Van der Moolen Holding's Replies to Questions included in CESR's Advice on Possible Implementing Measures of the Directive 2004/39/EC on Markets in Financial Instruments

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The Raad van de Effectenbranche – the professional organization for non-bank Dutch investment firms – was unable to come to a unified set of recommendations on the topics under discussion in this consultation, so Van der Moolen Holding NV, as a member of the Raad van de Effectenbranche, is pleased to have this opportunity to respond, solely on its own behalf, to the specific questions contained in the text of this documentation.

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p. 13

1.1 The independence requirement is disproportionate to the requirements of customer protection and, we suspect, may in fact impede an effective compliance function. An emphasis on the personal accountability of the compliance officer, and an enforcement regime that serves as a stark reminder of the responsibilities the role entails, is almost certainly preferable. Personnel qualified for this function are neither inexpensive nor, in many jurisdictions, easy to find. Imposing a strict independence requirement on such personnel multiplies costs and risks isolating the function in a way that is likely to detract from its effectiveness.

1.2 We are inclined always to seek proportionality based on the *nature* of business transacted, but concerned about the idea of reducing compliance requirements based on the *scale* of the business in question. It is small comfort to an aggrieved party that the source of his grievance has not (yet) taken the opportunity to disadvantage numerous others, and it is not at all clear to us why customers of smaller service providers deserve less in the way of protection than customers of large firms.

Different financial services activities inherently entail different degrees of risk to their customers, and these differences bear no relation to the sizes of the firms offering the services. For example, it is quite possible that a merger advisor with three staff could, through incompetence or malfeasance, do far more damage to the interests of both issuers and investors than a 500-person agency-only fixed income brokerage.

We are extremely supportive of any effort to relieve smaller firms of unnecessary regulatory bureaucracy, but we feel that the correct way to do this is not to exempt them from best practices, but to reduce the burden of bureaucracy for *all* firms. As a broad guideline, we might suggest that any level of regulatory requirement that puts a disproportionate burden on smaller firms is *ipso facto* excessive regulation. If regulatory requirements are proportionate to the actual needs of customers, they will not unduly disadvantage smaller firms.

p. 14

1.3 We believe that CESR should be extremely cautious about extending the protections contained in Standard 127 beyond the scope of investment management. We believe that the third option mentioned in the discussion is far preferable to the other two.

European citizens must have the right to carry out business in jurisdictions that do not meet European investor protection standards if they wish to, and it would be peculiar to prevent them from using European regulated agents for such business. For example, it would be unacceptable for a European of non-European origin to be prevented from using a European firm as agent to sort out the consequences of a foreign inheritance. In that case his European agent should be able to use judgment in selecting a non-EU agent to accomplish its customer's goals; the European agent has a duty of care in selecting the local agent and monitoring its activities on its customer's behalf: that should be sufficient customer protection.

Arguably, investment management is a fairly unique service within the context of the securities industry, to which special considerations should apply. However, it is not clear to us that even sub-advisory roles within investment management should attract this degree of regulation: we strongly suspect that the advisor's duty of care in selecting and monitoring a sub-advisor is sufficient. It is quite clear to us that other financial services activities should not attract such a degree of regulation, and we advise that 9(b) be deleted.

p. 27

4.1 It is not logically possible to demonstrate a factual negative. In the nature of the case, <u>no attempt at such a demonstration can add to regulators' comfort</u>. It is unacceptable to put firms in a position where it is not possible in principle to fulfil a regulator's requirements, and consequently information requirements must be specified rather than left open ended. This is not to suggest that, when the regulator has suspicions of a firm, it is not empowered to demand any information required to allay those suspicions. But as presented here, this provision opens the door to ever-more-demanding routine requests for information – a situation which we, along with most other firms in the securities industry, believe has already gotten entirely out of hand in most EU jurisdictions.

