virt-x

17 Feb. 04

Mr. Fabrice Demarigny

Committee of European Securities Regulators

11-13 Avenue de Friedland

75008 Paris

France

Our reference: VTX-VPR-COR-20040217/E

Dear sir:

Response to Call for Evidence

I am pleased to provide herewith the response of virt-x Exchange Limited ("virt-x") to your Call for Evidence with respect to the provisional Level 2 mandates for the Directive on Financial Instruments Markets ("the Directive"). We recognise this Directive to be the keystone of the new round of financial regulation in the EU, and the Level 2 measures to be a critical element in ensuring that the Directive is implemented in an effective, fair and balanced way which meets the twin objectives of investor protection and facilitating the efficient operation – and integration – of European markets.

Our comments below reflect our views on specific aspects of particular articles in the draft Directive. As the discussion on these issues develops over the coming year, we will amplify and extend our views as well.

Our comments are as follows:

Compliance Obligations for Firms (Article 13)

We note that it is as yet unclear whether a Regulated Market which chooses to establish an MTF or broker as a subsidiary would itself, as operator of such an entity, be required to meet "investment firm" obligations. We would strenuously assert that this should not be the case, and that any such obligations should only apply to the subsidiary entity.

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Conflicts of Interest (Articles 18 and 13(3))

We believe that conflicts of interest within investment firms require greater transparency and scrutiny than is currently mandated in Europe, particularly given the damage done to investor confidence by the financial scandals of the past few years. Certain types of conflict, discussed below, not only endanger investor protection but also present an invisible obstacle to the integration of the European market by distorting order flow against the principles of the free movement of capital to its most efficient use. In particular, we would highlight the following types of conflict:

1. Incentives and Compensation Structure for Traders

Where the nature of a trader's compensation or other incentives influences execution decisions, the potential for conflict with the interests of the customers. One example of this type of conflict arises when a firm seeks to maintain a large market share on particular exchanges in order to promote itself as a major market player (for instance, to potential investment banking clients). Where this focus on market share is communicated to the trader, or is incorporated in the trader's compensation, it creates an incentive to send orders to particular (dominant) markets even when other markets represent more favourable execution for clients.

It may be argued that such practices would be in violation of best execution rules, but this would only be the case where best execution is defined in a clear and enforceable way. If the best execution policy leaves execution decisions in the judgment of the trader based on an array of non-price factors (as the Level 1 provisions appear to do), then traders will be able easily justify order routing decisions which are in their own interests rather than their customers'.

2. Soft Commissions, Payment for Order Flow

The use of soft commissions provides a means by which fund managers can use fundholder assets, rather than their own capital, to pay for services which constitute a cost of doing business. They do so in the knowledge that investors often focus on management fees rather than fund performance, and that it is consequently to the fund manager's advantage to shift the cost of non-execution services from the (transparent) management fees to the assets under management. Here they are nearly invisible to the fundholder. Not only can this practice mislead the fundholder who is trying to compare the management costs of various funds, it also prevents existing fundholders from monitoring the efficiency and care with which the fund manager obtains the services in question. We see no justification for the practice and we call for the costs of doing business to be paid for with "hard" funds in a manner transparent to the fundholders.

The hiding of costs from fundholders is by no means the only way in which soft commissions and bundling harm the markets. As Dr. Benn Steil and Dr. Robert Schwartz have pointed out in their studies on the economics of soft commission trading[1], the costs (explicit and implicit) of soft commission trades are roughly three times those for electronic, non-intermediated execution-only trades. These excess costs lead to the underperformance of the funds in question, and constitute a tangible and material harm to the fundholders.

The fact that commissions are used to pay for services unrelated to execution is not a matter in dispute. In a survey conducted as part of Dr. Steil's article on controlling institutional trading costs, a substantial number of traders and Chief Investment Officers advised that they regard soft commission obligations,

[1] Steil, Benn "The Economics of Soft Dollar Trading", May 2003, available at www.efficientfrontiers.com, and Schwartz, Robert A, and Benn Steil, "Controlling Institutional Trading Costs: We Have Met the Enemy, and It is Us" , *Journal of Portfolio Management*, Spring 2002

and other factors wholly unrelated to best execution, to be appropriate grounds for directing order flow to particular brokers.

