



London
STOCK EXCHANGE

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Dear Fabrice

MIFID - CESR'S FIRST CONSULTATION ON SECOND MANDATE

Thank you for the opportunity to comment on CESR's first consultation on its second mandate on possible implementing measures for MiFID. This letter and its attachment constitute the London Stock Exchange's response.

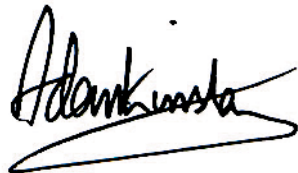
Some of the issues dealt with in this consultation are among the most contentious that CESR will have to consider and we appreciate that drafting the level 2 measures on these issues will be extremely difficult. Accordingly we would urge CESR to look for simple and practical solutions where possible. In particular, when determining the quantitative thresholds surrounding the systematic internaliser regime, CESR should consider the difficulties that will be faced by regulators and market participants if they are forced to apply a regime that has been over-engineered.

With respect to the requirements on systematic internalisers, I would also like to draw your attention to the issue of scope. A political decision was made at level 1 to impose certain obligations on a certain type of activity. If CESR is not careful in the way that it deals with the definitions of the activity and the firms concerned then it is in danger of broadening the scope to capture practically all firms that conduct principal business. This was clearly not the intention of the level 1 text and would add nothing but additional costs to European securities trading in return for no additional benefits.

Finally I would like to highlight the importance of creating certainty, without removing flexibility, when considering the treatment of structured products and in particular with respect to execution only business. There are currently a variety of alternatives to equity that provide similar economic exposure to investors and yet, because of differing national interpretations of what is meant by "derivatives", these potentially more efficient alternatives may be excluded from the execution only regime.

I hope that you find the attached comments useful in your deliberations and look forward to continuing to work with you on these issues.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Adam Kinsley', with a long horizontal flourish extending from the end of the name.

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APPENDIX - LONDON STOCK EXCHANGE RESPONSE TO SPECIFIC QUESTIONS RAISED IN CONSULTATION

SECTION II - INTERMEDIARIES

DEFINITION OF “INVESTMENT ADVICE” (ARTICLE 4(1) NO. 4)

Question 1.1. - Do you agree that advice on services, such as recommendation to use a particular broker, fund manager or custodian, should not be covered?

Yes. This clearly falls outside the definition of investment advice contained within the directive which requires that the advice is, “personal” and relates to “one or more transactions”. We believe this refers to the ‘what’ and ‘how’ of a transaction, not the ‘who’.

Question 1.2. – Do you agree with the approach that a personal recommendation has to be held out as being suited to, or based on a consideration of, the client’s personal situation or do you consider this criterion to be unnecessary or ambiguous and would like to refer to the bilateral nature of the relationships and bilateral contacts between the firm and its clients? In the latter case which criteria would you use to differentiate between a “personal recommendation” and a “general recommendation” or a “marketing communication”?

Question 1.3. – Do you think it is reasonable to restrict “investment advice” to recommendations of specific financial instruments or is it necessary to cover generic information including financial planning and asset allocation services for financial instruments?

We do not have strong views on these questions.

GENERAL OBLIGATION TO ACT FAIRLY ETC.

Question 3.1.: Do you agree with the proposals on portfolio management? Should any other issues be addressed under Article 19(1)?

Yes.

Question 4.1.: Do market participants think that adequate investment advice or portfolio management service is still possible on the basis of the assumption that the client has no knowledge and experience, the assets provided by the client are his only liquid assets and/or the financial instruments envisaged have the lowest level of risk if the client is not able to or refuses to provide any information either on his knowledge and experience, his financial situation or its investment objectives? Or would this assumption give a reasonable observer of the type of the client or potential client the impression that the recommendation is not suited to, or based on a consideration of his personal circumstances?

We strongly believe that certain investment advice or portfolio management services are still possible with limited or no knowledge of a client's experience. It would still be appropriate to offer certain services. Whilst these are likely to be low risk products and would need to be supplemented with appropriate disclosures, we do not think CESR should preclude such a possibility.

