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Wissen wo man handelt

CESR
The Committee of European Securities
Regulators
11-13 Avenue de Friedland

75008 Paris
Frankreich

Stuttgart, 15. September 2004

Response: **Consultation Paper, CESR´S Advice on Possible Implementing Measures of the Directive 2004/39/EC on Markets in Financial Instruments (June 2004, Ref.: 04-261b)**

Dear Madam,
Dear Sir,

Börse Stuttgart (Baden-Württembergische Wertpapierbörse) is the second largest stock exchange in Germany with a current market share of 34% of German floor trading.

In particular, we would like to comment on the following item/answer the following question:

Section III - Markets

Question 12.2:
Is the content of the pre-trade transparency information appropiate?

To the clarification we would like to point to the system of price determination by order specialists (Skontroführer) in closed order books on all German stock exchanges which is not grasped in the Consultation Paper and makes in that context superfluous pre-trade transparency.

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Thanks to the closed order book and the fact that the order book specialist is the only party with knowledge of the order book situation, private investors can give unlimited orders for any class of securities without concern. Because of the rules and regulations on price determination in place at the exchanges, private investors can be confident that their orders will be executed at a fair price and that no professional market maker will take unfair advantage of the order. By denying professional market makers a look at the limits that have been set, closed order books clearly protect the private investor.

Numerous instruments cannot be traded without a closed order book. This is always the case when the issuer of the security also functions as a liquidity provider in the market.

The combination of closed order book and order book specialist is particularly important in the case of derivative securities (warrants, certificates, reverse convertibles) and fixed-income securities where the issuer of the respective security or a market-making financial institution is the key market player. The order book specialists and closed order books ensure that the issuer cannot exploit its market position, since the private investor and issuer should have the same limited access to information during the pre-trade phase.

Special order types that are not recognizable for the investor even in an open order book (e.g., iceberg orders) and that give an incomplete picture of the actual order book situation can cause underlying uncertainty among private investors.

Strict set of rules and regulations governing the price-determining procedures of order book specialists have been established by each of the German stock exchanges, which are governed by public law. The oversight bodies in charge of trading record and monitor every single price-determining procedure. The supervisory bodies in charge of overseeing the exchanges as a whole also monitor these procedures. Sanctions are imposed on order book specialists who violate the rules for price determination. Statutory provisions ensure that order book specialists are impartial in their work. The exchange supervisory bodies also monitor the extent to which order book specialists are invested in the securities they determine prices for. Limits on their holdings have been established.

In Germany, prices are determined by impartial, independent order book specialists on the basis of closed order books, under the constant supervision of the responsible supervisory authorities (trading supervision and exchange supervision). This combination of impartial order book specialist and close supervision ensures that the price-determining procedures are carried out in accordance with the regulations.

The release of price indicators provides the market, and with it private investors, with enough reliable information about tradable prices. Given the monitoring procedures in place, having order book specialists determine prices using closed order books represents a top-notch mechanism.

<u>Enclosure:</u>
Paper of Principles of Closed Order Book Price Determination

Yours faithfully,

Rolf Deml
Deputy Managing Director

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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.

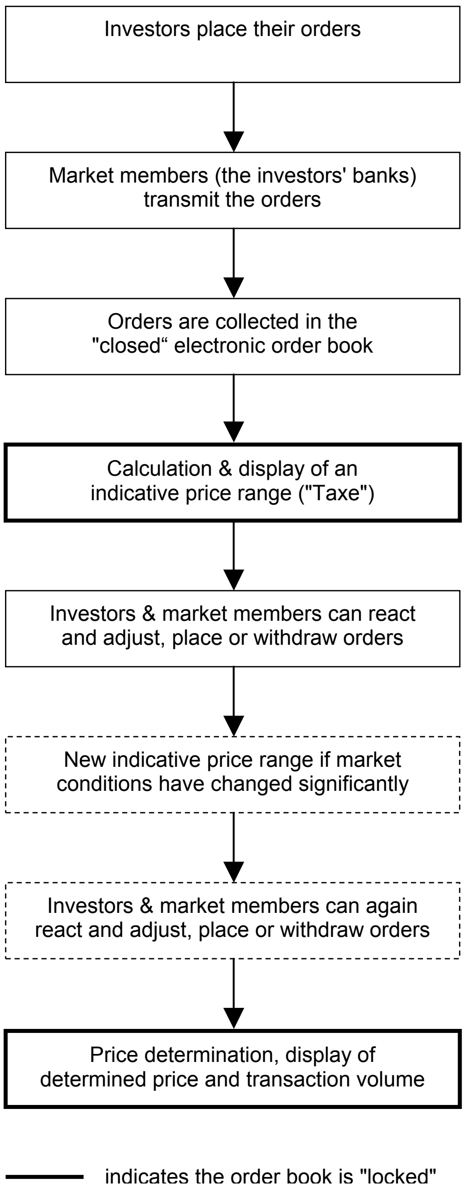
The fundamental rule of price determination is the principle of *"maximum execution"*, i.e. the price to be determined is that which will allow the greatest turnover of shares with the least carryover of unexecuted trades. If, on the basis of this principle, there is more than one possible price, the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

[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)