27 August 2004

Mandate to CESR for technical advice on possible implementing measures on the Directive on Markets in Financial Instruments

Complementary response of Euronext
to CESR's call for evidence dated 29 June 2004 (Ref. CESR/04-323)

Following Euronext's first response - dated 29 July - to CESR's call for evidence on implementing measures as concerns the Directive on Markets in Financial Instruments (MiFiD), and as indicated in that response, we would like to add the following comments regarding CESR's questions on internalisation and pre-trade transparency issues.

<u>1/. Specifying the criteria for determining when an investment firm deals on own account on an organised, frequent and systematic basis by executing client orders (i.e. systematic internaliser).</u>

The Directive has defined systematic internalisers as "investment firms which on an organized, frequent and systematic basis, deal for own account by executing client orders outside a regulated market or an MTF".

In our initial reply to CESR, we have given a first assumption that an "organised" system would imply the existence of procedures settled to execute those orders; that the "frequency" should be interpreted as the availability and consistency of the service of execution of clients' orders for own account; the "systematic" criterion being more or less a combination of both former ones. Moreover, since availability and consistency of the service are key indications of systematic internalisation, we believe that an investment firm offering its clients internal execution possibilities in its execution policy, has to be considered a "systematic internaliser" regarding the Directive, whatever means are used for the transmission of orders, and whatever the nature of the clients (even if professionals).

<u>2/. Defining what is to be considered a liquid market in an individual share for the purpose of article 27.</u>

According to article 27, systematic internalisers will be submitted to pre-trade transparency requirements only for shares in which there is a liquid market.

We agree that the criteria for a "liquid" share should be as simple as possible to facilitate implementation in all Member States. Therefore, we would tend to consider as a simple and consistent criterion to appreciate liquidity in all European markets/shares the fact of being part of a leading national index or a leading international index (provided such indices do not contain a large proportion of evidently illiquid shares, following the market liquidity parameters hereafter described). As concerns Euronext markets for example, and in addition to blue-chip national indices, being included in the Euronext 100 and Next 150 indices would be a relevant basis to identify liquid shares.

In addition, other usual measurement parameters of market liquidity could be concurrently appreciated for shares not belonging to such leading indices: volumes and number of transactions (considering overall volume of trading in a particular share), velocity (*taux de rotation*), spread, number of trading days...

3/. Specifying the criteria for determining when the price or prices reflect prevailing market conditions.

Article 27 stipulates that the price/prices published by systematic internalisers “shall reflect the prevailing market conditions for that share”.

To appreciate “prevailing market conditions”, and to ensure that prices quoted by internalisers remain competitive compared to prices quoted on other trading venues, we believe a limited gap compared to the best limit existing on the most relevant regulated market or MTF in terms of liquidity for a share would be a fair criterion (reference to a spread may be difficult since internalisers will be able to publish quotes for only buy or sale side).

- defining the classes in which liquid shares should be grouped as well as the criteria for its revision if necessary.

The Directive settled that, for the needs of the publication of prices by internalisers, the shares “shall be grouped in classes on the basis of the arithmetic average value of the orders executed in the market for that share”.

The average order size indeed seems to be a relevant criterion to define those categories. In that respect, whereas we do understand the practical necessity of avoiding having to operate a large number of classes, it seems nevertheless quite important to determine a sufficient number of classes in order to reflect the different levels of volumes and liquidity of the shares traded on the various European markets.

In any case, the different classes, as well as their number, should be subject to regular revision, we would suggest on an annual basis.

- defining what is to be considered an order large in scale compared to normal market size.

In the context of Article 27, CESR is to provide advice regarding “orders large in scale compared to normal market size”.

It is our opinion that orders large in scale should be defined as reflecting the reality of the trading on and off regulated markets/MTFs, whatever method is chosen to define thoses orders in comparison of standard market size orders (in particular the market impact of the orders). Should a method using a multiple of the SMS be retained, we think it would be realistic to consider orders to be “large in scale” when 8 to 10 times larger than “standard market size” orders on the considered shares.

- defining the SMS for each class of shares as well as the criteria for its revision if necessary.

The pre-trade transparency requirements of article 27 will be applicable to systematic internalisers “when dealing for sizes up to standard market size”.

We endorse CESR’s reference to “all orders” as a basis of calculation for the standard market size (either RM, MTF, and internalisers): a simple reference to the markets’ order books would, as said hereabove, not give a fair picture of the reality of the overall market in a share. Nevertheless, as much off-exchange data will only be known with the necessary consistency across Europe once the transaction reporting requirements of MIFID are implemented, we agree that calculation could in the meantime be based on the basis of reported on-exchange transactions.

