Determination of the Standard Market Size/ Classes of shares (27.1 and 27.2) - p.69

We concur to the view that the determination of the classes of shares prescribed by Article 27.1 of the Directive is to be done in a way that both ensures a number of classes manageable for systematic internalisers and allows for a representative standard market size to be established for all shares within each class. It is essential that these classes reasonably reflect the different levels of volumes/trading of the various liquid shares.

Nevertheless, and until CESR’s work on related issues such as “orders large in scale” is not completed, it remains difficult to determine a precise position and answer on the number of classes of shares that would be relevant.

Revision of the grouping of shares on an annual basis seems acceptable and sufficient, especially when “ad hoc” revisions are foreseen in the case of extraordinary events to ensure that classification reflects the appropriate SMS for the share question.

CESR’s proposal concerning the publication of the classification of shares - i.e. on the website of each competent authority - is appropriate from our point of view. Gathering the whole data into a single point, e.g. CESR's website, would be the ideal solution for publication, as it would offer market participants a simple access to a complete overview of the classes of shares.

Article 27 foresees that "the standard market size for each class of shares shall be a size representative of the arithmetic average value of the orders executed in the market for the shares included in each class of shares". We would like to highlight the necessity to see the term "orders executed" clarified by the European Commission at level II, as it is ambiguous and might thus be differently interpreted, generating different figures.

We agree with CESR that the arithmetic average value of the transactions should be calculated on the basis of the data on all trades made in the EU on the said share - excluding orders large in scale -, that is to say on the various types of venues (regulated markets, MTFs, internalisers), and OTC as much as the figures are known. A period of 12 months would indeed be appropriate for the calculation, knowing that the data coming from regulated markets would probably be solely used for the first calculation in the transitional period, as no EU-wide data will have been collected/be available.

The standard market size should be fixed as monetary value, and not as number of shares, as European markets indeed usually use these parameters. Nevertheless, as the quote size can be freely determined below the standard market size, a quote could be set in a round number of shares.

Calculations relative to the standard market size will be done excluding the "orders large in scale compared to normal market size" from the scope of data retained for a said share, according to Article 27.1. We believe it is appropriate to consider on and off regulated markets' and MTFs' trading to define orders large in scale.
Furthermore, it might seem theoretically relevant to adopt different sizes of "orders large in scale" as concerns pre-trade and post-trade transparency requirements, as the implications are not the same in both situations. Nevertheless, we believe it wouldn't be problematic to consider a single size of "orders large in scale" for both pre-trade and post-trade transparency provisions, as a matter of simplicity and practicability.

In the case of IPOs, and in order to allow a new share to be traded through systematic internalisation as well as on the market and potentially on MTFs, in a way ensuring fair price formation and investors' information, we believe that it would be reasonable to identify for the share a provisional class based on the initial standard market size from the first day of trading, complemented with foreseeable trading based on the performance of stocks having similar characteristics. Given the uncertainty of the situation in such case, flexibility would nevertheless be necessary: the standard market size should therefore not be set at a too high level and should be subject to possible review in due time.

Obligations of the Systematic Internaliser - p. 75

The publication "on a continuous basis" should be completed when the investment firm will publish quotes 100% of the normal trading hours set for the internalisation activity.

As concerns the "accessibility", we would advocate for a publication through means ensuring effective and easy public access (e.g. the offices of a third party such as a data vendor, the facilities of a regulated market etc…). Under certain conditions, such as that the quotes are easily accessible when entering the website, publication on the website of the investment firm could be envisaged.

As regards the requirement that the systematic internaliser should publish prices reflecting prevailing markets conditions, CESR envisages prices “close to comparable quotes on other relevant markets”, considering as “relevant” the execution venues included in the internaliser’s execution policy. This proposal seems acceptable, taking into consideration the provisions of Article 21.3 of the Directive which states that the execution policy “shall at least include those venues that enable the investment firm to obtain on a consistent basis the best possible result for the execution of client orders”.

Systematic internalisers are entitled by the Directive to update their quotes at any time, and to withdraw them under exceptional market conditions.

An internaliser should not only be entitled to update its quotes where the market conditions change or it comes across new information which changes its view of the relevant share but as often as it wants.

Regarding withdrawal, we are of the view that there should be an open list of “exceptional circumstances” allowing for withdrawal, held by competent authorities and to be completed by them on a case by case basis; such list should be sufficiently wide and open to include situations unforeseeable/unknown as of today. In particular, the suspension of trading on a regulated market, as well as being outside the trading opening hours of regulated markets, would be relevant circumstances for allowing withdrawal of quotes published by systematic internalisers.

We do not believe that the situation where a systematic internaliser would become the trading venue with the largest turnover in a particular share is very realistic in practice as concerns liquid shares. However, if this situation was to happen, we do not see the need for measures in addition to those of article 27.

Handling of client orders and executing the orders - p. 79

CESR’s mandate finally aims at precising a number of the Directive’s provisions relative to the handling of the clients’ orders and the execution of these orders.

First, in case the systematic internaliser publishes multiple quotes in a number of different sizes for a particular share, Article 27.3 of the Directive foresees that it is entitled to execute an order it receives between these sizes at one of the quoted prices, in a manner which is compliant with “best execution”. We endorse CESR’s position that there is no real need to further precise these provisions, as the best execution principles of Article 22 are indeed to drive this handling of orders by investment firms.

In case where volume of orders considerably exceeds the norm, Article 27.6 provides for the systematic internaliser a possibility to limit its exposure from multiple orders and the total number of transactions from different clients. We find CESR’s advice appropriate and sufficient, when precising that internalisers should develop an internal policy relating to the number/volume of orders that it can manage prudently without exposing itself to undue risk (the choice of number and/or volume of orders being left to its own discretion).

An exemption from executing orders at the quoted price is provided by the level I text, for certain orders received by the systematic internaliser from professional clients (i.e. transactions where execution in several securities is part of one transaction, or orders subject to conditions other than market price). We do not have any objection to CESR's proposal regarding portfolio transactions.

But we do not fully endorse the interpretation of the second exemption that is done by CESR. Indeed, concerning the "orders subject to conditions other than current market price", the advice should be more nuanced. Almost all existing types of orders would be covered by the wide definition currently given by CESR (i.e. "orders other than those containing a simple instruction to buy or sell immediately at the best available price…or at a specified price when the market price permits"). Current market price orders should only cover orders for which immediate execution against market price is possible, i.e. market orders and marketable limit orders or equivalent orders.