EXECUTION ONLY

Question 5.1.: In determining criteria, should CESR pay more attention to the legal categorisation or the economic effect of the financial instrument?

CESR should focus on the economic effect. The directive should not place unnecessary restrictions on the use of new and innovative products that can offer investors with more efficient ways of achieving similar economic outcomes to those provided by more traditional investments. To this end we believe that CESR's determination that non-complex products cannot include a derivative element is both unwarranted by the text and extremely unhelpful in determining this issue. There are two difficulties with this approach: "derivative" is not defined by the directive, meaning that different interpretations will be applied in different member states; and some instruments that are generally considered to be derivatives are no more complex or risky than other non-derivative products.

We are concerned that some member states will continue to view covered warrants as derivatives for this purpose and that this definition will exclude contracts for difference and other products that are un-gearred and offer a similar economic return to equity or debt.

As such, we strongly urge CESR to define non-complex instruments as all transferable securities, where those instruments do not create a geared or leveraged economic exposure.

Question 5.2.- Do you think that it is reasonable to assume that a service is not provided “at the initiative of the client” if undue influence by or on behalf of the investment firm impairs the client’s or the potential client’s freedom of choice or is likely to significantly limit the client’s or potential client’s ability to make an informed decision?

Whilst we do not disagree that it is reasonable to consider ‘undue influence’, we believe that this issue is already considered as part of the Proposal for a Directive on Unfair Business to Consumer Practices. CESR should focus its advice on the themes underlying Recital 30.

Question 6.1.: Do Market Participants agree that the quantitative thresholds for undertakings to request treatment as eligible counterparties should be the same as the thresholds for professional clients? Please provide the reasons for your position.

This seems reasonable.

SECTION III – MARKETS

DISPLAY OF CLIENT LIMIT ORDERS

Question 7.1.: In your view, what types of arrangements other than RMs and MTFs could be considered as complying with article 22.2?

We support CESR’s explanatory text and believe that the ‘visibility’ and ‘accessibility’ tests should be applied, even when considering appropriateness of a regulated market or MTF. For example, if there were three alternatives, the firm should pick the venue it believes is most likely to achieve best execution, and best passes the ‘visibility’ and ‘access’ test, i.e. “largest possible audience” and “earliest possible execution”.

There is an assumption that the tests would be met if an order was sent to a Regulated Market or MTF. We believe that this assumption should be subject to certain caveats. Most notably the Regulated Market or MTF needs to provide non-discriminatory access. If this were not the case, and the venue was only transparent to a closed user group, then it would be misleading to assume both the ‘visibility’ and ‘access’ tests had been met.

Having said this, we believe that if a Regulated Market or MTF does offer non-discriminatory access, then it would be difficult to envisage an alternative venue being better placed to meet the two tests given that the facility must be able to display distinct limit orders (this follows logically from the fact that quote-only Regulated Markets and MTFs can’t be used to meet this obligation), and must allow for prompt (i.e. automated) execution.

As such we believe the following words should be inserted at the beginning of paragraph 3 of box 13:

“Where there is a more appropriate alternative such that the investment firm does not transmit .. ”.

The advice should also specifically allow for the use of order routing via other investment firms provided that the end result is the same i.e. the order is both visible and accessible.

Question 7.2.: Do you consider the proposal on publishing the client limit order in a quote-driven system appropriate?

Yes, provided that the wording is clarified to state that this refers to quotation only systems. Where a regulated market or MTF provides for both quote and limit order display these should be acceptable.

PRE-TRADE TRANSPARENCY – SYSTEMATIC INTERNALISERS (ART 4 AND 27)

Question 8.1.: Do consultees agree with criteria for determining systematic internaliser? Should additional/other criteria be used and if so, what should these be?

We broadly agree with the criteria that have been identified, and whilst we believe that these may not be the only factors to consider, we do not believe that further criteria are necessary. Competent authorities will need a certain amount of discretion to determine those entities that are engaged in systematic internalisation.

Question 8.2.: Should the criteria be fulfilled collectively or used separately?

We do not see how the criteria could practicably be applied separately within the meaning of the Directive. To do so would catch far more firms than intended. For example, if the term “organised” is considered separately, it is conceivable that all investment firms would be caught by the definition. This clearly is not the intention of the directive.

