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CESR
The Committee of
European Securities Regulators
11 – 13 avenue de Friedland

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France

Munich, 14. September 2004

Consultation Paper on Possible Measures for Implementing Directive 2004/39/EC on Markets in Financial Instruments

Enclosure: Typology Paper "Closed Order Book", Depiction of Procedure during trading

Dear Madam,
Dear Sir,

Munich Stock Exchange is commenting below on the Consultation Paper containing CESR´s Advice on Possible Measures for Implementing Directive 2004/39/EC on Markets in Financial Instruments (Ref.: CESR/04-261b) – referred to hereinafter as "Consultation Paper".

The comment relates exclusively to the proposals made in Section III of the Consultation Paper on the compulsory opening of order books (marginal notes 3 and 9). The closed order book market model plays a major role in securities trading at Munich Stock Exchange and at other German stock exchanges, and should definitely be retained above all for the sake of protecting investors. A statutory obligation to open order books must be avoided.

As far as the system and sequence of securities trading in Germany are concerned, we refer to the enclosed typology and the diagram of procedure given in it. Munich Stock Exchange was involved in drafting this illustration. So as to avoid repetition, we expressly affirm its content.

All the same, the following points appear to us to be particularly important:

- Pre-trade transparency is still guaranteed in the closed order book market model. Before the price is actually determined, the market personnel informs the market by disclosing an indicative price range, stating bid and ask prices between which a stock market price might be fixed, depending on the current order book status. Apart from this, the market is also informed about the indicative size. Using this information, investors can make a sound decision on whether to buy or sell.

- The system of floor trading in the Federal Republic of Germany, with the closed order book market model as one of its main components, guarantees that a short-term lack of equilibrium in orders can be balanced out by market personnel able to enter into voluntary self-dealing, or by waiting a reasonable period before fixing the next

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indicative price range. Being able to go in for self-dealing, the market personnel also assumes the function of a liquidity provider (whereby selling transactions are subject to giving priority to the obligation to perform brokering activities, and to the prohibition of accentuating price developments). By combining information, waiting periods and intervention by market personnel, prices which are not in line with the market are avoided. A short-term lack of equilibrium in orders, in particular in non-high liquidity securities, is largely avoided. On top of this, discharging part-orders incurring correspondingly higher fees on the investor is extremely rare with the closed order book market model. Under an open order book system, such control and optimisation of pricing by neutral market personnel would hardly be possible, because the trading options compulsorily require the confidentiality of the order book status at this stage.

- The protection of private investors especially is guaranteed in particular by giving all groups of investors equal treatment. Information which may be gathered from an order book open to all would primarily be exploited by "professional" investors equipped with suitable software, whilst private investors would find it hard to make use of this information. With the closed order book system, private investors who are in particular need of protection are protected from professional investors taking advantage of the fact that they have more knowledge. This makes it more difficult for players thus making use of the order book status to manipulate the market. In addition, price determination is supervised by the Stock Exchange Trading Surveillance Office and the Stock Exchange Supervisory Authority in the respective federal state. The Free State of Bavaria therefore supports our view.

For the sake of protecting investors and market integrity, we therefore urgently ask you to refrain from prescribing compulsory disclosure of the order books. As far as we can see, a far-reaching opening of the order books in German securities trading would reduce the protection of private investors, the very market players in need of particular protection. This can hardly be the CESR's intention.

Yours faithfully,

A. Schmidt

Andreas Schmidt
General Manager

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.

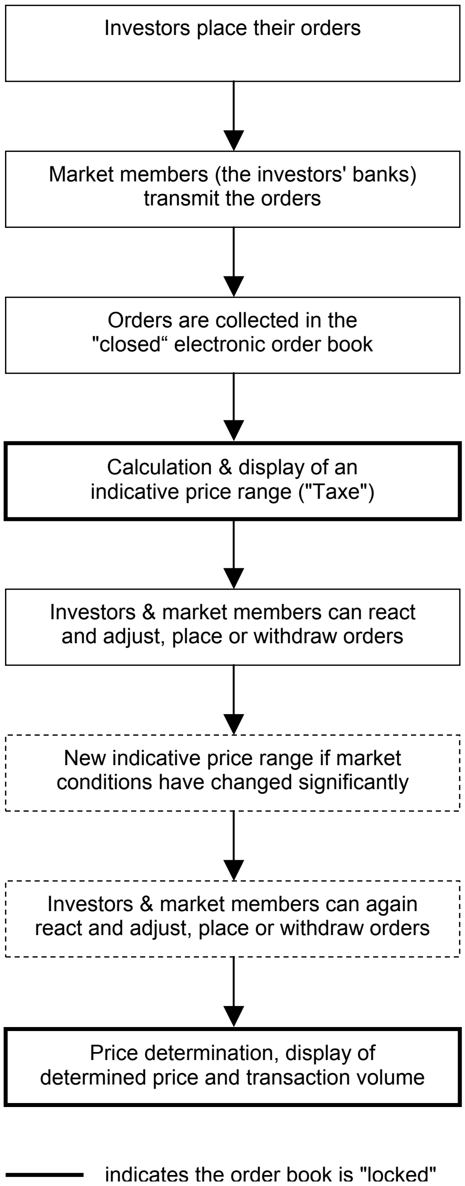
The fundamental rule of price determination is the principle of *"maximum execution"*, i.e. the price to be determined is that which will allow the greatest turnover of shares with the least carryover of unexecuted trades. If, on the basis of this principle, there is more than one possible price, the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