4.2 We have no strong opinion on how long records should be retained or what they should consist of. However, we believe strongly that record-keeping requirements should be commensurate with the regulator's likely information needs. As issuance and merger activities (categories i and ii) should be a primary regulatory focus, the requirements here should be high. Since the contents of general financial advice to corporations (category iii) are not, by and large, a subject for regulation, record-keeping requirements in this area should be correspondingly light. Much of what falls under iii) is of an informal, discursive and contextual nature that would be difficult to specify or record, unwieldy to report according to fixed schedules or forms, and unlikely to reveal much to a reader who was not present at the conversation. This, certainly, is one area where paperwork can be avoided.

p. 32

5.1 The question as phrased begs the more fundamental question of whether any jurisdiction should be making such requirements in the first place. A partial regulatory opt-out risks institutionalizing regulatory practice which should not exist in the first place. Strict enforcement of the rule as written, without opt-outs, will serve to highlight the anti-competitive nature of such requirements in those jurisdictions that impose them. It is unclear to us why regulators who impose unacceptable practice should have the damage they do to their financial services competitiveness ameliorated: such opt-outs simply assist protected national champions in escaping the consequences of their unjustifiable protection.

p. 33

5.2 and 5.3 The phrasing implies that the investment firm has ultimate control over the disposition of the assets involved, which it frequently does not. It suffices that the investment firm reports where it <u>delivered</u> the assets. In 5.3, alternative (a) is clearly excessive.

p. 41

6.1 and 6.2 The fact that extensive use of examples is deemed necessary in this case is *prima facie* evidence that the regulation is inadequately specified. Further proliferation of examples will not repair this. In this context, alternative (a) under Question 6.2 is clearly to be preferred. Further specification (*i.e.*, in reference to (c)) should not be included in the Directive: the individual regulator should decide, and specify, what is sufficient to satisfy it.

p. 42

6.3 and 6.4 Much is made of the risk that analysts could "talk the firm's trading book" – *i.e.*, tailor their recommendations to suit the firm's trading position – but this is unrealistic, as a comparison of typical trader time horizons with the time required to prepare and issue a research report confirms. On the other hand, the trading desk should be well-insulated from foreknowledge of changes in analysts' recommendations: it is common practice, in advance of the issuance of a research report, for firms to build inventory/take a short position in the relevant issue, and this is <u>unquestionably</u> front-running. In this context, reviewing the research in a draft that excludes recommendation or target price (*cf.* (e)) is obviously <u>not</u> a sufficient protection. Otherwise, analysts should be kept at arms length from direct involvement in investment banking activities such as, equity issuance and corporate restructuring, but that need not be a matter of complete removal from these activities. Under 6.4, we believe the first alternative (a) is preferable.

p. 66

10.1 In Box 10, 8)b) is rather beside the point if the terms of the lending are not disclosed. The purpose of 8)b) is precisely to prevent investment firms from lending customer assets without notification and without sharing the proceeds of the loan. 16)c) should indicate that total transaction charges incurred are reported separately from other charges. Paragraph 19) would place inordinate burdens on managers of funds and similar commingled vehicles: it should specify that its provisions apply solely to separate account management.

p. 73

Q1 The Directive should make no such specification. Customers should be able to decide what is important to <u>them</u>, in consultation with their advisor if necessary. To protect itself, the investment firm should be permitted to create a "default" specification, provided that it informs its clients of this policy.

Q2 Again, it is the customer, not the firm, who should determine. In the absence of any indication from the customer, the firm may need to rank the factors, but then the firm implicitly accepts the burden of justifying its decision to its customer. The list as given seems adequate.

Q3 They may not only differ based on services, clients, instruments and markets, but the same client demanding the same service in the same instrument and market may have different needs on at different times. This should not be an area subject to centralized regulatory *diktat*. Again, the investment firm should be permitted to create a "default" specification, provided that it informs its clients of this policy.

Q4 We leave the burden of responding to firms that execute client business.

pp. 75 - 79

As a firm that does not for the most part execute client business, it would be inappropriate for us to answer these.

p. 84

Q1 The definition appears to be adequate and exhaustive to us.

Q2 It is rather difficult to imagine accepting an order from any source without this information, and unclear what other information might be necessary to carry it out.

Q3 Time stamping should be required, the accuracy of time clocks regularly monitored by the regulator, and records actually examined. If a regulator is serious about enforcing investor protections it has no other recourse.