The systematic internalisation provisions are onerous and should only be applied to those firms that genuinely meet the definition.

As such, we strongly believe the criteria should be fulfilled collectively.

Question 8.3.: Should CESR set criteria for the term “frequent”? If so, do consultees support the setting of numeric criteria or do they believe that a more flexible approach would be useful? What should these criteria be?

We do not believe that CESR should set numeric criteria for the term “frequent”. Whilst we accept that to do so might give firms more certainty as to whether they need to fulfil the provisions of Article 27, we believe that this will add to the complexity surrounding the provisions.

Complexity would arise as the criteria would need to be set as well as being constantly monitored and enforced. Obtaining the relevant data would be an extremely difficult task both in terms of the logistics and in terms of the resource and expense incurred by both regulators and firms.

As in other areas, we would strongly urge CESR to seek simplicity.

Although opposed to it, if CESR does opt for numeric criteria, then we believe that the proportion of the firm’s business is far more meaningful than the proportion of the business done in the market, as in fragmented markets no single firm is likely to internalise more than 5% of the total business executed, so even if CESR set a 1% or 2% internalised market share criteria, it may well be an empty set.

Question 8.4.: Do you agree with the proposed obligation to disclose the intention to cease systematic internalisation? Should CESR propose more detailed proposals on this and if so, what should be the appropriate notice period?

It is not clear to us that the proposals in the area are called for by the mandate. We certainly do not believe that CESR should provide more detailed proposals.

Question 8.5.: Should liquidity be measured on an EU-wide or national basis?

EU wide. The objective is to create a pan European market and regulators will have trading data from all member states for each security under the proposed transaction reporting arrangements with which to calculate liquidity.

Question 8.6.: Do consultees have a preference in favour of setting pre-determined criteria or using a proxy approach?

To be clear, liquidity is inherently difficult to measure and there are numerous ways of doing so. Therefore it is a truism to say that whatever method is adopted, it will in effect be a proxy.

Having said that, we believe that the methods under the heading 'pre-determined criteria' are preferable to the use of indices under proxies, as none of the proxies provided would produce a satisfactory outcome.

Question 8.7.: Regarding the different criteria described above, do consultees agree with the analysis of each of them, and are there other methods which should be evaluated?

We appreciate the comprehensive list that CESR has considered but we believe that many of the measures either do not properly identify liquid stocks (e.g. (b) whether a stock trades each day) or are far too complicated to be useful (e.g. both (e) size of spread and (f) market impact are difficult to record and can be measured in different ways).

CESR should be looking for a pragmatic and simple solution.

The best criteria of those that have been identified are a combination of c) the average number of trades per day, and d) daily turnover per share. However, used independently, they both have drawbacks.

In c), CESR has suggested that a stock that trades 480 times per day could be classed as liquid. However, this takes no account of the size of the trades. Many of them could be for immaterial amounts of just a few hundred Euro. A stock that trades 500 times a day but in very small sizes can not be assumed to be liquid, as institutional investors would not be readily able to deal in these stocks.

In d) CESR has suggested the number of shares traded could be useful. We disagree as the number of shares traded in one stock (priced at say €0.50) could be ten times more than the number of shares traded in another (€10) stock, but the consideration traded in the €10 stock would be twice as much. Consideration, which CESR has not identified, is a much better measure as it deals with differently priced shares.

It may be more useful for CESR to consider a combination of c) and d) amended to reflect consideration rather quantity of shares. CESR could consider a measure that considers those stocks that trade frequently each day, together with a measure of consideration traded. This could result in a simple measure that combines those stocks that trade 480 times per day, whilst ignoring small trades of say less than €2,000, by creating a simple measure that considers those stocks that trade more than $(480 \times €2,000)$ €960,000 per day.

We believe that this approach has the advantage of being easy to calculate whilst not being impacted by differing share prices. CESR already has the data from the exchanges to calculate suitable thresholds. As such it could be calibrated to be €1m, €10m or €100m as CESR sees fit.

