EFFAS THE EUROPEAN FEDERATION OF FINANCIAL ANALYSTS SOCIETIES

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Comment by DVFA on CESR Consultative Concept Paper on the proposed Financial Instruments Markets Directive (ISD2), Articles 25, 56 and 58 (Ref. CESR/04-073b)

Dear Sir, dear Madam,

EFFAS, the European Federation of Financial Analysts Societies is the umbrella organisation of national analysts societies. EFFAS comprises 20 national member societies representing more than 14,000 investment professionals, mainly financial analysts and asset managers.

We appreciate the opportunity to participate with our opinion on the consultative concept paper published by CESR. The opinion is structured as answer to each of the questions asked by CESR in this paper.

Q 1: Do you agree with the approach suggested above to determine the methods and arrangements for reporting financial transactions in one set of criteria applicable to, both, the conditions for a trade matching and reporting system to be considered valid to report transactions to competent authorities, and the criteria allowing for a waiver? If you do not agree, what other approach would be more appropriate in your view?

Answer:

We agree with the approach suggested by CESR.

Q 2: What requirements should such an inventory contain?

Answer:

Data security, system reliability a mentioned by CESR.

In addition, the inventory should contain a generally available formatting standard with open ended interfaces.

Is is advisable to introduce a common format of data transfer throughout the member states with a view of facilitating a forwarding and processing such data.

Q 3: What other issues, if any, should CESR take into account when responding to the Mandate concerning the "methods and arrangements for reporting financial transactions"?

Answer:

The methods and arrangements for reporting must strike a reasonable balance, to wit a compromise within the different purposes for which the data are collected. The introduction to the questionnaire names the following bullet points as purposes or aims for regulation:

market integrity
proper functioning of the market
maintaining investors' confidence.
market fragmentation,
avoidance of market abuse,
conduct of business rules (e.g. front-running behaviour),
detection of money laundering
identification of market trends.
fairness and efficiency of markets,

Many of these points are overlapping or identical. They might be collected under the heading market integrity, understood as integrity of the totality of the different trading venues for one instrument. Other reasons are detail problems under the general purpose (good business conduct, discovery and deterrence of criminal insider dealing etc). Others are only remotely related to market integrity understood as the proper functioning of the markets for the benefit of investors, e.g. detection of money laundering. The latter might not even influence the markets beyond the instrumentalisation of markets for illegal purposes. For the purpose of identifying market trends, we fail to see a regulatory interest to collect data. This is a task which the markets and their participants and accompanying service firms should fulfil in their own interest. The regulators should stay away from any attempt of determining and influencing market trends.

There is another issue which plays a major role in the reporting. Some information must be available on the shortest possible term in order to avoid market break downs or irreparable damage to the investor community at large. Other information is needed to enable investigation of wrong doing without short term impact on the markets at large. The reporting

must allow the recipients of the data to follow the order trail down to the original source of a transaction. The reporting requirements must be tailored in a manner which allows an efficient pursuit of these two major purposes without unnecessarily burdening the reporting entities.

These principles result in the following recommendations:

The integrity of the markets at large require an overview of all transactions concerning a particular instrument. This data will be centralised at the most relevant market. This market should also be the collection point for all data of derivatives on this particular instrument regardless of the existence of another more relevant market for the derivatives proper. Each regulator foreseeing a need for immediate action to preserve the integrity of a market in a particular instrument ought to obtain direct access to the centralised data base at the most relevant market in order to assess any problems in the specific markets under its regulation.

Q 4: What would general criteria for measuring liquidity be?

Answer:

General criteria for measuring liquidity are width of the market (ask-bid spread), depth (volume quoted), immediacy, resiliency (elimination of imbalances).

Q 5: What specific criteria could be useful in measuring liquidity? Should they be prioritised?

Answer:

We do not recommend that these elements be used in the same priority. Liquidity for the purposes of the ISD2 reporting requirements should be measured in a simpler way. It need not measure the most efficient market, but rather the most important market for a very simple purpose. In a world of fragmented markets, a centralised database is needed to allow an overview over all transactions in all market fragments. This is the only justification for this rule. This purpose of centralising is not defeated if this central collection point is not maintained at the most relevant market for other purposes or if the relevance shifts in time before a change of the reporting point is ordered. To have the, untechnically speaking, biggest market as data collection centre makes sense because there exists an assumption that the operator of this market will have the greatest interest and the ability to detect risks for the integrity of the overall markets in a particular instrument. Therefore, we recommend that the following three elements be combined within a reference period:

Highest Volume traded (numbers of instruments, not value)
Highest Number of days in which trading occurred
Best distribution of the volumes over these trading days.

Q 6: What could be an appropriate mechanism for assessing liquidity in a simple way for the purposes of this provision?

Answer:

The formula for finding the most relevant regulated market would include

the product of the actual volume of the instrument traded and the number of days in which the volume was traded giving weight to a market in which trades over time come close to a statistically normal distribution.