Q4 It is extremely difficult to imagine what these conditions might be. If an investment firm is unable to determine the proper sequence of the orders it has in hand then it should be required, at the very least, to refrain from trading for its own account until they have been executed. We would actually go further: if an investment firm's order entry system is so chaotic that this sort of confusion arises, it should be required to fill all the customer orders it has confused at the best price obtained on any of them, and absorb any losses that might result. This advice, as written, is almost an invitation to firms to abuse customer orders when times get difficult, which is precisely when customers require the greatest protection.

Q5 No: where this possibility exists then aggregation should be forbidden.

Q6 Yes: if customers run any risk of being disadvantaged, they should be informed of the circumstances under which it might happen and given the opportunity to insist that their orders not be treated in this way. To avoid the confusion that an allocation procedure unique to each firm would create, the regulator should specify the procedure.

Q7 Absolutely not: own-account business should be rigorously segregated from customer business, precisely so that these issues (and the risk of disadvantaging customers as a consequence) do not arise.

Q8 No : why should institutional customers be forced, through lack of information, to accept conditions that are considered unacceptable to retail customers?

p. 90

12.1 We are rather concerned by point 6 in the advice. The rapid change in prices known as "quote flicker" is clearly undesirable, but any rule-making designed to prevent it is likely to create more problems than it solves – in particular, it is likely to add to uncertainty and further disrupt markets at precisely the moment when they are functioning poorly. Investors can avoid the uncertainties arising from "quote flicker" by entering their trading interest as limit orders. Electronic execution systems are not confused by a rate of price change that is incomprehensible to a human being, so the use of limit orders is adequate protection without introducing the risk of unintended consequences through rule making on the minimum time that quotes must be valid.

12.2 We have never seen convincing justification for any form of large trade exemption. In our opinion these are simply advantages enjoyed by certain firms at the expense of the market as a whole: eliminating them would cause broker-dealers to increase the discounts they offer on principal trades, thus increasing the cost to the investor of executing a large order against a broker-dealer principal, and, in all justice, that is where the costs belong. However, if there are to be such exemptions, the threshold for them should be set quite high, and should be based on average size of orders in the relevant instrument. Basing them instead on average daily volume will distort the picture for shares in which retail activity is unusually high or low, and basing them on estimated market impact is essentially the same procedure as basing them on average order size, except that it introduces additional uncertainties into the calculation. Assuming we are forced to accept such exemptions – and we reiterate that we regard them as unacceptable – we would argue that the threshold should be at least twelve times average order size, and that thresholds should be refreshed at least quarterly.

12.3 Yes.

12.4 No: see comment on 12.2.

12.5 Yes, yes and yes: crossing systems should be exempted.

12.6 If we are forced to accommodate such exemptions, then yes. The question does not address the issue of post-trade transparency for large trades: there is even less justification for such an exemption than in the case of pre-trade transparency.

12.7 See comment on 12.2: we believe that a method based on average size of orders is far preferable to any other method. See also comment on 16.3 below.

pp. 95 - 6

13.1 It is difficult to imagine any system other than trade-by-trade that would afford anything that might legitimately be regarded as "transparency."

13.2 Paragraph 21 omits any mention of systematic internalizers or of a requirement that reports should be made in real time. If internalizers are included within the scope of paragraph 21, then the market forces alternative mentioned in this question is sufficient.

13.3 As a minimum, yes, and provided that information is retained *somewhere* for longer periods, should access to it be required for regulatory or academic research purposes.

13.4 Absolutely not: what is "transparent" about that?

13.5 Yes and yes: sixty seconds is ample.

13.6 No: as stated, we are unaware of any convincing justification for delayed reporting of any kind or in any circumstances. As with exemptions from pre-trade transparency, this is simply to transfer risk from some firms to the market as a whole, with no compensating transfer of benefits. But assuming that such an exemption is made for principal facilitators, we see no reason to compound the damage by extending it to others.

13.7 Harmonization of security codes would at best be a minor convenience for regulators and the industry in the long run, although getting there is likely to be costly. Given that the current regime of identifiers suffices for the industry's purposes, we do not see the logic of such a proposal. Further, it is unclear to us why this is a regulatory issue or why it arises in connection with ISD revision. We do not believe that harmonized codes should be a priority for CESR or for the industry as a whole.

