Bundesverband
Öffentlicher Banken
Deutschlands

Committee of European
Securities Regulators (CESR)
11-13 avenue de Friedland

F-75008 Paris

Name: Dr. Annette Maas
Telefon: +49 30 81 92 - 2 52
Telefax: +49 30 81 92 - 2 58

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Draft Technical Advice on Possible Implementing Measures of the Directive 2004/39/EC on Markets in Financial Instruments - 2nd Set of Mandates – CESR/04-562

Dear Madam or Sir,

We welcome the opportunity to comment on CESR's Consultation Paper "Draft Technical Advice on Possible Implementing Measures of the Directive 2004/39/EC on Markets in Financial Instruments - 2nd Set of Mandates". The Association of German Public Sector Banks, VÖB, is one of the main associations in the German banking sector. The VÖB has 62 members, including the central savings banks/giro institutions (Landesbanken/ Girozentralen), federally and state-owned special credit institutions and stock exchanges.

As a member of the ZENTRALER KREDITAUSSCHUSS (ZKA), the VÖB has contributed to the ZKA's comments on the present consultation paper. We fully support these comments, but would like to emphasise one issue that is of special importance to us:

Art. 22 (2) MiFID requires to facilitate the execution of client limit orders, which are not immediately executed under prevailing market conditions, by making it public in a manner which is easily accessible to other market par-

Lennéstr. 11 • 10785 Berlin
Postfach 11 02 72 • 10832 Berlin
Telefon (030) 81 92 -0
Telefax (030) 81 92 -2 22

ticipants. This obligation can be fulfilled by transmitting the client limit order to a regulated market (RM) and/or MTF.

In this context CESR states that the RM or MTF has to run a "public" order book (box 13). The transmission of the limit order to a quote driven market would not fulfil this obligation unless a special mechanism is introduced. CESR reasons that a client limit order has to be made visible to other market participants ("visibility") and be easily and rapidly executed once market conditions allow ("accessibility") to reach the target of Art. 22 (2) MiFID.

The term "public order book" does not seem fully clear to us. An order book, where market participants or investors can see every order, would be an "open" order book in our terminology. The obligation to transmit a client limit order only to markets with an open order book, is not acceptable for German public sector credit institutions and German stock exchanges and is not necessary to reach the target set by Art. 22 (2).

For decades, price determination in the most market models of German stock exchanges has been conducted by market members acting as market personnel ("Skontroführer") by means of closed order books on the basis of the principle of continuous auction trading. A member of this market personnel is authorised for the price determination of a specific security. He or she is committed to strict neutrality and all operations are constantly supervised by the Trading Surveillance Office ("Handelsüberwachungsstelle", "HüSt"). The Trading Surveillance Office records and monitors every single price-determining procedure. Additionally, the supervisory bodies in charge of overseeing the exchanges as a whole also monitor these procedures. Sanctions are imposed on members of the market personnel who violate the rules for price determination. Statutory provisions ensure that the members of market personnel are impartial in their work. The exchange supervisory bodies also monitor the extent to which members of market personnel are invested in the securities they determine prices for. Limits on their holdings have been established.

The process of price determination begins with the collection of all buy and sell orders in the electronic order book, to which only the assigned market personnel authorised to determine prices in the respective security has access. Prior to the actual price determination, the market personnel discloses an indicative price range (so called "Taxe"). On the basis of the current order book status, the "Taxe" informs the market about the bid and ask offers, between which the price of the security can be determined. With the entry of the indicative price range into the exchange's computer system, the information is immediately displayed and accessible to *all* investors, regardless of whether or not they are admitted to trading at the exchange. They can therefore react and if need be, (re-)adjust their orders in due time, in accordance with the liquidity in the respective security, before the price is determined. Investors, who have not yet given an order to that market, can decide – on the

basis of this indicative price range – whether they place their order at a specific exchange or an electronic trading system.

For the purpose of actually determining the price, the market personnel "locks" the order book, in other words, no more buy and sell orders are accepted. The price is then determined, based on all the buy and sell orders currently represented in the order book. The fundamental rule of price determination is the principle of "maximum execution", i.e. the price to be determined is the one which will allow the greatest turnover of shares/securities with the least carryover of unexecuted trades.

For further details concerning the system of price determination of securities in Germany, please see the enclosed Principles of Closed Order Book Price Determination.

The process described above ensures that all investors have the same level of information. Furthermore, the indicative price range gives investors the necessary information for the selection of the platform and the operation of their orders. Retail investors can even place unlimited orders in less liquid securities, because, due to the closed order book, professional market participants cannot take advantage of the situation and the retail investor's order is processed at a fair market price.

Considering this, we are of the opinion, that the visibility and accessibility of a client limit order transmitted to a RM/MTF with a closed order book is ensured, when it uses the price determination process described above. The indicative price range given by the market personnel makes the order visible to all investors. In addition, the client limit order can be easily and rapidly executed once market conditions allow it, because the market personnel is obliged to execute the order once it becomes executable.