We also note the finding in “The Economics of Soft Dollar Trading” that, even if all services were to be paid by the fund manager with “hard” funds from its own resources, it would still be able to maintain a substantial operating profit (*and* the fund holders would actually be better off than under soft commission arrangements).

Directed commissions and commission recapture arrangements are also detrimental to the fair and efficient operation of the market because they tend to focus broker selection on factors other than execution quality. As we have pointed out on many occasions, best execution is the foundation of customer protection in the handling of orders. It is also an important element in ensuring that markets operate efficiently by requiring that orders are routed to where they will execute on the most favourable terms. Directed commissions, soft commissions, and any other mechanism which distorts the selection of broker and/or execution venue are contrary to this process and are wholly without justification. We will comment further on the effect of directed commissions in our coming discussions on best execution and market integration.

To address the types of described above, we would recommend that the Level 2 provisions prevent this type of conflict of interest by establishing a retail best execution policy based upon the best net price (see our comments on best execution, below). If no such enforceable standard is established, we would urge the Level 2 measures to prohibit incentive or compensation structures which reward traders for executing trades on markets based on market share, payment for order flow or other factors not directly related to the best execution of the customer order.

<u>Conduct of Business Obligations When Providing Investment Services to Clients (Article 19)</u>

In defining the exact content of conduct of business obligations, the most important distinction will be that between “retail” and “professional” clients. In most cases, this distinction will not be difficult, as most investors are clearly identifiable as belonging to one or the other classification. There will remain a number of clients for whom the classification is more problematical, and in such cases the client should be able to self-classify, i.e., opt up to “professional” status or opt down to “retail” status.

The classification is important in the application of a number of other provisions of the Directive, and we believe this approach is the simplest while still maintaining the flexibility required for those customers who believe they have been inappropriately classified.

<u>Appropriate Information to be Provided to the Clients or Potential Clients (Article 19)</u>

We believe the following types of information, among others, must be provided to clients:

1. <u>Information concerning the firm and its services</u>. In our view, the most important information to disclose in this respect is that which concerns conflicts of interest within the firm, as described in our remarks concerning Article 18 above.

2. <u>Warnings</u>. The investments and services about which warnings should be issued, and the specific nature of the warnings, are too wide and varied to permit individual enumerations. Moreover, changes in market practice and investment products may quickly render any such list out-of-date. Rather, we

believe that warnings should be aimed at providing the information necessary for investors to make an informed decision, and that firms seeking to avoid potential litigation will have sufficient incentive to provide warnings as appropriate. We also believe that warnings are, by and large, appropriate for retail investors but not necessary (at least to the same extent) for professionals.

3. Execution venues. We believe that investors should be made aware of the execution venues on which it executes customer trades. This information is particularly important with respect to best execution, as it provides an indication of the vigilance with which a firm seeks the best price for the customer.

Additional information should include the type of instrument which the firm executes on the venue, whether it is a regulated market, and by which Competent Authority the venue is regulated. Where a firm internalises trades, executes them on an MTF, or otherwise executes them away from a regulated market, an appropriate risk disclosure should be made concerning the differences in regulatory protection accompanying execution on such venues.

4. Costs and associated charges. As a general principle, we believe that all costs should be transparent in order to enable the investor to make an informed decision. With respect to the specific charges associated with a trade, we foresee that a detailed listing of costs on the written confirmation of each trade would be overly burdensome for the firm and overly detailed for the investor. However, a summary of charges should be provided in writing at the time of the account opening, periodically (at least once per year) thereafter, and upon request.

Our view is that information which has been identified as requiring periodic updating should be updated at least once per year, by the same means through which the customer receives other routine information such as account statements.

In general, our position on the disclosure of information is that it must not be seen as a substitute for enforceable regulation. Rather, it provides a further means of protection and facilitates competition amongst firms. No other investor protection measures should be weakened on the reliance that a customer will access, understand, and act upon information disclosed by the firm under regulatory obligation.

Best Execution Obligation (Article 21)

Best execution is, in the end, aimed to protect retail investors. Yet a best execution policy which does not have a clear benchmark against which executions can be judged is not enforceable. A policy which is not enforceable cannot protect anyone.

