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**RESPONSE TO CESR'S DRAFT TECHNICAL ADVICE ON POSSIBLE
IMPLEMENTING MEASURES OF THE MIFID: INVESTMENT ADVICE; BEST
EXECUTION; AND MARKET TRANSPARENCY - SECOND CONSULTATION
PAPER - MARCH 2005**

virt-x welcomes the opportunity to submit views on CESR's draft technical advice in respect of best execution and market transparency. We would be pleased to expand on any of the comments where that would be helpful to CESR.

We preface our responses to detailed questions with some overarching comments:

Best execution is an issue of very far-reaching importance: it is the core of investor protection. Periodic disclosure to clients on quality of execution is desirable but it must be made useful unless it is to become a bureaucratic burden of added cost without added value.

Many investors will have statistics published by a number of investment firms and they must be able to understand the significance of the various statistics to their own trading. However, armed with such information, it is unlikely that individual investors will switch brokers periodically based on the figures.

Therefore, ensuring best execution on a trade-by-trade basis is intrinsically more important than periodic disclosure.

Because of this, an investment firm must at least check relevant venues through a consolidated price montage. A venue must be regarded as relevant if it is material to the price formation process in a security and/or has the capability of providing the best overall result for a client execution.

Where the venue is not material to the price formation process, as for example in the case of RSP business in the UK, pre-trade transparency is not appropriate.

Our responses to some of CESR's detailed questions are attached.

CHAPTER 3: Best execution (Articles 19(1) and 21)

56. Question for Comment: Please suggest situations and circumstances in which a firm might satisfy the requirements of Article 21 while using only one execution venue.

A single-market benchmark is wholly inappropriate:

- technology improvements and market structure changes mean that consolidated price facilities are widely available
- a single benchmark reinforces the strength of an existing market which will not offer the best price at all times
- a single benchmark would favour one market over others without good reason.

The client's best interests cannot therefore be served unless a firm uses available technology to access all relevant venues.

Question for consultation: Do market participants consider that the distinction between internal and external costs is relevant? Does the investment firm have to take into account also internal costs? If so, which ones?

Our view is that incremental costs to be taken into consideration are those which:

- affect the final price for the investor and
- are knowable in advance of the transaction in relation to the execution venue and
- for the sake of practicality, are reasonably quantifiable.

The "implicit" costs (market impact and opportunity costs) should also be taken into account where relevant, and we agree with CESR that it is for the investment firm to judge the significance of such factors.

We recognise that the costs of direct access should generally be a matter for the investment firm (subject to the outcome of its review of execution venues). However, a firm must at least check other venues through a consolidated price montage or through indirect access to a market or other venue.

110 c) If firms are required only to make this information available upon request, would that address respondents' concerns about overwhelming clients with too much information?

We are concerned that the cost of providing information will outweigh the benefits which the client will derive from the disclosure. We therefore agree that information should be made available on request. The client's entitlement to ask for such information must of course be sufficiently prominent.

The information must be such as to answer a client's fundamental question: "does the firm have the right technological infrastructure in place in order to be able to achieve the best possible result for me?"

Whilst we support disclosure to clients, we consider that the firm's regulator has a very important role in ensuring that the firm complies with the provisions of Article 21 (1) and its requirement to get the best possible results for the client.

N/A. Additional comment from virt-x
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The draft Level 2 advice in Box 2 on page 22 sets out the proposed criteria which an investment firm must take into account in determining the relative importance of the factors listed in Article 21(1).

We recommend the inclusion of criteria related to the cost and efficiency of clearing and settlement; we would be pleased to provide detailed evaluation criteria on request.

CHAPTER 4: Market Transparency

Q 1.1: Do the revised criteria for assessing 'organised, systematic and frequent' better delineate the activity of systematic internalisation? If not, what further modifications would they propose?
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We believe that the qualitative criteria should be made more precise. We presume that an investment firm will wish if possible to avoid being categorised as a systematic internaliser; however, there seems to be scope for a firm to decide inappropriately that its activities fall outside the definition because, for example:

- it does not have a "separate" business model or
- the internalisation activity is not marketed as such or
- the activity is not made available to clients on a "continuous" basis.

Also, if the firm has a separate business model in which systematic internalisation has a commercial role AND non-discriminatory rules and practices governing internalisation, the provisions in the draft Level 2 advice would appear not to be applicable.