Therefore, to achieve "visibility" and "accessibility" it is not necessary to transmit client limit orders to a RM or MTF using an open order book. What is more, it would be to the disadvantage especially of retail clients, if price determination on the basis of a closed order book were not possible in the future. An order book should only be "public" in the sense that the market using this market model is fully supervised.

Besides, CESR's draft advice exceeds the provision of Art. 22 (2) MiFID which only requires the transmission of a client limit order to a RM or MTF. Hence, we suggest to modify the wording of box 13, No. 2:

> "2. Notwithstanding the provisions under No 1, the obligation would be met where the limit order is sent to a Regulated Market (RM) or a Multilateral Trading Facility (MTF)."

We would be grateful, if you would take our comments into account. Should there be any queries, please do not hesitate to contact us.

Yours sincerely,
Bundesverband Öffentlicher Banken Deutschlands

Oliver Görke Dr. Annette Maas

Enclosure
Principles of Closed Order Book Price Determination

Principles of Closed Order Book Price Determination

The discussion surrounding the future measures for implementing the Markets in Financial Instruments Directive (MiFiD) has made it clear that there is evidently a considerable need for clarification regarding the market model of "closed order book trading" by market members acting as market personnel (so called "Skontroführer") authorised for price determination in a specific security. The guiding principles as well as the technical procedures of this market model which has been long established in Germany and especially predominates in floor trading are thus described and explained below.

General Characteristics

The market model of closed order book price determination is based on the principle of *continuous auction trading*. All buy and sell market and limit orders are first collected in the electronic order book, to which only the assigned market personnel authorised to determine prices in the respective security has access. In performing this function, he is bound to the strictest neutrality and is under the constant and closely scrutinised supervision of the Trading Surveillance Office ("*Handelsüberwachungsstelle*" or "*HüSt*" for short) at the respective stock exchange.

Operational Procedure

Phase I – Order Placement

Orders can be placed either verbally (on the floor or by telephone) as well as electronically through the exchange's order routing system, thus avoiding any discrimination in the way that orders are placed. An order entrusted to a bank by an investor who is not admitted to trading on the stock exchange is immediately electronically entered in the order book. Floor traders who place verbal orders with the market personnel, which are then entered into the order book by the market personnel via the exchange's computer system, are therefore not put in any type of privileged position.

Phase II – Market Information

Prior to the actual price determination, the market personnel discloses an indicative price range (so called "*Taxe*"), which informs the market about the bid and ask prices based on the current order book status, between which the price can be determined. This indicative price range is necessarily *not* "firm", since it is based on a "snapshot" of the momentary order book status, which can change continuously up until the time of the actual price determination.

As opposed to displaying a theoretical equilibrium price, the investor is informed indirectly, via the spread of the indicative price range, as to how the buy and sell orders are distributed in the order book. With the entry of the indicative price range into the exchange's computer system, the information is immediately displayed and accessible to *all* investors.

Based on the information provided by the indicative price range, all investors, regardless of whether or not they are admitted to trading on the exchange, can therefore react and if need be, (re-)adjust their orders in due time, in accordance with the liquidity in the respective security, before the price is determined. On the other hand, for an investor just coming to the market, the indicative price range serves as a basis for deciding whether to place his or her order with the market personnel at a specific exchange or whether to place it in the electronic trading system alternatively.

Traditionally and in accordance with the stock exchange regulatory framework, the market personnel is obliged to submit a binding offer on the basis of the order book status by open outcry to the traders on the floor or in response to an enquiry from a market member. The market personnel can – and generally will – refrain from doing so if there is no apparent demand for this on the floor.

Given the major structural changes taking place in floor trading, which practically no longer exists in the strict sense of the word, the offer by open outcry has for all practical purposes entirely lost its importance. Its

original function of generating liquidity has been very largely replaced by the combination of the electronically published indicative price range and electronic order routing.

Against the setting of today's modern stock exchange infrastructure, the offer by open outcry is no longer a constitutive element of the market model. Today, an estimated 99% of all exchange prices are determined without offers being made beforehand by open outcry.

Phase III - Price Determination

For the purpose of actually determining the price, the market personnel "locks" the order book, in other words, no more buy and sell orders are accepted. The price is then determined, based on all the buy and sell orders currently represented in the order book at this time.