13.8 Improving the publicly available information on stock lending is desirable from both a practitioner and a regulatory perspective, but as a practical matter it is not clear to us how this could be accomplished at reasonable cost, or how, in Europe's current, fragmented clearing structure, quality of data could be assured. We are inclined to think that this is a topic that can better be addressed at a later date in connection with clearing reform.

13.9 No: we do not believe that this is an appropriate role for CESR and we believe that existing data dissemination utilities can find a way to accomplish the goal without CESR's help.

p. 100

14.1 The requirements as given seem reasonable and sufficient and we do not believe that additional requirements will add greatly to investor protections.

14.2 The requirements under paragraph 7 seem unduly onerous: surely the reporting obligation is on the issuer, not the RM, and the RM should have no liability for the accuracy of information it disseminates simply as a service to issuers and users. Making requirements of the issuer should be sufficient, provided that regulators do their job of enforcing them: it is inappropriate to shift the regulator's duty in this connection onto a third party.

pp. 104 - 5

15.1 Although competent authorities should make extremely sparing use of this exemption, they ought to be permitted the flexibility to grant it in special cases. Exemptions should be granted where it is agreed in advance between the regulator and the reporting entity that existing electronic reporting formats cannot accommodate a particular type of report, or where there is system failure. Otherwise, it is difficult to justify any exemptions.

15.2 We have no strong opinions on this matter, but in general, we believe that demand for a transitional regime is largely a matter of foot-dragging.

15.3 It is unclear to us why this is a regulatory issue or why it arises in connection with ISD revision. As a matter of principle, we cannot support calls for harmonization that are not preceded by a detailed analysis of costs and benefits.

15.4 Yes, we agree with the minimum conditions. We have few opinions on the other matters discussed in this question, but in general, we believe that if a reporting channel is deemed acceptable by the regulator, and if an investment firm submits its reports properly to that channel, then its regulatory obligations are fulfilled. If the reporting channel then fails in its obligations, the regulator always has available to it the sanction of removing its approval of that channel.

15.5 We have no further comments to make on this matter.

p. 110

16.1 and 16.2 We are inclined to think that the use of proxies could cause as many difficulties as it solves. The validity of a proxy must itself be justified, and given that market conditions change over time, justified continuously: examination of actual transaction data for the instrument concerned is a comparatively trivial matter for computer analysis. While we are aware that there may be cases where data availability or other factors constrain a straightforward analysis, on the whole it would be best where possible to examine actual market behaviour. The proxies mentioned in paragraph 8 are obviously flawed: the domicile of an issuer is in almost all cases irrelevant to the question in hand, while a "test" using the market in which an instrument was initially listed to a substantial extent defeats the point of having such a "test" in the first place.

16.3 and 16.4 We are concerned about establishing such procedures at Level Two: without extensive specification, the revision procedures are likely to lack nuance. The reference to "volume and/or turnover" in paragraph 15 is an indication: if one market trades € 1.5 billion of an instrument in numerous transactions, while another market is used to execute a single transaction of € 1.6 billion (a common situation in the United States), then which is the more liquid market? In answer to the last question of 16.3 and the whole of 16.4, we believe that goodwill and pragmatism among CESR members will give better results than detailed rule-creation.

16.5 We are inclined to think that the Mandate is unrealistic in its demand for such a degree of specificity at Level Two. There is little reason to believe that a detailed and comprehensive set of rules for such a new project can be in place *ab initio*. Since a certain amount of case-by-case improvisation is almost inevitable, why not bow to the inevitable and allow procedures to be worked out cooperatively over time? This would allow for greater nuance right from the start, give full recognition to the acknowledged difficulties of this topic, and allow for rules of thumb to be developed empirically.

p. 113

17.1 We do not see any advantage to substantial effort at harmonization in this area, but we do see the potential for substantial cost. The list in Annex A seems adequate and sufficient.

17.2 We are inclined to think that the benefits of harmonization in this area are unlikely to be very great, so the cost of harmonization should be examined very critically.

