THE COMMITTEE OF EUROPEAN SECURITIES REGULATORS

Ref.: CESR/04-562

CESR's Draft Technical Advice on Possible Implementing Measures of the Directive 2004/39/EC on Markets in Financial Instruments

2nd Set of Mandates

CONSULTATION PAPER

October 2004

EXECUTIVE SUMMARY

Background

The Directive on Markets in Financial Instruments (Directive 2004/39/EC - "MiFiD") was adopted by the European Parliament and Council on 21 April 2004 (OJ L145/1 of 30 April 2004). The Directive will replace the Investment Services Directive 93/22/EEC.

According to the Lamfalussy Process, the Commission may adopt implementing measures, so-called "Level 2 measures", with respect to a large number of provisions of the Directive. Before the Commission presents a proposal for implementing measures to the European Securities Committee, it seeks the technical advice on these measures from the Committee of European Securities Regulators ("CESR").

Purpose

The purpose of this consultation document from CESR is to seek comments on the draft technical advice that CESR proposes to give to the European Commission on the implementing measures set out in the second set of mandates received by CESR from the EU Commission on 25 June 2004.

Areas Covered

Given the extent of issues covered by this consultative document, it is not possible to briefly summarise the key issues which are addressed. Broadly speaking, this draft advice covers, *inter alia*, specifying the list of financial instruments as regards commodities derivatives, the definition of investment advice, general obligation for the investment firm to act fairly, honestly and professionally and in accordance with the best interest of the client, suitability test, appropriateness test and executon only business, limit orders display, eligible counterparties and pre-trade transparency for systematic internalises.

Call for comments

CESR invites comments on the appropriate level of regulatory intervention in addressing the needs of retail and professional clients.

Additionally, CESR would like to raise the attention of retail investors to a number of questions and issues that are of direct interest to them, including:

a) definition of investment advice;
b) general obligation for firms to act fairly, honestly and professionally and in accordance with the best interest of the client;
c) suitability test, appropriateness test and execution only business;
d) pre-trade transparency for systematic internalisers;

Among others, these items are highlighted by specific questions in this consultation document. However, even where no specific questions have been posed, CESR invites all market participants (practitioners, consumers and end-users) to comment on the draft advice contained in this consultation document.

Consultation Period

Consultation closes on **21 January 2005**. Responses to consultation should be sent via CESR's website in the section "Consultations".

A public hearing will be held in Paris, at CESR premises, on 19 November 2004. An agenda for the hearing will be available in the CESR website.

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INTRODUCTION

1. CESR publishes its consultation paper on its draft technical advice to the European Commission regarding the second set of technical implementing measures for the Directive on Markets in Financial Instruments (Directive 2004/39/EC, MiFiD). This document is aimed at receiving responses to its content and to a number of specific questions included in the document itself.

2. It should be stressed that CESR's draft technical advice should not be perceived as legal text, even if it is precise to facilitate its comprehension in the consultation phase. It is the responsibility of the Commission to draft a proposal for implementing measures taking into account the technical advice provided by CESR.

3. CESR has included a number of questions to highlight those areas in which it would be particularly helpful to have views. Comments are, of course, welcome on all aspects of the proposed CESR advice but, if changes are required, any reasoning accompanied by any practical examples of the impact of the proposals will be very useful. CESR also welcomes specific drafting proposals when respondents are seeking changes to the proposed Level 2 advice.

4. Respondents to this consultation paper should post their responses on CESR's Website (www.cesr-eu.org) in the section "Consultations". CESR will publish a feedback statement on the consultation justifying its final choices vis-à-vis the main arguments raised during the consultation.

5. The Directive on Markets in Financial Instruments was adopted by the European Parliament and Council on 21 April 2004 (OJ L145/1 of 30 April 2004). The Directive will replace the Investment Services Directive 93/22/EEC (ISD).

   The decision to revise the ISD reflects common agreement that structural changes in EU financial markets requires legislation to be adapted in order to advance integration of the single market in financial services. The Directive will form one of the cornerstones of the EU's securities regulatory regime, and is intended to deliver an effective 'single passport' for investment firms and regulated markets. The new Directive broadens the range of investment services and activities for which authorisation is required under the existing ISD; it clarifies and expands the list of financial instruments that may be traded on regulated markets and between investment firms; it also introduces rules on the provision of investment advice and more detailed rules on conflicts of interest. Standards for regulated markets and multilateral trading facilities are included, as well as new rules on handling client orders.

   According to the Lamfalussy Process, the Commission may adopt implementing measures, so-called "Level 2 measures", with respect to a large number of provisions of the Directive. Before the Commission presents a proposal for implementing measures to the European Securities Committee, it seeks technical advice on these measures from the Committee of European Securities Regulators ("CESR").

6. On 25 June 2004, the Commission published "The formal request for Technical Advice on Possible Implementing Measures on the Directive on Markets in Financial Instruments". In addition to confirming the provisional mandate, published 20 January 2004, the Commission asked CESR to deliver its technical advice in form of an "articulated" text concerning some new areas of the Directive by 30 April 2005. The text of the individual mandates is set out in each specific section of CESR's Level 2 advice.

7. In order to accomplish its tasks CESR set up three Expert Groups: Expert Group on Markets, chaired by Mr Karl-Burkhard Caspari; Expert Group on Intermediaries, chaired by Mr Callum McCarthy; Expert Group on Cooperation and Enforcement, chaired by Mr Michel Prada. (The

three Expert Groups are coordinated through a steering group, which is chaired by CESR's Chairman, Mr Arthur Docters van Leeuwen.) The Expert Groups are assisted by a Consultative Working Group formed of 21 market participants by CESR. In preparing this draft technical advice CESR has been in contact with the US Authorities (SEC and CFTC) to discuss issues of common interest.

8. CESR published a Call for Evidence on 29 June 2004 with a work-plan containing indications of the most relevant steps in the process of approval of its technical advice.

9. In conducting its work CESR has taken into account all its existing work and achievements relevant in the area of intermediaries, markets and cooperation (the complete list of these works is given in Annex 2). In particular, a substantial part of the draft advice under the section on Intermediaries is based on the CESR Standards for Investor Protection, following a decision taken by CESR to include these Standards in its technical advice to the Commission unless these are not in line with the text of the Directive anymore.