It is therefore vital that the Level 2 provisions for Article 21 clearly stipulate that best execution, for retail investors, be judged against the best price net of costs available to the customer. The non-price factors which are included in the Level 1 text are generally applicable only to the trades of institutions and other professional investors and rarely should be considered by the trader executing retail trades. If the Level 2 provisions were to fail to distinguish between the needs of retail and professional investors, the presence of these factors and the generality of the Level 1 standards would leave the trader with an unwarranted and unwise degree of discretion, removing the benchmark which would make best execution enforceable for those investors for whose benefit best execution is meant.

Moreover, as our response throughout this document points out, an enforceable and thereby effective best execution regime is also the best safeguard against other types of abuse or conflicts of interest. Ensuring that retail customers receive the best available net price is, in the end, the keystone of customer protection for retail investors, since all other considerations and conflicts are judged by the degree to which they prevent the investor from receiving the best return available on their investment.

We therefore propose that the Level 2 provisions:

Require that competent authorities ensure that firms' procedures for retail trades focus on obtaining for the customer the best available price net of costs for the size of the order in question.

- That the costs to be considered in this calculation be those which are directly related to the trade in question (e.g., are not overhead costs) and are knowable before execution,
- That firms' procedures include review of any regulated market on which the share in question trades
- That firms' procedures include a regular and rigorous review of market practice and technology to determine whether other costs can be included in the price calculation, or other markets can be included among those to be checked, as market practice and technology develop.

Require competent authorities to ensure that firms' procedures for non-retail trades permit consideration of non-price factors, and that the enumeration and the priority of these factors be left to the judgement of each competent authority according to national practice.

In order to ensure necessary flexibility, that the competent authorities be required to permit retail customers to affirmatively waive the retail best execution standard in favour of non-retail treatment, either on a one-off or until-revoked basis; and that absent such a waiver all retail customers be assumed to opt for retail protection.

That competent authorities also be required to all customers, retail and non-retail, to affirmatively waive "prompt" execution as part of an instruction to the executing trader to seek a more favourable price (a "not-held", or discretionary, order).

Client Order Handling Rules (Article 22)

CESR is requested to provide technical advice on possible implementing measures concerning:

1. *The conditions with which the order handling procedures and arrangements that investment firms have to set up shall comply in order to obtain prompt, fair and expeditious execution of client orders.*

The fair execution of a client order, in our view, contains two closely related elements: that the firm obtain execution in accordance with the norms of best execution as delineated above, and that the firm not act in a way which unfairly discriminates among customers. The former point is addressed in our views on Article 21. As to discriminatory handling of customer orders, firms should not be permitted to give priority in execution, better execution prices, or lower costs based on soft commissions, monetary payment, or other factors which constitute a conflict of interest between the firm and its customers.

The prompt and expeditious execution of client orders should require that market orders are executed without undue delay once they are received, that limit orders are executed as soon as they are executable on any regulated market.

The distinction between retail and professional customers is important in order to provide retail customers with the protection they need and professional clients with the flexibility necessary for efficient execution of their orders. The distinction between the two with respect to “fair” execution is discussed in our response regarding Article 21 (net-price based execution for retail, more flexible approach for professional). With respect to prompt and expeditious executions, institutions will often trade in large size and this clearly may require that the order executed over time in order to obtain the best result.

A final point is worth making with respect to “prompt, fair and expeditious” execution. When all is said and done, it is obtaining the fair price (best execution) which matters most to the customer. Prompt and expeditious execution is normally important only to the extent that it prevents the order from receiving a less favourable price as a result of the market moving while the order is being held. The profitability of an investment rests only on the net price at which it was bought and sold, and for this reason concerns relating to the prompt execution of an order should be subordinate to concerns for receiving a fair price.

2. *The situations in which or types of transaction for which investment firms may reasonably deviate from prompt execution so as to obtain more favourable terms for clients.*

In many cases, a customer may wish to waive prompt execution and direct the trader to seek a more favourable execution for the order. This holds true for both retail and professional clients. In such circumstances, the customer should be able to waive prompt execution and provide the trader with discretion to seek a more favourable price, on the understanding that the trader will not be held responsible for any loss incurred by the market moving in an unfavourable direction whilst the trader is seeking better prices. Where a customer has affirmatively waived prompt execution in this manner (either on a one-off basis or on a blanket basis), firms should not be held liable for a breech of prompt execution, provided that they otherwise conform to the principles of best execution.