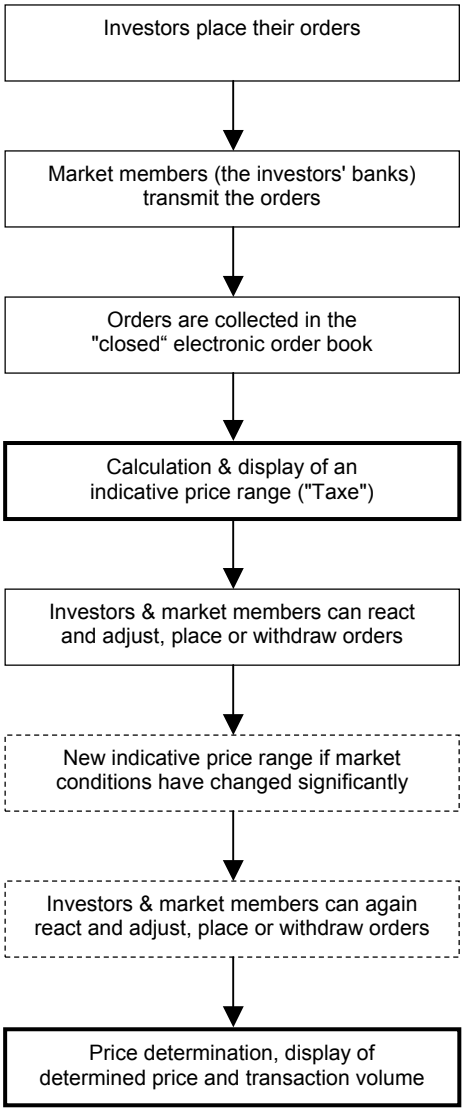
The fundamental rule of price determination is the principle of *"maximum execution"*, i.e. the price to be determined is that which will allow the greatest turnover of shares with the least carryover of unexecuted trades. If, on the basis of this principle, there is more than one possible price, the principle of *greatest possible price continuity* requires that the price determined should be the one that is the closest to the price that was last determined.

Example:

Volume	Buy (Bid)	Pricing	Sell (Ask)	Volume
(50)	104		106	(200)
(50)	103		104	(150)
(100)	102	**102**	102	(100)
(50)	101		101	(50)
(50)	100		100	(50)
(100)	98			

Each price that is determined is published together with the number of shares traded via the exchange's computer system and thus accessible to all investors.

Technical sequence:



Equal Treatment of All Orders and Market Personnel Neutrality

It is characteristic for auction-based price determination that all buy and sell orders, including market orders with no price limit, are executed at the one price regardless of when they were placed and the size of the order. This distinguishes the system from market maker systems as well as from forms of electronic trading where orders are executed according to a price/time prioritisation. As opposed to a conventional market maker

system, where the market maker pockets the bid-ask spread, thus leading to an inherent conflict of interests between investors – who are interested in the spread being as narrow as possible – and the market maker, who *ceteris paribus* strives for a wide spread, the market personnel acts as a neutral agent between the buying and selling side and thus guarantees equal and neutral treatment of all placed orders. In return, the market personnel receives a volume-based brokerage fee *(so called "Courtage")* from the seller and the buyer.

Market personnel acting as "Liquidity Providers"

In addition to the actual price determination, market personnel are also increasingly assuming the function of "liquidity providers" by voluntarily self dealing *("Selbsteintritt"),* "absorbing" the carryovers on the buy or sell side that can still exist upon application of the maximum execution principle. As liquidity providers the market personnel supports the market particularly in less liquid securities by increasing the marketability and negotiability of the securities and reducing the risk of costly partial executions.

The market personnel's act of self dealing is governed by a set of rules that again commit him or her to strict neutrality and prevent investors from being placed at a disadvantage by the market personnel's self-dealing interests. In particular, the brokering activities must take priority and the self-dealing may not have an accentuating effect on price developments. All transactions or trades that a market personnel voluntarily executes in the course of self-dealing are also subject to the constant and closely scrutinised supervision of the competent Trading Surveillance Office at the respective stock exchange.

Benefits of Closed Order Book Price Determination

While the market model of closed order book price determination shares the general characteristic of all auction systems by granting all investors a due response time in the pre-auction phase, the closed order book offers additional benefits, making it attractive in particular but not solely to retail investors, especially in trading less liquid shares:

While in an *open* order book environment the "costs" of market impact can be anticipated by investors, the attempt to drive the price in a specific direction incorporates a much higher risk when prices are determined on the basis of a *closed* order book.

As a result, the closed order book "protects" the orders of investors and increases their willingness to place both orders with wider limits[1] and market orders[2] alike, thus *ceteris paribus* increasing liquidity in a specific security. In addition it facilitates and enhances the willingness of the market personnel to act as a liquidity provider, since the amount of market risk he/she "absorbs" in the course of voluntary self-dealing won't be disclosed to the market, preventing other market participants from "playing" against his or her account under one-directional market conditions.

In accordance with these characteristics, it is not surprising that academic research seems to affirm the positive impact of closed order book price determination on market integrity. In fact, a recent global empirical analysis by Aitken/Siow[3] even comes to the conclusion that the closed order book market model offers the comparably best protection against price manipulation since the uncertainty about the trading volume required to optain a desired market impact detracts market participants from manipulative behaviour.

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[1] The closed order book mitigates the *"free trading option"* problem: In an open order book environment, limit orders can be viewed as providing the market with a free put (call) option to sell (buy) shares whenever new information arrives at the market which justifies a price lower (higher) than the stated limit.

[2] Especially in less liquid markets when a market order can not be executed instantly, an open order book could generate a *"second mover advantage"* for somebody placing a price-setting limit order which would enable him or her to extract value from the market order.

[3] Michael Aitken, Audris Siow. Ranking World Equity Markets on the Basis of Market Efficiency and Integrity, November 2003 (working paper attached to this document)