10. More details on process and CESR's work plan, as well as a list of papers already published by CESR with relevance to this first set of mandates, are given in the Annexes to the consultation paper.

DRAFT TECHNICAL ADVICE

SECTION I – DEFINITIONS

a) References in this advice to the "Directive" mean, unless the context requires otherwise, Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments.

b) References in this advice to terms defined in the Directive shall have the meaning given to them in the Directive unless the context requires otherwise.

c) CESR proposes using the same definitions contained in its consultation paper issued on 17 June 2004 on the first set of mandates under the MiFiD (Ref. CESR/04-261b).

SECTION II - INTERMEDIARIES

Definition of "investment advice" (Article 4(1) No. 4)

Extract from Level 1 text

Article 4(1) No. 4: "Investment advice" means the provision of personal recommendations to a client, either upon its request or at the initiative of the investment firm, in respect of one or more transactions relating to financial instruments.

Extract from the mandate from the Commission

DG Internal Market requests CESR to provide technical advice on possible implementing measures on the definition of "investment advice" by 30/04/2005 and in particular on the criteria for differentiating a personal recommendation from

- General recommendations,

- Marketing communications,

- Information given to the clients or from

- Simple offer

- The activities carried out by tied agents.

Draft CESR advice

Explanatory text

In view of the consequences that flow from the characterisation of behaviour as the provision of investment advice (including the requirement for authorisation as an investment firm and the requirements in Article 19(4)), it is important that investment advice is defined in a proportionate manner, while ensuring an appropriate level of investor protection.

In the light of the very wide range of activities that will need to be measured against the definition of investment advice, this definition should contain an appropriate level of flexibility and enable all relevant circumstances to be taken into consideration in determining whether advice has been provided.

In view of an existing definition of "recommendation" in EU legislation concerning financial services, CESR considered whether it is appropriate to adopt the definition under Article 1(3) of the Commission Directive 2003/125/EC of 22 December 2003 implementing Directive 2003/6/EC as regards fair presentation of investment recommendations and the disclosure of conflicts of interest ("MAD"). However, the following considerations lead to the preference for a new definition which adopts only certain criteria of the definition in the MAD.

First, the definition of "*recommendation*" under the MAD corresponds with the aim of that Directive to impose a requirement on investment firms to fairly present investment recommendations such as research reports. However, the definition under consideration has to be designed for the purpose of adequately covering "investment advice" by the MiFID. In the normal course of business, recommendations by investment advisers are of a different nature than research reports designed for a large and heterogeneous group of recipients.

Second, almost all suitable criteria of the definition in the MAD have been incorporated in the proposed definition for MiFID, though formulated in different manner in order to fit into an adequate definition. Yet, the criterion "*suggesting an investment strategy concerning one or several financial instruments*" has been left out because this alignment with the MAD would not provide answers to the underlying question in respect of the inclusion of "*generic recommendations*" within "investment advice" (as discussed in detail below).

Recommendation

A "*recommendation*" by the person advising the client is an opinion of the advisor about the merits or value of one or more transactions in financial instruments for the client or potential client or any other indication that such a transaction or transactions would be desirable or beneficial for the client or potential client. This will definitely include, among others, recommendations:

- to buy, sell, subscribe for, exchange, redeem, hold or underwrite one or more specific financial instruments; or
- to exercise, or not to exercise, any right conferred by a financial instrument to buy, sell or subscribe for financial instruments.

Recommendations on the timing of any of the investment decisions mentioned above should also be considered as investment advice for these purposes (e.g. recommending to a client that he should wait until the end of the month before buying shares of Company X) or on the amount of assets to invest.

On the other hand, the mere provision of information of a general nature on financial instruments and financial services, provided that the purpose of theses activities is not to provide, either explicitly or implicitly, a recommendation on any of the matters referred to above, should not be considered as investment advice under the MiFID. Hence, under the conditions mentioned above, among others, the following should not be regarded as investment advice:

- an explanation of the implications of exercising certain rights or the happening of certain events (such as death);
- providing a credit rating for the issuer of a bond;
- advice on the likely meaning of uncertain provisions in an agreement relating to, or the terms of, a financial instrument or on the effect of contractual terms and their commercial consequences or on terms that are commonly accepted in the market;
- advice on how to complete an application form; or
- advice on the value of investments for which there is no ready market.

CESR considered whether advice on the use of a "*service*" (e.g. advice on the merits of using a particular broker or investment manager) should be covered by the term "*investment advice*". On the one hand, Article 19(4) requires the investment firm to obtain information from the client or potential client in order to recommend the "*investment services and the financial instruments*" suitable for him. This indicates that advice on services may be covered. On the other hand, the term investment advice is defined under Article 4(1)(4) as "*personal recommendation in respect of one or more transactions in financial instruments*". If at all covered by this definition, the term "*services*" seems to be restricted to the services provided in effecting the recommended transaction. However, in view of the fact that no Member State appears to currently regulate advice on the provision of investment services and only one Member State has recently enacted measures to do so, CESR decided to give the advice to the EU Commission not to include this issue at the present time.

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?*

Personal

The recommendation is deemed to be personal if it is given to a person and appears as suited to or based on his personal situation, i.e. each recipient has reasonable grounds to believe that the recommendation takes his specific situation into account because it is represented either explicitly or implicitly to the recipient as being suited to, or based on a consideration of, his personal circumstances. In other words, a recommendation issued on behalf of an investment firm without prior request of the client or potential client shall also be deemed to be personal if, from the position of a reasonable observer of the type of the client or potential client, all relevant circumstances together indicate that the recommendation is suited to, or based on a consideration of, the client's or potential client's personal circumstances.

The extension of the term investment advice to communications that give the impression that the client's situation has been considered shall enable the supervisory authorities to prohibit and/or sanction this behaviour by unauthorised persons with the means of the MiFID. Otherwise, these activities could only be prohibited by national laws and regulations which are not harmonised within Europe.

A simple disclaimer shall not make a recommendation impersonal which otherwise is represented to be suited to, or based on a consideration of, the client's personal needs and circumstances. Though not in a conclusive manner, the inclusion of a disclaimer in the communication may be relevant in determining whether the communication is represented to the recipient(s) as being suited to, or based on a consideration of, their personal circumstances. The assessment of the nature of a communication shall consider the overall effect of all of the circumstances surrounding the communication.