Q 7: What other considerations should guide CESR in its work regarding the assessment of liquidity in order to define a relevant market in terms of liquidity?

Answer:

Only regulated markets should be accepted as relevant markets for reporting purposes because they provide the best access to the general public. The risk of this centralised information being abused or being manipulated for proprietary purposes is lower in these markets than in other market places. General access in itself is an element of relevance.

The reference period to determine the most relevant market must be a time period in the past and the definition must be valid for reasonable time period for the reporting entities regardless as to whether the relevance has shifted during the reporting period.

We recommend a period of one year as reference period to define the relevant market for the following year.

Q 8: Do you agree with the approach proposed by CESR for determining the minimum content and common standard/format for transaction reports? Are there other approaches that could usefully be considered?

Answer:

We agree with the CESR approach.

We think that the transaction reporting must contain the information whether the transaction was a proprietary transaction of the participant or a transaction for the account of a customer. Principal trading for others, i.e. with a cover transaction in market should be considered trading for a customer and not as a proprietary transaction. The reason for this element of a trade to be reported is that it is necessary to open the order trail down to original the source of a transaction. Otherwise, it might be difficult for regulators to determine in time who the moving forces in the markets are.

Reporting should initially be restricted to the level of order matching, i.e. where the transaction takes place. The reporting of all investment firms participating in order

processing down the order trail should be avoided. IT causes a duplication of reporting for one transaction. The reporting of a transaction as a customer trade allows the regulator to follow the order trail to the original source of the transaction.

Q 9: Apart from the types of information set out in Art. 25 par. 4 and the Mandate, what other information might be usefully included in transaction reports?

Answer:

Only such information should be included which is necessary to meet the primary purposes of the reporting obligation. One should not attempt to pack the reporting with data which might be interesting to the regulators but has no immediate impact on the overall market integrity. It seems to us rather necessary to keep the technical format of the reporting open so that additional information might be generated in the reporting if this should prove necessary in the future. The firms subject to the reporting requirement should be advised that they create the necessary open interfaces to their data structures. This might allow the regulators to broaden later the reporting base.

Q 10: Do you agree that the content of transaction reports has to be equal irrespective of the entity reporting the transaction? What considerations could justify a different treatment of reporting parties?

Answer:

We agree with the equal treatment.

Q 11: Do you agree that this preliminary assessment on the scope of the implementing measures is appropriate, and with the approach suggested above to determine the criteria under which the operations of a regulated market in a host Member State can be considered as of substantial importance, or would you consider another approach more appropriate?

Answer:

We agree with CESR's approach to determine first the criteria of „substantial importance" of a regulated market's presence in a host member state.

Q 12: What relevant criteria should be taken into account in order to assess the substantial importance of the operations of a regulated market in a host Member State?

Answer:

The first and foremost criteria to assess the substantial importance of operations are

- the promotion and advertising of a regulated market operator in a host member state to the general investor public to prompt orders to use this particular regulated market
- the promotion in the host member state to become a member or adhere to this regulated market to investment firms in order to bring their retail business or part of their retail business to this regulated market.

The „substantial importance“ should be restricted to the direct or indirect approach to the general public, primarily aimed at the retail investor. This investor segment requires appropriate protection. Regulated markets organised in a member state should not be subject to measures by a host member state for the activities to win institutional business in these states. These institutions are sufficiently competent to assess themselves the operation of a regulated market and the impact on these institutions.

Q 13: What other indicative elements should CESR take into account when drafting its technical advice in this field?

Answer:

The duplication of supervision should be avoided as much as possible. The supervision should be concentrated in the home member state. It may be implemented by the exchange of information and cooperation between the regulators of host member states concerned and the regulator of the home member state

Q 14: To what extent should CESR take into account the nature of the information to be exchanged in order to set up different categories of information and corresponding procedures of exchange of information (i.e. routine, case specific)?

Answer:

Only case specific information. Routine exchanges tend to be treated in a routine fashion by the recipient. Case specific information will focus the attention when and if required by a particular case.

Q 15: To what extent do you agree with the approach outlined above? In particular, are there any issues which you believe would be more appropriately dealt with at Level 3? What other considerations should guide CESR?

Answer:

Any provisions covering the above issues should be inserted in the body of rules issued at Level 2. Level 3 is restricted to coordinate the interpreting and applying these rules within the framework of national legislation and interpretation. We think all the issues dealt with in the consultative paper are issues for law making at level 2.

As one may see from the above answers, our federation favours an approach which concentrates regulation and supervision at the home member state and involves host member states only to the absolute necessary minimum.

We feel that the issue how much information should be exchanged between regulators and to what extent host member states regulators are involved is not one for the regulators and CESR to decide, be it only for the fact that any additional and not absolutely necessary activity by the regulators in their exchanging information and cooperation means cost production which depending on the methods of financing these activities might have to be carried by the regulated entities.

If the system of decentralised regulation leads to a overly complicated network and to duplication of activities with corresponding additional expenses, the political issue of a European central regulator must be raised.