There may also be scope for the "safe harbour" to be used in an unintended manner. It appears that a firm may announce that it has ceased to act as a systematic internaliser in a security, and therefore benefit from the safe harbour, whilst continuing to engage without penalty in a type of internalisation which may fall outside the letter rather than the spirit of what CESR is seeking to achieve.

It is very important that identification of systematic internalisation should be conducted on a fair and consistent basis across Member States and we would welcome some guidance on how the identification process is expected to work in practice and how consistency and fairness will be ensured.

Q 1.2: Is the proposed use of a quantitative measure as an additional indicator useful?

We support the introduction of the quantitative criteria.

Since a yearly evaluation cannot be made to determine whether a firm should be subject to Article 27 from the date of implementation of the MiFID, and we doubt whether sufficient statistics are available to enable the calculation to be done effectively, some transitional arrangements will be required and these should be specified at the EU level and not on a national basis.

Q 2.1: Does the proposed approach to identifying liquid shares establish a sound methodological approach in the context of Article 27? If not, please specify (in sufficient detail) a modified or alternative approach and explain why it would be superior.

We have commented previously on the drawbacks of using free float as a criterion.

Apart from this, we generally support the methodology but we have concern at the proposed discretion for member states in applying the quantitative criteria. We would prefer the criteria to include more than 500 trades per day on average and/or an average daily turnover of more than Eur 2 million.

Given the importance of ensuring consistency across members states in determining whether a share is liquid for the purposes of Article 27, the calculation methodology must be defined in detail and be unequivocal on matters such as single/double counting.

Q 3.1. Do consultees agree with the specific proposals as presented or would they prefer to see more general proposals?

We agree with establishing specific proposals. We also recommend measures to enable adjustments to be made fairly and openly should the need arise.

Q 3.2. Is the content of the pre-trade transparency information appropriate?

We have some general comments as well as some specific comments in respect of paragraphs 76, 78 and 84:

General comments:

We consider that CESR's previous approach to the requirement to make public pre-trade information was correct in referring only to the information RMs or MTFs "advertised through their systems" under their rules.

We note that the advice has now been modified following consultation with the Commission and within CESR, but we believe that the revised approach is not consistent with the Level 1 provisions: Article 44(1) provides that "Member States shall, at least, require regulated markets to make public current bid and offer prices and the depth of trading interests at those prices which are advertised through their systems for shares admitted to trading. [...]". The Directive is therefore very clear that the minimum obligation applies to "those prices which are advertised through their systems".

Whilst we support the flexibility which CESR has shown in recognising that waivers should be applied for different market models, we are concerned that the generality of some of the drafting may lead in practice to a lack of clarity as to what pre-trade transparency is to be expected when the MiFID is in place.

Paragraph 76

Paragraph 76 states that, "Where an RM or MTF operates a quote driven trading system, it should make public, in a montage for each share, information on the best bid and offer currently available, together with the best bid and offer (price and volume) of each market maker in that share."

We of course agree that the best bid and offer currently available must be made public and we further believe that the size of that best bid and offer must also be displayed.

Paragraph 78

This paragraph provides that, where an RM or MTF operates a trading system which does not align with any of the market models described in the earlier paragraphs, a standard of pre-trade transparency comparable to the pre-trade transparency to those market models must be achieved. We welcome CESR's effort to accommodate new market models. We are of the view that it is not possible to seek comparability by imposing standards which are appropriate for a different market model, for example, "The five best bid and offer levels are made public, if the price discovery mechanism so permits".

Instead we advocate setting out:

- a fair, open and consistent method of assessing whether a market model's pre-trade transparency (or lack thereof) conforms with the principles of fair and orderly trading and investor protection, and

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- assessment criteria which are as specific as possible, which do not relate to a different market model, and which test to what extent publication /non-publication would affect the price formation process and the perception of existing and proposed investors in a security.

Paragraph 84

Sub-paragraph (a) refers to a transaction made “within or at the current spread on the RM/MTF, if applicable, or within a set percentage of a suitable periodic reference price if a continuous reference price is not available”. Since the reference price could be the price on a local market for a share which is traded on a number of markets, we recommend changing the wording to ““within or at the current spread on that and/or another RM/MTF or [...]”.

Q 3.3: Do consultees agree on the proposed exemptions to pre-trade transparency? Are there other types or order/transaction or market models which should be exempted?