Investment advice shall also include cases where only the circumstances indicate that the recommendation is based on the consideration of the client's personal situation. Thus, a recommendation may be personal though it does not expressly involve a consideration of the client's situation (e.g. "Mr. Miller, it is a good idea to buy shares of company S"). In this case, in order to establish that the investment firm has implicitly provided investment advice, the relationship between the parties, their communication in its entirety as well as other relevant factual circumstances have to be considered (e.g. the evaluation of the client's existing portfolio and his financial situation by the investment firm during a face-to-face communication with the client and/or the agreement about the provision of investment advice). The abstract definition proposed therefore includes the "*implicit*" provision of personal recommendations.

The reference to the appearance of the communication as being suited to the recipient's personal circumstances is not intended to anticipate the legal consequences of an investment firm providing investment advice under Article 19(4). Rather, it serves as criterion to determine when a communication is deemed to be personal in contrast to other recommendations and pieces of information.

However, it may be felt that a personal relationship between the client or potential client and the investment firm or their bilateral communication (e.g. by telephone or email) is sufficient to constitute an assumption that investment advice is provided if a recommendation is provided to the client. This approach would have the advantage of providing easily applicable criteria for the definition of "personal recommendation". The drawback is, that it would also make a differentiation between "personal recommendation" and "general recommendation" or "marketing communication" rather difficult in many cases. Furthermore, it would cover recommendations which are clearly not intended to constitute investment advice (e.g. the handing over of a marketing folder that recommends a new product or the simple transfer of a research report by email).

CESR provides two options in its advice. This is indicated by the term "*specific*" in square brackets under paragraph 1 of the advice.

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"?*

One or more transactions relating to financial instruments

Since personal recommendation might be very specific, i.e. recommending one or more particular financial instruments ("Taking your personal situation into account, you should buy 50 shares in Company S, 100 bonds of Company B and 200 units in Collective Investment Undertaking U), or more generic, i.e. recommending types of financial instruments ("Taking your personal situation into account, you should invest 30% of your liquid assets in stocks and 70% in bonds"), CESR considered the width of the definition of "investment advice".

Including generic recommendations in the definition would lead to the consequence that financial planning services and advice on asset allocation on financial instruments will be "core" investment services. Hence, an authorisation would be required to provide these services where the other conditions set out in the Directive are met. However, an investment firm authorised to provide investment advice could in any case provide the service of financial planning and asset allocation relating to financial instruments without a separate authorisation for another financial service or ancillary service under the MiFID. Investment firms will not be forced to obtain a top-up authorisation if they provide specific recommendations and generic recommendations. The latter will either be covered by the definition of investment advice or fall outside the scope of the MiFID.

In any case, advice on products not covered by the MiFID such as real estate or insurances contracts, clearly does not require authorisation for the purposes of the MiFID, nor is the provision of advice that is excluded from the application of the MiFID by Article 2(1)(c) or Article 3(1) indent 2 or any other applicable exemption covered by the Directive.

An advantage of a very broad understanding of investment advice covering generic recommendations could be the fact that the suitability–test under Article 19(4) MiFID and other relevant provisions of the MIFID would apply to a wider range of recommendations. Arguably, clients should have an equivalent claim for a proper assessment of the suitability of the generic recommendation for their personal situation. Hence, a broad definition might enhance investor protection.

Although financial planning and asset allocation are often provided for very wealthy or institutional clients, at the first glance, it is not comprehensible why these clients should not be equally protected if the recommendation was not suitable for their personal situation.

In practice, investment advice often refers to a wide range of products and services, even beyond the scope of the MiFID. Therefore, a distinction between generic and specific recommendations on financial instruments to a particular client could be considered as artificial.

Furthermore, it may be felt that competitive differences between investment firms providing investment advice and generic advice with firms providing exclusively generic advice might occur if firms systematically restrict their business to asset allocation and financial planning in order to avoid authorisation and regulation under the MiFID. However, a business model based on the possibility to evade regulation by the MiFID could also be established in many other areas. Furthermore, entities considering such a business model would have to balance the regulatory costs they would avoid by not receiving an authorisation with the negative effect on their reputation.

On the other hand, it should not be disregarded that a personal recommendation of specific transactions in particular instruments could entail an aggravated risk. In the case of a generic recommendation, the client still has to make up his mind about, or obtain advice on, the concrete instruments for his investment whereas, in case of specific recommendation, he could directly order the recommended financial instrument(s). Thus, the more specific the recommendation the higher the influence on the client's decision to act on the advice, particularly on unexperienced investors. Moreover, especially specific recommendations increase the risk of churning or mis-selling. A narrower definition would also be clearer and allow for a more precise determination of the services covered.

Additionally, as a matter of fact, the client has to provide information about his personal situation before financial planning or asset allocation is provided. At the same time, considering the prognostic nature of generic information and the free choice of the investor regarding the specific instruments, it may be more difficult to prove wrongful advice in practice. Hence, the inclusion of generic recommendation in the scope, except for some cases (e.g. recommendation to a retired person with an average pension to invest almost all of her assets in illiquid penny stocks), will not be of use for many investors but will increase the burden on firms and the scope of regulation under MiFID.

Moreover, even if cases of mis-selling involve the provision of generic advice, it is likely that such generic advice will have been followed by, or combined with, a specific recommendation (e.g. the retired person in the example given above will be advised to buy specific penny stocks). This is because the express or implied linkage to a particular financial instrument will generally provide the opportunity for the person engaging in mis-selling to make a financial gain by selling that product.

Though the wording of the Directive is not very clear in this respect, it could be argued that it underlines the narrower interpretation. According to Article 4(1)(4) MiFID investment advice means a personal recommendation in respect of "*one or more transactions*". Financial planning and asset allocation services do not constitute direct advice on "transactions". At all events, they could lead to transactions if the investment firm sequentially recommended a specific financial instrument or the client autonomously decides to trade a specific financial instrument.