<u>Reporting of Transactions (Article 25)</u>

We concur with the thrust of Article 25, that is, that competent authorities have access to all transaction information necessary to perform their regulatory functions. However, we believe the wording of the article and the associated mandate potentially creates a situation which is anti-competitive and inimical to the goal of integrating the European marketplace.

Specifically, paragraph 3 stipulates that arrangements be made to ensure the competent authority of “the most relevant market in terms of liquidity” receives the transaction data. We strenuously object to any reference to “most relevant markets”, with or without reference to liquidity, as these references and the resulting regulations would only serve to reinforce the fragmentation of the market among isolated, dominant exchanges. It is difficult to see how the flow of capital (in the form of orders and transactions) across national borders would be facilitated by any regulation which in its effect encourages liquidity to remain with a market deemed to be “most relevant”.

The problem, as we see it, is that any rule which requires firms to send a transaction report to a particular competent authority may, in its effect, lead the firm to effect the trade on a regulated market within that competent authority’s jurisdiction. This is because regulated markets frequently “onward report” the details of a transaction to the market’s competent authority, so that the firm does not need to go to the additional time and effort of sending a separate transaction report to the competent authority. Where firms must report the trade to a particular competent authority, though, separate reports may need to be made by the firm.

We note, however, that the mandate does not require arrangements by which the *firm* makes the information available to a particular competent authority. This leaves scope for a more sensible approach. The sharing of transaction information should be viewed as a matter for the competent authorities themselves, and not the exchanges or firms involved in the transaction. As such, the Level 2 provisions should require competent authorities to make arrangements *among themselves* to ensure that transaction details are provide to those other authorities who have a regulatory need for the information. The use of "contact points" as described in Article 58 seems to be a practical approach in this regard.

We would further recommend that any reference to "most relevant in terms of liquidity" be interpreted to mean any market in which the security is admitted to trading, or alternatively the market on which the liquidity itself is most relevant – the market on which the best net price resides.

Transparency Obligations (Articles 28, 29, 30, 43 and 44)

We concur that transparency of prices is necessary for the order interaction which is the foundation of an efficient price formation process as well as for the integration of the market. The range and depth of trading interests should be sufficient for traders to gauge both the best prices and the potential volatility of the market in the shares in question. In most electronic markets, it is common that the depth of interest be shown to at least five levels (where five levels exist), and we see no compelling reason to expect any fewer. We note, though, that markets and data vendors may provide different levels of service which provide more or fewer levels of information depending on the needs of the customer.

We support the concept that large size orders should be exempted from immediate reporting obligations in order to protect the price formation process. While the exact threshold for determining whether a particular order constitutes such a "block trade" requires further discussion, we believe that the threshold should be based on the total consideration (value) of the trade rather than the number of shares involved.

Admission of Financial Instruments (Article 39)

If a single market for financial services is to be created, it is important that shares be as easily traded on one regulated market as on any other. Toward this end, virt-x has since its inception admitted to trading those equities which are components of the major European indices, and we now see other markets doing the same. This trend should be encouraged as it breaks down the existing national bias which contributes to the present fragmentation of the European market.

Any arrangement which places an excessive burden or liability on markets which admit these shares to listing should therefore be avoided. Indeed, any measure requiring markets to actively and continuously investigate the compliance of these shares would duplicate efforts presumably being undertaken in the "home" market. Indeed, such a requirement implies that home market authorities cannot be relied upon to conduct effective oversight. Instead, we believe that markets should be required only to notify the home competent authority that the shares have been admitted to trading by the market, so that the competent authority may notify the market should the issuer fall out of compliance, and that the market be required to have access to media vending services through which regulatory problems would be publicly disseminated.

Obligation to Cooperate (Article 56)

As with the case with “most relevant markets” in Article 25, we object to the use of a standard based on whether a regulated market is “of substantial importance”. It is far more sensible to simply require that competent authorities establish cooperation procedures with any and all competent authorities under whose jurisdiction the shares in question are traded.

Exchange of Information (Article 58)

We support the concept of “contact points” for the dissemination of information among competent authorities.

As I noted at the beginning of this letter, I foresee that we will have further contributions to make as the debate on these issues develops. In the meantime, I believe that it would be helpful to meet in order to further amplify and clarify our views, and I hope to have the opportunity to meet with your staff in the near future to do so. In the meantime, I am of course at your staff’s disposal should they have any questions regarding our response.

Yours sincerely

Scott McCleskey

Director

Public Regulatory Policy