- determining the arrangements through which competent authorities will calculate the arithmetic average value of the orders executed in the market for each share for determining the class to which each share belongs and in particular the period for revision and the time period for determining which orders are to be included in the calculation.

We agree that, in order to provide with reliable calculations, the competent authorities should be able to centralise all the orders executed in the relevant shares. At present, “exchange” and “on-exchange reported” data may be used as a basis for calculation, but in any case not only the data contained in order books: indeed, all transactions in all liquid shares have to be considered. Furthermore, a consistent method of calculation should be retained by the regulators (CESR) in all Member States, in order to get homogeneous thus consolidatable data from all trading venues (as an example, Euronext various markets’ data concerning orders, as transmitted to our regulators, are calculated on the basis of the number of transactions divided by an average “fragmentation rate”, giving the number of orders; this might be differently calculated on other European markets…).

These calculations should be revised regularly, even though not too often (a half-year basis would be appropriate). Regulators should nevertheless have flexibility to revise under exceptional/defined circumstances.

- determining the arrangements through which competent authorities shall make public to all market participants the class of shares to which each share belongs.

Publication of the classes of shares to which each share belongs could be done efficiently on the regulatory authorities’ websites. A notice in well known financial/economical newspapers would also be useful (even if only to refer to the publication on the authority’s website).

4/. Specifying the general criteria for the handling of client orders in case that the systematic internalisers publish multiple quotes.

The Directive says that “where the systematic internaliser is quoting in different sizes and receives an order between those sizes, which it chooses to execute, it shall execute the order at one of the quoted prices”.

Handling of client orders should in any case be driven by best execution principles.

5/. Specifying the criteria for determining when a quote is published on a regular and continuous basis and is easily accessible as well as, the means by which investment firms may comply with their obligation to make public their quotes, which shall include the following possibilities: through the facilities of any regulated market which has admitted the instrument in question to trading/ through the offices of a third party; through proprietary arrangements.

It is our opinion that "accessibility" should imply visibility and access to quotes for all investors. This requirement would be met as long as it is allowed for the published data to be consolidated, which is in our opinion a major criterion to ensure a consistent display of information. This being a pre-requisite for effective delivery of best execution, as well as to allow a proper markets' surveillance by competent regulators.

As regards the "regular and continuous" criteria for publication, the rule should be the obligation to publish quotes continuously during markets opening hours.

6/. Defining which market circumstances that could be considered as exceptional that could allow a systematic internaliser to withdraw its quotes/ the conditions under which quotes can be updated/ the criteria for determining what constitutes considerably exceeding the norm in order to limit the total number of transactions from different clients.

The Directive stipulates that systematic internalisers "shall be entitled to update their quotes at any time", and "shall also be allowed, under exceptional market conditions, to withdraw their quotes".

We consider that the regime of withdrawal of quotes "under exceptional market conditions" should be linked to the one applicable to a regulated market or a MTF and decided by regulators under strictly established criteria (such as "force majeure", market disorders or sudden fluctuations, major operational disruptions…).

Updating of quotes needs to be rather flexible in order to allow internalisers to adapt to market fluctuations. However, this should be monitored, in particular to avoid abusive updating (e.g. selective price improvement for privileged clients by "second split" updating…).

7/. Specifying the general criteria for determining those transactions where execution in several securities is part of one transaction or orders that are subject to conditions other than current market price.

Article 27 foresees that "systematic internalisers may execute orders they receive from their professional clients at prices different than their quoted ones (…), in respect of transactions where execution in several securities is part of one transaction or in respect of orders that are subject to conditions other than the current market price".

Regarding the category of "transactions where execution in several securities is part of one transaction", particular attention should be paid that "portfolio" transactions are really

done on the basis of price tailored for the whole portfolio, and not at prices tailored for each specific included share).
As for "orders that are subject to conditions other than current market price”, this definition should typically not include all types of orders with specific execution modalities, but that are in fact linked to current market price (e.g. VWAP, that are executed at an average of the market prices, stop loss orders etc…). In that respect, the fairest criterion would be the order’s link to the offer/demand confrontation, as opposed to other criteria (e.g. collateralisation).

8/. Specifying the criteria for determining what is a size customarily undertaken by a retail investor.

European surveys based on panels of investment firms known for their particular knowledge/experience regarding client orders’ routing, could be a relevant basis/reference to appreciate the “size *(of order)* customarily undertaken by a retail investor”.