Since the delineation between specific and generic recommendations is floating, specific cases of personal recommendation that could be qualified as either specific or generic have to be evaluated according to the specific circumstances on a case-by case basis (e.g. whether a recommendation to buy shares of the Finish telecommunication sector is a specific recommendation). The abstract definition proposed addresses this issue by referring to "*implied personal recommendations*".

In the end, CESR provides two options in its advice. This is indicated by the term "*specific*" in square brackets under paragraph 1 of the advice.

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?*

Contract

CESR is of the opinion that a contract with the client should not be a prerequisite for the provision of investment advice or, vice versa, a personal recommendation should not only be covered by the Directive if a contractual relationship exists between the adviser and the client. Some jurisdictions provide for concepts such as pre-contractual liability or implied agreement without consideration, while others do not. Since the principles of contract law are not harmonised throughout Europe, the conditions for formation of a contract and liability might vary according to the relevant jurisdiction. Though a regulatory approach may influence the interpretation by some courts, the regulatory approach should not depend on unharmonised principles of private law. Since this problem was already noticed by CESR, the CESR Standards on Investor Protection also clarified in its definitions that investment advice could be provided "*either incidentally or under a contract for investment advice*".

However, the actual existence of a contract between the investment firm and the client about "*continuous investment advice*" could constitute a strong indication and will be one of the factual circumstances which have to be considered for the assessment whether investment advice has been provided in a specific case.

Differentiation between personal recommendation and other terms

The mandate asks CESR to advice on criteria for differentiating "*personal recommendations*" from the terms "*general recommendation*", "*marketing communication*", "*information given to the client*", "*simple offer*" and the activities of "*tied agents*".

General recommendation

The main criterion for differentiating "*general recommendation*" from personal recommendation seems to be the fact that a general recommendation is not held out as being suited to, or based on a consideration of, the client's personal circumstances but is intended for distribution channels or for the public.

Marketing communication

The main criteria for differentiating a personal recommendation from "*marketing communication*" is that the latter is generally not held out as being suited to, or based on a consideration of, the client's personal circumstances and is intended for public distribution. Moreover, "*marketing communication*" is, as a rule, not issued on a client's request but at the initiative of the investment firm.

Moreover, CESR ascertained that a general recommendation could also be part of a marketing communication.

Information given to the client

"*Information given to the client*" specifically includes, but is not limited to, the necessary information that is required to be provided under Article 19(3) of the Directive. Accordingly, it includes all pertinent information provided to clients or potential clients necessary to reasonably enable them to understand the nature and risks of the investment service and of the specific type of financial instrument that is being recommended or simply offered. Furthermore, "*information given to the client*" refers to all other information that may have an influence on investment decisions provided without making any comment or value judgement on its relevance for an investment decision relating to financial instruments.

The main criteria for differentiating a personal recommendation from "*information given to the client*" that it is factual information that is generally neither held out as being suited to, or based on a consideration of, the recipient's personal circumstances, nor includes a recommendation.

Simple offer

CESR considers the term "*simple offer*" as artificial because it is not used in this sense by the MiFID. We therefore base our advice to the EU Commission on criteria for differentiating the term "*offer*" from personal recommendation.

The term "*offer*" should not be restricted to the definition of "*offer of securities to the public*" under Directive 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading. Rather, an offer in the context of the MiFID should also include a promise or commitment in relation to one or more transactions in financial instruments not covered by the Prospectus Directive and the provision of an investment service. In contrast to a personal recommendation, an "*offer*" will generally lack a value judgement or other recommendation in respect of one or more transactions in financial instruments and will generally not be held out as being suited to, or based on a consideration of, the recipient's personal circumstances.

The distinction between "*personal recommendation*" and "*information given to the client*" or "*offer*" takes into consideration that, in general, simply giving information or making an offer in a factual manner without making any comment or value judgement on its relevance to investment decisions which an investor may make will not involve a personal recommendation.

Subject to the presentation of the information or offer in a particular case, examples of such information or offers may include the following:

- Listing the prices of financial instruments;
- Circulating company news or announcements;
- Offering to buy or sell particular financial instruments;
- Explaining the terms and conditions of a financial instrument;
- Comparing the benefits and risks of one financial instrument as compared to another;
- Publishing league tables showing the performance of financial instruments of a particular kind against set published criteria;
- Publishing details of directors' dealings in the shares of their own companies; or
- Alerting persons to the happening of certain events (for example that shares in company Y have reached a certain price).

Hence, a recommendation may be made where the circumstances surrounding the provision of information or making of an offer give it the force of a recommendation, either explicitly or implicitly (e.g. including statements using the word "recommend" or equivalent formulations). For example:

- A person may offer to provide information on directors' dealings on the basis that, in his opinion, when directors buy or sell investors would do well to follow suit;
- A person may offer to tell a client when shares reach a certain value on the basis that when the price reaches that value it would be a good time to buy or sell them; or
- A person may provide information on a selected, rather than balanced basis which would tend to influence the decision of the recipient.

A simple disclaimer shall not prevent a communication amounting to a recommendation, when this is the clear effect of the communication. Though not in a conclusive manner, the inclusion of a disclaimer in the communication may be relevant in determining whether it is purely the provision of information or the making of a simple offer or whether it also involves the making of a personal recommendation. The assessment of the nature of a communication shall consider the overall effect of all of the circumstances surrounding the communication.

Tied agents

Concerning the differentiation between "*personal recommendation*" and "*tied agents*" CESR does not see any criteria for a meaningful distinction. The mandate does not ask for an interpretation of Article 23(1) MiFID. Though the formulation of Article 23(1) "*providing advice in respect of such financial instruments and services offered by that investment firm*" is ambiguous with respect to the question whether the formulation "*such financial instruments*" refers only to those instruments placed by the principal, CESR has not received a specific mandate on this issue. The statement that an investment advice by a tied agent cannot be considered as independent and impartial, also seems to be beyond the mandate. Since CESR could only state that tied agents may also provide investment advice within the limits of Article 23(1) MiFID, we decided not to provide advice on tied agents.

Overlaps between personal recommendation and the other terms

CESR considered whether a communication by an investment firm must fall exclusively within one of the above categories or could involve an overlap between two or more categories of these categories and/or an overlap with the term "personal recommendation". Though in most cases the terms "*general recommendation*", "*marketing communication*", "*information given to a client*" and "*offer*" could be distinguished from personal recommendation by the given criteria, CESR recognised that overlaps might occur. In these cases, each relevant regime will apply to the communication by the investment firm.