In a previous submission to CESR, we supported in principle the proposed waiver for crossing systems and suggested that it should have application to, for example, the Retail Service Provider (“RSP”) business in the UK (under which an RSP matches customer orders through its own proprietary systems before reporting them to an exchange. The RSP’s transaction prices are determined by reference to the prices on one or more exchanges. Since the RSP’s prices are not material to the price formation process in a security, the prices do not need to be subject to the advertising requirement).

Our understanding of the recently-issued draft Level 2 advice is that the RSP model will fall within the waiver set out in paragraph 86.

Assuming this to be the case, we have no other market models which we currently think should be exempted. We recommend that flexibility is retained to accommodate requests for waivers as new market models evolve in the future.

Q 3.7: In your opinion, would it be more appropriate to fix the SMS as monetary value or convert it into number of shares?

We recommend a monetary value.

Q 3.8: Do you consider subsequent annual revisions of the grouping of shares as sufficient or would you prefer them to be more frequent? Should CESR make more concrete proposals on revision, especially, should the time of revision be fixed at level 2?

We think that annual revisions of the groupings will generally be sufficient but we recommend that CESR provides for an interim revision to be carried if, for example,

markets have been highly volatile and the groupings as a whole become unrepresentative.

We agree that the revision should be fixed at level 2.

Q 3.11: Do you agree on the proposal on publication of the classification of shares, would you prefer establishing a single contact point (at level2)?

A single contact point is preferable (e.g. the CESR website).

Q 3.12: Do you have further comments on the proposals for the obligations of systematic internalisers?

On the withdrawal of quotes, the systematic internaliser obligations should not apply if an RM or MTF has announced a waiver of the market maker obligations in that security. Such an approach would need to address the difficulty that the systematic internaliser obligations could be misapplied if:

- an RM/MTF disapplied market maker obligations without sufficient grounds or
- if only one RM/MTF with a very low market share waived the obligations.

Q6.4: Do consultees consider that intermediaries should benefit from the maximum delay proposed, regardless of whether they have unwound their position? If not, on what basis should CESR recommend a rule aimed at requiring immediate disclosure once all, or the major part, of the position have been unwound?

We consider that the maximum delay should not be allowed where a position has already been unwound.

Although virt-x's current block trade arrangements have a deadline (of the end of order book trading that day or the following day depending on when the business was commenced), the rules specify that a trade report must be made when the business is "substantially completed" which we regard as at least 80% completed. We recommend a similar approach to CESR.

Q6.5: Do consultees agree with the proposal that Competent authorities should be able to grant pretrade waivers and/or approve deferred publication arrangements that comply with the minimum thresholds regardless of whether or not the competent authority of the lead market adopts higher standards? Would it be better to require all member states to follow the transparency arrangements adopted by the competent authority of the lead market, whether by the competent authority or the lead market operator? CESR would like to receive comments that throw more light on the pros and cons of each option?

Our view is that, instead of either of the suggested options, all competent authorities to adopt the same standards. This would:

- avoid regulatory arbitrage
- be simpler for market participants to have the same deferred publication arrangements across the EU, and
- be more aligned with the harmonising aims of the Directive.

However, we recognise that the Directive provides for discretion for competent authorities in granting waivers and approving deferred publication arrangements. We recommend that the minimum discretion should be allowed and that a process should be established to ensure that discretion is exercised openly and consistently.

Of the suggested options, our preference would be for the standard adopted by the competent authority of the lead market because this would minimise the scope for regulatory arbitrage.

Q6.7: Do the proposals adequately address issues relating to less liquid shares? If not, what arrangements would be preferable?
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We would prefer to see a regime across the EU for less liquid shares and we do not therefore think that member states should be given scope for customising their own regimes.

Q6.9: Do consultees have any other comments on the proposals in this section

We have 2 further comments, on paragraphs 141 and 142:

Paragraph 141

Post-trade information should be published for transactions outside an RM or MTF which were subject to other conditions than the current market price of the share, but with an indicator explaining the reason for the deviation from the current market price.

The proposal that such transactions should be published only if they have information that is significant for the efficient price formation could rely too much on a firm's subjective judgement as to significant information.

Paragraph 142

We believe that deferred publication should also be permitted where an investment firm acting as agent in a large transaction provided that it is for the direct purpose of facilitation of a client's business.

4 April 2005