Question 8.8.: Is it possible and/or appropriate to use for the purposes of article 27 a combination of absolute and relative criteria to define shares as liquid?

If CESR feel it is important that smaller markets have liquid shares, even if they do not meet the absolute thresholds, then it should consider an additional requirement that, for example, the top 5 stocks in every member state should be automatically considered liquid, irrespective of daily consideration traded. We do not believe this means that a stock is technically liquid, however, it would be better to tackle the question of ensuring each member states has some 'liquid shares' this way rather than to come up with a more complicated general liquidity measure. To do so might ensure that all member states have some liquid stocks, but it might also result in some member states having far too many.

Question 8.9.: Do consultees consider the proposed figures (i.e. 480 trades per day and 95% of total trading) as appropriate? If not, and where no figures are suggested what are the appropriate figures in your opinion?

European exchanges have provided CESR with data so that it can analyse trading across all EU exchanges. We believe that CESR should put up a 'straw man' with a firm recommendation of what stocks would be liquid based on the data it has collated. We anticipate that just looking at the number of trades per day could result in anomalous results and would suggest that a consideration-based approach would be more reliable.

Question 8.10.: Do consultees agree with the analysis of the relative merits and drawbacks of using proxies such as indices?

We agree that the proxies would be unsatisfactory.

Question 8.11.: Which criteria would best accommodate the needs of different markets within the EU?

A consideration based approach would be the most efficient and most cost effective to apply and would, accordingly, best meet the needs of the different markets within the EU.

DETERMINATION OF STANDARD MARKET SIZE

Question 9.1: Do you agree with CESR's approach of proposing a unified block regime for the relevant provisions in the Directive or do you see reasons why a differentiation between Art.27 MiFID on the one hand and Art.29, 30, 44, 45 MiFID on the other hand would be advisable?

Yes. Although it should be clear that CESR is proposing a common methodology and not a single block regime.

Question 9.2: Would you consider a large number of SMS classes, each comprising a relatively small bandwidth of arithmetic average value of orders executed, as problematic for systematic internalisers?

CESR needs to balance the need to properly differentiate the range of securities with the need to have a simple regime that firms can operate within. It should be noted that SMS will only be need to be calculated for those shares that are classed as liquid.

CESR should consider the need for simplicity. The London Stock Exchange employs 13 bands to cover shares from the full liquidity spectrum. However this is far more than is necessary and desirable for the purposes of Article 27 as the requirements only apply to liquid shares. The London Stock Exchange's top 400 stocks are contained within 6 bands.

Question 9.3.: In your opinion, would it be more appropriate to fix the SMS as monetary value or convert it into number of shares?

As we anticipate that SMS would only be calculated on a relatively infrequent basis (say once a year) we believe that fixing as a monetary value is more meaningful as it will be unaffected by changes in share price.

Question 9.4.: 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? In particular, should the time of revisions be fixed at level 2?

We believe that annual revisions should be sufficient. More frequent revisions would lead to unnecessary disruption and costs.

Question 9.5.: Do you support the determination of an initial SMS by grouping the share into a class, once a newly issued share is traded for three months, or do you consider it reasonable to fix an initial SMS from the first day of trading of a share by using a proxy based on peer stocks?

We strongly support the second option, which is to initially fix the SMS from the first day of trading based on expected trading and peer stocks.

The first option is flawed in that there will be no SMS for the first three months meaning that Article 27 would not apply at a time of high levels of trading.

It is worth noting that the London Stock Exchange deals with IPOs by setting a banding ahead of trading based on expected trading levels. This is then revisited at the next periodic review.

Question 9.6.: Do you consider a two week period from publication as sufficient for systematic internalisers to adapt to new SMSs?

Yes this should be sufficient.

Question 9.7.: Do you agree on the proposal on publication of the classification of shares? Would you prefer the establishment of a single contact point (at level2)?

We agree with CESR's advice that publication should be left to relevant competent authorities.

OBLIGATIONS OF THE SYSTEMATIC INTERNALISER

Question 10.1. Do Consultees consider that there might be specific regulatory issues and specific provisions needed where a systematic internaliser is the trading venue with the largest turnover in a particular share falling within the scope of Article 27?