For example, where the investment firm prepares a brochure, a leaflet or a prospectus that constitutes a general recommendation, a marketing communication and/or involves the provision of information, it is conceivable that this document is also used as a basis for a personal recommendation. Also, if the investment firm prepares a research report which is intended for distribution to the public and then sends this report with a personalised recommendation to a specific client (e.g. "Mr Miller, taking your personal situation into account, the financial instrument discussed in this report also seems to be perfectly suited for your needs"), the communication may involve both the provision of investment advice and the distribution of investment research. Therefore, in addition to the regime for the preparation of research (i.e. the organisations requirements for research and the disclosure of conflicts of interests), the regime for investment advice may apply if the relevant factors are sufficient to establish that a "*personal recommendation*" has also been given. Likewise, the regime for the making of an offer to the public and the regime for investment advice will apply if a prospectus which meets the other conditions under the Prospectus Directive is used for the provision of investment advice.

CESR also recognised that overlaps between "*marketing communication*" and personal recommendations might occur, e.g. where spam mail is addressed to a wide range of clients for marketing purposed, though the mail is personalised and appears to be tailored to each recipient's specific situation. Depending on a consideration of all of the relevant circumstances of the particular case, both regimes may apply to such communications.

General considerations

Finally, CESR is of the opinion that, in spite of a definition of investment advice and a definition of personal recommendation, the classification of a communication or a service as investment advice always needs a case-by-case consideration of all relevant factual circumstances from a client's perspective. We therefore rejected to list all conceivable scenarios in the advice.

Draft Level 2 advice

BOX 1

Definition of Investment advice

1. "*Personal recommendation*" means any information given to a person including a value judgment or opinion or any other express or implicit recommendation whether to a) buy, sell,

subscribe for, exchange, redeem, hold or underwrite one ore more [*specific*] financial instruments or b) to exercise, or not to exercise, any right conferred by one or more [*specific*] financial instruments to buy, sell or subscribe for one or more financial instruments, or c) to carry out any other transaction relating to one or more [*specific*] financial instruments that is held out, either explicitly or implicitly, to the recipient as being suited to, or based on a consideration of, his personal circumstances *[or is made in a bilateral communication or relationship]*.

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?*

2. In comparison with personal recommendation, most "*general recommendations*" are neither explicitly nor implicitly held out as being suited to, or based on a consideration of, the client's personal circumstances.

3. In comparison with personal recommendation, most "*marketing communications*" are not held out as being suited to, or based on a consideration of, the client's personal circumstances and is issued to the public. "*Marketing communication*" is generally not issued on a client's request but at the initiative of the investment firm.

4. In comparison with personal recommendation "*information given to the client*" is generally factual information that is neither held out as being suited to, or based on a consideration of, the recipient's personal circumstances, nor does include any comment or value judgement in respect of one or more [*specific*] financial instruments or specific transactions or is intended to influence the client in this respect.

5. In comparison with personal recommendation, an "*offer*" will generally lack a value judgment or other recommendation in respect of one ore more transactions in financial instruments and will generally is not be held out as being suited to the recipient's personal circumstances.

6. Though these terms can be differentiated from "*personal recommendation*" by the criteria mentioned above, there may be overlaps. It is therefore necessary to determine whether, based upon a consideration of all the relevant circumstances, the test set out in paragraph 1 is satisfied. If this is the case, each relevant regime will be applicable.

List of Financial Instruments (Article 4 – Annex I Section C)

Extracts from Level 1 text

Article 4: Definitions

(1)(2) "Investment services and activities" means any of the services and activities listed in Section A of Annex I relating to any of the instruments listed in Section C of Annex I;

The Commission shall determine, acting in accordance with the procedure referred to in Article 64(2):

- the derivative contracts mentioned in Section C 7 of Annex I that have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are cleared and settled through recognised clearing houses or are subject to regular margin calls

- the derivative contracts mentioned in Section C 10 of Annex I that have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are traded on a regulated market or an MTF, are cleared and settled through recognised clearing houses or are subject to regular margin calls;

Annex I – list of services and activities and financial instruments

Section C – Financial instruments

(7) Options, futures, swaps, forwards and any other derivative contracts relating to commodities, that can be physically settled not otherwise mentioned in C.6 and not being for commercial purposes, which have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are cleared and settled through recognised clearing houses or are subject to regular margin calls;

(10) Options, futures, swaps, forward rate agreements and any other derivative contracts relating to climatic variables, freight rates, emission allowances or inflation rates or other official economic statistics that must be settled in cash or may be settled in cash at the option of one of the parties (otherwise than by reason of a default or other termination event), as well as any other derivative contracts relating to assets, rights, obligations, indices and measures not otherwise mentioned in this Section, which have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are traded on a regulated market or an MTF, are cleared and settled through recognised clearing houses or are subject to regular margin calls.

Preliminary comments on all Mandates under Article 4(1)(2)

Implications of these mandates

The level 2 measures that will be prepared on the basis of CESR's advice will directly affect the scope of sections C(7) and (10) of Annex I to the Directive, which set out the definition of two of the ten classes of financial instruments listed in the Directive. The mandate relating to the interpretation of the word "commodity" is also relevant to the definitions of three of the other classes of instrument (sections C(1) (by virtue of Article 4(1)(18)(c)), (5) and (6) of that Annex).

This impact on the range of financial instruments falling within the Directive will affect the scope of the Directive (for example through the general and specific definitions of "investment services and activities" and the definitions of a regulated market and an MTF).

In the context of investment services and activities, Article 5(1) of the Directive provides that "*Each Member State shall require that the performance of investment services or activities as a regular occupation or business on a professional basis be subject to prior authorisation in accordance with the provisions of this Chapter.*" However, this is subject to Article 2(1) of the Directive, which provides a number of exemptions from the scope of the Directive.

In addition, the scope of each of the exemptions in Articles 2(1)(i) and (k) is determined by reference to the concept of a commodity, which is the subject of one of the mandates considered in this advice. Under Articles 65(3)(a) and (d) of the Directive, the European Commission is to report to the European Parliament and Council by 31 October 2006 on the continued appropriateness of these exemptions.