17.3 They seem reasonable to us.

17.4 It is our understanding that principal transactions are those that create or eliminate an economic risk on the part of the facilitating investment firm, and agency transactions are those that do not. However, for the purposes of such reports we would regard "matched principal" transactions as principal trades, since to do otherwise would invite questions as to the counterparty of what is reported as an agency trade, which would defeat the purpose of arranging a matched principal trade in the first place.

17.5 Development of an EU-wide investor identification system strikes us as an unacceptably ambitious, hugely expensive and open-ended initiative. We would argue strongly against such a proposal, on grounds of cost effectiveness and its potential to create significant problems if not run with extreme accuracy and efficiency. We do not foresee any significant benefits from the proposal, and certainly none that are commensurate with its costs and risks.

17.6 It would be welcome, in this as in other instances, if some serious consideration were given to what the purpose of collecting this information might be. Serious attention to the cost that the securities industry incurs in providing such information is overdue.

p. 124

18.1 This seems a reasonable, but perhaps not an exhaustive, list.

18.2 and 18.3 The criteria under paragraph 22(d) and those mentioned under paragraph 23 are potentially disastrous: they will almost certainly lead to confusion, excessive cost, jurisdiction-hopping and regulatory paralysis. We believe that the burden should be on CESR's membership to iron out among themselves, on a case-by-case basis, where and to what extent issues related to "substantial importance" arise – and in general we believe they should arise <u>very</u> <u>seldom</u>. We believe that a claim of "substantial importance" can <u>only</u> be justified on the grounds of internal security market considerations, and that arguments relating to shareholdership, level of employment, *etc*. are <u>entirely</u> irrelevant.

p. 130

19.1 Yes, they seem sufficient.

19.2 We agree, provided that there is any real point to the exchange at all. If the recipient does nothing routinely with the reports other than file them, then it is not clear why such a mechanism is put in place and surely occasional requests for data as a need to examine them arises would suffice. The cost of elaborate archival arrangements for information that is not in fact ever examined is unsupportable.

19.3 Cost benefit analysis: first, last and always.

19.4 Probably not. Surely some of these are matters of such minor detail that CESR members will be able to organize them without reference to such guidelines. A consideration of bilateral arrangements among the few CESR members that are in fact likely to make use of these provisions should be considered: for the majority of EU jurisdictions they are never likely to be very relevant.

p. 133

Q1 These are matters that we do not believe that CESR should need to consult on. However, we recognize the very real risk that they will be implemented with little regard to cost effectiveness and thus are likely to become a burden and issue for the securities industry. Before embarking on a program of extensive IT investment we would urge CESR members to consider the point of this exercise and to weigh the realistically achievable benefits to be derived from it. If this results in delayed implementation it is unlikely that the industry will object. Given the length of time that setting up such an IT infrastructure can take, the possibility of a lengthy implementation period is almost certainly appropriate.

Q2 The advantages and disadvantages are entirely dependent on what the system is used for, and since at present there is no indication of how it might be used – and based on current practice among CESR members, little indication that it would be used at all – this is difficult to answer. All of which serves to emphasize the need for detailed cost/benefit analysis. Our suspicion is that a realistic assessment would argue against major infrastructure investment.

Q3 We would hope that CESR can succeed in working sufficiently collegially that no formal dispute resolution mechanism is required. In particular, we would hope that CESR succeeds in establishing sufficient *esprit de corps* that, where a member seeks to arrogate powers to itself that are not justified by considerations strictly of securities regulation, that other members can effectively exercise moral suasion on it. Should the need for dispute resolution arise, we would take this as *prima facie* evidence of the failure of CESR. In our opinion, the function of CESR is to be an experts' group, and while we recognize that experts occasionally disagree, as experts they should be well equipped to resolve such disagreements. One way to avoid a formal mechanism, and a way of "giving teeth" to the idea of moral suasion, would be to put any such dispute to the vote among the membership, and to make public the nature of the disagreement and individual members' votes.

Van der Moolen Holding NV is grateful to have had this opportunity to offer these comments. The preparer of these comments would be happy to offer further clarification if CESR desires it.

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