The scenario cited in the question does not appear to be discussed in the paper. Without further background it is difficult to comment.

If a single systematic internaliser succeeded in becoming the primary trading venue for a security then it would become the central price formation mechanism of that security. In this eventuality CESR might need to think about its advice in other areas such as prices reflecting market conditions.

However, in the absence of a regulatory failure and provided that the internaliser is meeting full transparency and access requirements imposed by Article 27, we do not think CESR requires additional specific provisions.

Question 10.2: Do consultees agree that the availability of quotes during 100 % of normal trading hours of the firm is reasonable and workable requirement for “on a continuous basis”?

Whilst we agree in principle, it might be unhelpful to impose a quantitative requirement (i.e. 100%) given that there are qualitative exemptions in the text that allow firms to withdraw quotes in certain circumstances.

Question 10.3: Do consultees think that publication of quotes solely on the firm's own website meets the “easily accessible”-test?

No. Such an arrangement would act as a barrier to consolidation.

Question 10.4.: Do you agree with the proposed general criteria for determining when a price or prices reflect market conditions or do you think that more specific criteria should be added? In the latter case; which criteria do you think should be added?

Yes. More specific criteria could inhibit price formation by forcing firms to quote artificial prices and may also discourage liquidity provision.

Question 10.5: Do you prefer either of the criteria defining exceptional market conditions, and should those criteria be supplemented by an open list of exceptional market conditions?

Both criteria are acceptable, indeed the second is a necessity. If a regulated market or competent authority has had to suspend trading as it is concerned that there is not an orderly market, it is essential that trading is suspended elsewhere.

As such, we would urge CESR to amend its advice in paragraph 3 of Box 17 to state:

*“Systematic internalisers ~~may~~ **must** withdraw quotes whenever trading on a regulated market is suspended.... “*

We don't see the need for a list of conditions as we believe firms and competent authorities will be able to apply the criteria without any additional direction.

Question 10.6.: Are there exceptional market circumstances where a systematic internaliser should be able to withdraw its quotes even though a trading suspension has not been called by the regulated market. In the latter case, which market conditions should be added to an open list?

Yes. An example would be where the firm itself is experiencing system problems or has been subject to some other unexpected event such as a building evacuation.

Question 10.7.: Do you agree that the proposed approach to the updating of quotes is acceptable or would you prefer more specific criteria? In the latter case, which criteria could be added?

The proposed approach is acceptable. There is no need for more specific criteria.

HANDLING OF CLIENT ORDERS AND EXECUTING THE ORDERS

Question 11.1: Do consultees agree that it is unnecessary for CESR to provide additional advice in respect of the handling of client orders where a systematic internaliser publishes multiple quotes?

Yes.

Question 11.2.: Would there be any benefit to CESR making more detailed recommendations concerning how a firm should set the number and/or volume of orders that represents the norm? If so, what form should they take?

No.

Question 11.3: Do consultees agree with the definition of a transaction where execution in several securities is part of one transaction? In particular, is there a need to specify a minimum number of securities and if so, what should the number be?

Any minimum number will, to a certain extent, be arbitrary but ten may serve as a useful benchmark.

Question 11.4.: Do consultees agree with the approach to “orders subject to conditions other than current market price”?

Yes. It is sufficiently open to accommodate the variety of orders that ought to be covered.

Question 11.5: Should the size be based on a EU-wide criteria or would national approaches be preferred?

The size should be based on an EU wide criterion as individual securities are likely to be traded in more than one market.

Question 11.6: Do consultees prefer having a fixed threshold for all shares, or should the size be linked to the grouping of shares (and subsequently to the SMS of each class) or to some other factor? If so, which?

There should be a fixed threshold as the rationale for bandings does not typically apply to retail sized orders. The simplest option for retail investors would be to have one size that is effective throughout the EU.

Question 11.7: If a threshold is set, how should it reflect the different sizes around the EU, i.e. should it be the highest retail size, the lowest or something in between?

Retail size should be derived from the size of the average retail trade with a multiplier applied to reflect the range of sizes generally dealt by retail investors and should be a single measure for all shares in each market.