Authorisation imposes requirements to comply with a number of obligations under the Directive and, in the case of certain investment firms, under the Capital Adequacy Directive (Directive 93/6/EEC)[1]. However, it also confers certain rights on investment firms under Chapter III of Title II to the Directive.

Scope of this advice

CESR emphasises that its consideration of this mandate has been limited to the context of the Directive. In particular, the draft advice on the definition of a "commodity" is valid only for the Directive and is in not intended, without further explicit consideration, to affect the various definitions of "commodity" in national and other legislation for other purposes. Examples of such measures include the Market Abuse Directive (Directive 2003/6/EC).[2]

However, there are other EU measures which refer to provisions of the existing ISD that will be affected by the level 2 measures under Article 4(1). This is because Article 69 of MiFID provides that references to terms defined in the ISD shall be construed as references to the equivalent term defined in MiFID. Examples of such measures include the Capital Adequacy Directive[3], the Banking Consolidation Directive (Directive 2000/12/EC)[4], the Prospectus Directive (Directive 2003/71/EC)[5] and the Directive on Investor Compensation Schemes (Directive 97/9/EC)[6].

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[1] The Commission published a proposal for the re-casting of the CAD on 14 July 2004.

[2] The penultimate indent in Article 1(3) of MAD refers to "derivatives on commodities", which does not automatically link into the ISD. However, there is a cross reference to the definition of a "regulated market" under ISD, which is defined under MiFID by reference to the definition of a financial instrument, including commodity derivatives.

[3] The definition of an "investment firm" in Article 2(2) of that Directive refers to the definition of an "investment firm" under Article 1(2) of the original ISD. By virtue of Article 69 of MiFID, this reference shall be construed as a reference to the equivalent term under MiFID (the definition of an investment firm in Article 4(1)(1)).

[4] Annex I to that Directive is amended by Article 68 of MiFID.

[5] The definition of "securities" in Article 2(1)(a) of that Directive refers to the definition of transferable securities in Article 1(4) of the original ISD. By virtue of Article 69 of MiFID, this reference shall be construed as a reference to the equivalent term under MiFID (the definition of "transferable securities" under Article 4(1)(18), which contains a reference to "commodities" in sub-paragraph (c)).

The structure of the mandates

The mandate given by the Commission to CESR covers the following important questions (in part implicitly rather than explicitly):

(a) *What is a derivative contract?*

While this is not explicitly part of the mandate, an understanding of this aspect is important to the questions posed as both of sections C(7) and (10) only apply to "derivative contracts". Accordingly the explanatory text covers this topic as part of the introduction to the draft advice on the mandate questions.

(b) *What is a "commodity"?*

This is explicitly the question asked in 3.1(1) in the mandate, and is considered on its own in the draft advice.

(c) *When is a derivative contract relating to a "commodity" within the scope of the Directive, bearing in mind the wording of recital (4) to the Directive?*

This is the question asked through paragraphs 3.1(2) and (3) in the mandates. Because of their close interaction the two points are answered together in the draft advice. This approach is consistent with the fact that a number of respondents to the call for evidence under the second round mandates took different approaches as to whether particular issues should be addressed under mandate 2.1(2) or (3).

(d) *Are there any other derivative contracts (not otherwise specified under Annex I to the Directive) which are within the scope of the Directive, bearing in mind the wording of recital (4)?*

The questions posed in paragraphs 3.1(4) and (5) are of similar effect to question (b) above, but are dealt with separately in the draft advice. Paragraph 3.1(6) is of similar effect to question (c), but is combined with an implicit question about how paragraphs C(4) to C(6) of Annex I should be taken into consideration in this context, bearing in mind the wording of recital (4) to the Directive. These points are considered further in the draft advice on this question posed in the mandate.

"Relating to"

CESR notes that each of the paragraphs in Annex I to the Directive which cover derivative instruments use the phrase "relating to". CESR considers that this phrase refers to a direct link between the derivative contract and the relevant underlying commodity or factor. Thus, for example, a contract for differences based on the price of crude oil would be a derivative contract relating to oil. Conversely, a contract for differences based on the transportation costs for oil would not be a derivative instrument relating to oil, but rather one relating to oil transportation costs. While the meaning of this phrase is not something which is the subject matter of a mandate, CESR believes that it is appropriate to set out its understanding of the phrase to aid interpretation of its advice in this area.

The nature of a derivative

As noted above, the mandates do not ask for advice on the meaning of a "derivative". However, as this concept is central to the scope of sections C(7) and (10) of Annex I, and therefore to the overall impact of this advice, it is appropriate to make some observations on this subject.

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[6] The definition of an "investment firm" in Article 1(1) of that Directive refers to the definition of an "investment firm" under Article 1(2) of the original ISD. By virtue of Article 69 of MiFID, this reference shall be construed as a reference to the equivalent term under MiFID (the definition of an investment firm in Article 4(1)(1)).

The commodity and financial markets meet real commercial needs. For example, the user of a commodity, who is often a manufacturer, needs to be able to maintain stability in the price of his product or at least to be able to calculate his costs and therefore his price for a product which he may not be able to market until some time in the future. If the producer of the commodity is prepared to bind himself to supply particular quantities at agreed prices at some time in the future, there is no problem (the producer and user enter into a simple forward supply agreement). However, the producer may not know whether his crop will be good or bad in terms of quality or quantity. He may, and often will, be unwilling to enter into any supply contracts at the time at which the consumer needs to be able to fix his costs and prices.

The markets evolved to reconcile these otherwise irreconcilable needs. It can do this in a number of ways, but in essence the market participants back their judgment of how the price will move between the moment when the user needs to achieve certainty as to his costs and the moment when the producer is willing to enter into firm contracts to supply:

- In its simplest form the dealer in the market enters into a forward contract to sell a commodity to the user and waits to buy the same amount of that commodity from the producer, hoping that the forward price which he has agreed with the user will be higher than that which he eventually has to pay the supplier. Similarly the dealer may acquire rights to require a producer to sell and/or the user to buy.

