



**RESPONSE TO THE CONSULTATION PAPER FROM THE
COMMITTEE OF EUROPEAN SECURITIES REGULATORS:**

**CESR'S DRAFT TECHNICAL ADVICE ON POSSIBLE
IMPLEMENTING MEASURES OF THE DIRECTIVE 2004/39/EC
ON MARKETS IN FINANCIAL INSTRUMENTS - 2ND SET OF
MANDATES.**

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REF.: CESR/04-562

virt-x is pleased to have the opportunity to comment on the consultation paper from the CESR on the second set of mandates on the implementation of Directive 2004/39/EC across EU Member States.

SECTION III – MARKETS

Display of client limit orders (article 22.2)

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

We agree that publication on a quote-driven system would not fulfil the essential criteria unless the system has suitable means of meeting those criteria, potentially making it a hybrid system. Where such suitable means exist, the quote-driven system would then become “an appropriate venue that achieves similar results” to the order book of a regulated market or MTF.

Pre-trade transparency – Systematic Internalisers (article 4 and 27)

1. Definition of Systematic Internaliser

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 agree with the proposed criteria of a business model in which internalisation has an identifiable commercial role, the existence of rules and infrastructure related to internalisation, and the assignment of personnel and/or a technical system for the internalised business.

We also suggest that references in a firm's customer documentation should indicate the extent to which the firm intends as a matter of policy to internalise business.

Ultimately, we believe that it should be a matter of discussion between a firm and its regulator to determine whether the firm engages in systematic internalisation and, if so, the securities in which it so functions,

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

We suggest 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?

In principle we support a flexible rather than numeric approach.

We share CESR's reservations about a quantitative approach to “frequency” but we think that this is nevertheless required in some form. Also, an element of timing is essential in determining frequency: two of the thresholds considered by CESR (percentage of internalised business and overall market share) have no timing element.

We suggest that the intention of the Directive is to exclude from its scope a firm that does not internalise on a frequent basis. It may therefore be more relevant, and probably simpler, to look at what should not be regarded as frequent. – for example, where a firm does not intend that internalisation will be a daily feature of its business. Indeed, intended frequency may be as great a determinant as actual frequency.

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?

We support the proposed obligation to disclose the intention to cease systematic internalisation and we think that a notice period of at least 5 business days should be required (unless earlier cessation is required by the firm's regulator).

We suggest that there should also be a subsequent period of time (for example, one month) during which the firm may not recommence systematic internalisation in the same security. A systematic internaliser will offer a choice of venue to market participants but, if the venue can be active or inactive according to market conditions, this could lead to damaging market fragmentation.

We also suggest an obligation on systematic internalisers to disclose publicly the intention to commence systematic internalisation. Otherwise, other market participants may not become aware for some time of a new venue which publishes quotes.

2. Scope of the Rule (Article 27.1)

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

It would be consistent with the aims of the Directive to measure liquidity on an EU-wide basis.

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

Although we do not generally favour a proxy approach, Europe-wide indices would seem to offer a sensible and pragmatic proxy for determining the securities in which a systematic internaliser should have obligations.

However, we suggest that it would be desirable to assess the liquidity of a sample of securities and to compare the results with the composition of the relevant index in order to test the validity of the use of an index as proxy. Such a review on a periodic basis may also be worthwhile.

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 would like to comment as follows:

c) Average number of trades per trading day – we agree that there is no equal distribution of the trades across the trading hours. Also, would the average number of trades per trading day be computed based on the most relevant market only or on all available trading venues for the security?

e) Size of the spread - (calculated as a difference between bid and offer compare to mid price). The size of spread tends to depend on the market model. Quote driven markets generally have much larger spreads and the data may be less useful than for electronic order books.

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?

We believe that a combination could be used but that this may not be necessary initially if the use of indices is shown to be valid (our responses to Q8.6 and Q8.10 refer).

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?

We favour using 95% of total turnover.

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 lack of consistency in the compilation of national indices would render their use of uncertain value. Europe-wide indices would be preferable.

We note CESR's concerns that there could be conflicts of interest where an exchange is responsible for deciding the index constituents. This concern could be countered by stipulating that an acceptable index must be purely rule-driven and without discretion on the part of the exchange.

We agree that taking into account only exchange-traded volumes would be a limitation in the longer term. It may therefore be appropriate to commence using indices as proxies and then to gather data to enable competent authorities to calculate liquidity based on a combination of absolute and relative criteria.

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

Relative activity in different shares would be the most useful in assessing which securities are to be deemed liquid for the purposes of systematic internalisation.

3. The determination of the Standard Market Size / Classes of shares (27.1 and 27.2)

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?

We strongly support the proposed approach.

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?

It is difficult to answer this question without simulation metrics. We suggest avoiding undue complexity.

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?

We recommend using monetary value since it is not altered by corporate actions affecting the capital structure of the listed securities (for example, stock splits).

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 recommend formally harmonising the annual revision time across all EU markets.

The revision process will be a significant task, encompassing a very large number of securities across Europe, and it will be very important to ensure that a common computation methodology is set and that it is used consistently.

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?

Either method would be acceptable.

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

We think that systematic internalisers should be able to adapt to new SMSs in a two week period from publication.

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 level 2)?

We agree that each competent authority should make the information available in easily accessible form, and at least on its website. It would be desirable to make the

information easily machine readable in order to facilitate mass downloads and automated transfers into electronic trading systems and databases.

4. 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?

In addition to the quoting obligations, it may be necessary to require the systematic internaliser to offer other market users reasonable access to its services if it has the largest turnover in a security and becomes key to the price formation process.

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”?

Yes, except in “fast market” or equivalent market conditions. (Please also see our response to Q10.6)

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

Publication on a website is unlikely to achieve sufficient visibility unless it encompasses quotes from a reasonable number of investment firms.

We are therefore of the view that publication which is limited to an investment firm’s own proprietary website would not provide a worthwhile increase in transparency but would increase industry costs since other market users would need actively to check the sites .

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?

We agree with the proposed general criteria.

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?

We prefer the option of making a link to the decision of the regulated market to suspend trading (but please also see our response to Q10.6).

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?

A systematic internaliser should also be allowed to withdraw its quotes in the following circumstances:

- if a regulated market has declared a “fast market” (or equivalent) in the security and has relieved market makers of their quoting obligations. This would not apply in the case of a trading suspension related to systems problems of the regulated market and/or its participants)
- for a specified time after a company announcement in respect of a security and/or its relevant sector
- when the volatility in the share has exceeded a specified threshold (although we recognise that this could be difficult in less liquid shares).

In addition, there should be market integrity provisions to prevent an investment firm from entering or deleting quotes if the investment firm or client has no intention to execute the order(s).

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 seems reasonable.

"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?

The proposed advice (to develop procedures, to communicate restrictions to customers, and to maintain an audit trail) appears sufficient.

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?

We agree with definition of “10 or more securities grouped together into a basket and traded as a single lot against a specific reference price” and also with the proposed minimum number of securities.

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

We suggest that CESR’s proposed wording could provide a loophole from the obligations in that a firm could, for example, always receive orders from professional clients with a non-standard settlement date (e.g. T+4 instead of T+3) in order to execute the orders at prices which differ from their quoted ones.

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

Again, we suggest that it would be consistent with the aims of the Directive to measure liquidity on an EU-wide basis.

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?

Linking size to the grouping of shares (and subsequently to the SMS of each class) would be preferable.

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?

Please see our response to Q11.6.

20 January 2005