- In a slightly more sophisticated form, he watches the market and if at some intermediate stage he thinks that he has wrongly forecast the movement in price, he finds another dealer who takes a different view and enters into a buying contract with him, thus crystallising any profit or avoiding any further loss.

- In a yet more sophisticated form, dealers who do not wish to be involved in taking a long-term view of how the price of the commodity will move, will enter into pairs of contracts, one for the notional sale and one for the notional purchase of a particular quantity of the commodity, the intention of both parties being that no property in the commodity shall pass, but that the contracts will be fulfilled by paying sums of money based upon price differences at different times.

The last of these scenarios describes the essence of what is generally meant by the term "contract for differences". The concept has developed from this into forms in which the notional sale and notional purchase are combined into a single contract, and into forms in which there is no sale or purchase of any good or service at all, but rather there is an agreed starting point in a reference index or value (such as a published stock exchange index) and one party "buys" and the other "sells" that reference mark and becomes liable for (or entitled to) a sum referable to the degree of change in the reference index or value at the expiry of the contract.

Fundamentally, it is possible to group all derivatives into one of three broad categories: options, futures and contracts for differences:

Option (including a cash settled option): a right to buy or to sell property at a particular price (the exercise price), during a particular period (or on a particular date); the right is acquired for a consideration (the option premium); the exercise price is only required to be paid if the right is exercised.

Future/forward: a contract entered into for the purchase or sale of property for completion (settlement) at a later date than is usual for "immediate" cash contracts – the settlement date. It is to be contrasted with transactions in the "spot" or cash market which contemplate that settlement will occur as soon as is usual for the relevant property.

Contract for differences: as illustrated above, this is a single contract in which there is no true agreement for the sale or purchase of any property. The parties simply agree that one will pay the other in cash the difference between two measures, at least one of which remains to be determined when the contract is entered into, at a particular time. Common examples include:

- One party notionally agrees to pay the other a fixed rate of interest, while the other agrees to pay the first party a floating rate of interest. The terms of the contract provide that only the difference in value between the two rates will be settled by the parties (an interest rate swap).

- (Essentially the example provided above) the parties agree a starting point in a reference index or value (such as a published stock exchange index) and one party "buys" and the other "sells" that reference mark and becomes liable for (or entitled to) a sum referable to the degree of change in the reference index or value at the expiry of the contract. There is no sale or purchase of any good or service at all.

A contract for difference can be distinguished from "fixed odds bet", which is not a derivative transaction. Under a fixed odds bet, a fixed amount will become payable on the occurrence of a certain eventuality. However, the amount payable does not vary depending on the degree of variation from the starting point.

An example of a fixed odds bet would be if X agrees to pay Y 1000 euros if the number of points achieved by a football team in a league in the whole of a season is more than 30 points above the number it has at the time the agreement is made. If the team's points total goes up by 29 points, nothing is payable. If the total goes up by 35 points, 1000 euros are payable.

Rights under a contract under which money is received by way of deposit, or in consideration for the issue of a debt instrument, on terms that any interest or other similar income return to be paid on those sums will be calculated by reference to fluctuations in an index or other factor should not be treated as contracts for difference.

It is important to note also that either of the "option" or "forward/future" forms of transaction may be used by the original producer or the ultimate user of the commodity in order to manage his costs and other risks. This kind of hedging is different in the regulatory risks it poses to hedging used simply to manage exposures generated by speculative trading in these contracts. However, the contracts themselves may be identical in form or terms. In the context of derivative contracts falling within section C(7), it is necessary to consider whether that contract is not for commercial purposes and has the characteristics of other derivative financial instruments.

Extract from the mandate from the Commission

3.1(1) Definition of commodity

DG Internal Market requests CESR to provide technical advice on possible implementing measures by 30/04/2005 on following issues: (1) A definition of commodity.

<u>Explanatory text</u>

General approach

In section IV.3 of its November 2002 proposal in relation to ISD 2 the Commission stated that:

> "*The exclusion of commodity derivatives from the existing ISD definition of financial instruments has the following implications:*
>
> – *investment firms cannot benefit from the ISD passport for the cross-border provision of investment services in commodity derivatives – even though, the capital Adequacy Directive requires them to hold capital reserves against any trading book exposures in commodity derivatives;*
> – *specialised commodity dealers are not covered by ISD rights or obligations;*

- *exchanges and other trading arrangements which provide for, inter alia, organised trading in commodity derivative instruments cannot rely on ISD provision for admission of remote members or provision of trading screens.*

Having considered the many aspects of this complex issue, the Commission proposes that commodity derivatives be included within the scope of ISD. The absence of single market framework for this business is anachronistic, particularly when one considers parallel steps taken to liberalise underlying commodity and energy markets."

There were mixed views amongst respondents to the call for evidence as to the extent to which clarity is required as to the definition of a commodity. Some respondents said that no level 2 measures are required on this point. An argument for this approach is that there is an ever expanding range of things that are suitable for treatment as commodities. Other respondents welcomed the certainty that a harmonised definition would bring.

Clarity on the meaning of the term "commodity" - in particular whether to take a broad meaning (covering all fungible things which are capable of being traded) or to take a narrower definition (eg goods of a fungible nature which are capable of being delivered, such as raw materials or standardised physical goods) – would be important in understanding the scope of "financial instruments" as prescribed under Annex I and the extent to which the exemptions in Articles 2(1)(i) and (k) of the Directive apply. This will assist in achieving a common interpretation of the scope of the Directive among Member States. Therefore, CESR proposes to provide advice to the Commission in relation to this question.

CESR does not consider that it is feasible or helpful to try to provide an exhaustive list of commodities for the purposes of the Directive. CESR considers it sufficient to provide certainty to market participants and for the operation of the Directive for a more generalised approach to be adopted. The majority of respondents to the call for evidence supported this approach. CESR has formulated its draft advice accordingly. The draft advice does contain a non-exhaustive list of commodities by way of example. However, this list is not intended to limit the scope of the generalised characteristics set out in the advice.

Fungibility

A number of the respondents to the call for evidence identified fungibility as a characteristic of a commodity. In relation to an obligation to deliver an asset or to pay an amount calculated by reference to fluctuations in the price of units of an asset, "fungibility" means that a unit of that asset is indistinguishable and wholly interchangeable with another unit of the same asset. For these purposes, a particular asset may be fungible for some obligations but not for others. This feature makes an exhaustive list of "commodities" impractical.

As mentioned above, the degree of fungibility will, to a degree, depend upon the terms of the relevant obligation in relation to that asset. For example in relation to a contract to deliver 100 pigs of a specified age, weight, health and breed that does not identify individual animals, animals satisfying the specified criteria would be fungible. However, in the context of a contract to deliver a specific animal and no other (for example, for the purposes of breeding), that animal would not be fungible.

The focus for the purposes of section C(7) should be on the obligation to deliver the asset and not on the transfer of ownership that is eventually used to settle that obligation. The fact that 100 identified pigs are used to settle the obligation contained in the above contract does not mean that pigs were not fungible for the purpose of that obligation.

It is important to note that for these purposes, we are concerned with the feature of fungibility in relation to the commodity which underlies the contractual arrangement and not to the contract itself. Therefore, it is not relevant whether a particular commodity derivative is fungible with other commodity derivatives.

The treatment of intangibles

There is no relevant existing definition in either the ISD or the CAD of "commodity" (or of "commodity derivative"). However, CAD appears to contemplate commodities as being of various types – notably, base and precious metals[7], agricultural products ("softs") and "other commodities (including energy supplies)" – in article 11a. This is more consistent with a narrower approach of the kind mentioned above. A similar approach is taken in the definition used for regulation in the United States[8], and a number of internet sited glossaries follow a similar approach (See the appendix for other internet-based glossary definitions).

A right or entitlement that has no physical manifestation would not fall within this approach. A purely intangible right that is legally deemed to be manifested in a physical document of title, such as a bearer bond, would also be excluded under such an approach.

It is not clear why the concept of "commodity" should cover any purely intangible asset, such as an emissions allowance (or indeed whether such a pure intangible can be seen as an "article of trade"). Once the jump to pure intangibles is made, there are a number of other areas (eg derivatives relating to freight capacity, gas storage capacity, weather and bandwidth) which might come within the definition. Further consideration is required as to whether this kind of right is appropriately considered under Annex I, paragraph C(10) instead.

- One approach would be that the existence of paragraph C(10) indicates that the definition of a "commodity" was not intended to include the matters expressly referred to in that paragraph.

- However, there are some overlaps between paragraphs in Annex I (for example between C(4), (5) and (9)), which indicates that the paragraphs are not necessarily mutually exclusive. Therefore, another approach would be that paragraph C(10) is merely intended as a means of avoiding doubt about whether the Directive is intended to cover certain things which have not traditionally been considered commodities, but which are frequently traded alongside them.

With the exception of the question of the treatment of electricity, which is discussed below, only a minority of responses suggested that any other wholly intangible assets should be considered as commodities. Consistent with this approach, CESR has based its draft advice in this area on the assumption that the existence of paragraph C(10) indicates that the definition of a "commodity" was not intended to include the matters expressly referred to in that paragraph. However, for the reasons set out below, this is reflected in the use of the concept of "goods" instead of by reference to tangibles and intangibles.

Question 2.1.: Should "commodities" for this purpose be limited to goods?

If this approach is taken, the items listed in paragraph C(10) will be excluded from the definition of "commodities" for the purposes of the Directive.

Question 2.2.: Alternatively, should an approach be taken that permits rights or property specifically mentioned in C(10) and other intangibles to be treated as "commodities" as well?

The treatment of electricity

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[7] CAD treats gold as if it is a currency, rather than as a commodity for the purpose of the calculation of commodities risk pursuant to Annex VII to that Directive. However, this is a result of a specific provision to that effect, which is particular to that context.

[8] The US Commodity Exchange Act includes the following products in its definition of "commodity": "wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, Solanum tuberosum (Irish potatoes), wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil, and all other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products, and frozen concentrated orange juice, and all other goods and articles, except onions."

The responses to the call for evidence showed a consensus that energy supplies should be considered as commodities, whether or not they could properly be regarded as tangible assets.

As has been highlighted in the responses to the call for evidence, there are good reasons for avoiding different categorisations, and thus different treatments under the Directive, between electricity and other energy supplies. There are similarities between the trading structures and participants, and to some extent in settlement mechanisms (such as the UK's "balancing point" constructs for gas and electricity trading). Accordingly, CESR's draft advice treats electricity and other energy supplies in the same way, and uses the concept of "goods"[9]. This approach also has the advantage of excluding other financial instruments (such as warrants).

The treatment of telecommunications bandwidth

The responses to the call for evidence made reference to the continual development in the financial markets. As described below (in relation to 3.1(5)) CESR's attention was drawn to derivatives markets based on telecommunications bandwidth. CESR's assessment is that telecommunications bandwidth does not fall within the concept of "goods" (unlike electricity) but is in the nature of a service or transfer of rights[10]. However, in the light of the responses to the call for evidence CESR agrees that this derivative market should be considered to be within the scope of the Directive. Accordingly the draft advice in relation to paragraph C(10) of the Directive suggests its inclusion under that part of Annex I.

Question 2.3.: Should derivative instruments based on telecommunications bandwidth be considered to be within the scope of the Directive?

Question 2.4.: If it should be considered within the scope of the Directive, should it be considered to be within the scope of paragraph C(7) or of paragraph C(10) of Annex I?

The meaning of delivery

The ability to deliver goods which are to be treated as commodities should not, for these purposes, require the physical movement of goods from one place to another if the commercial environment applicable to those goods do not necessitate this. It should be sufficient for the identification of a commodity that the goods are capable of being delivered in answer to an appropriate demand. For this reason the draft advice allows for delivery through the means of documents of title to the relevant goods (for example, where ownership of the cargo on a ship is transferred by delivery of a bill of lading) or other methods of transferring ownership of goods without physically delivering them, including under arrangements that require or permit settlement of contracts by notification of a trade to the operator of an energy supply network.

Trading

The responses to the call for evidence took differing views as to whether there needed to be an ability to buy and sell the underlying, with either liquidity or some form of trading value arising from those transactions.

Requiring a liquid market for the underlying would theoretically narrow the scope of the definition of a commodity quite considerably. However, bearing in mind recital 4 to the Directive, no such limitation applies to the category of financial derivatives falling within Section C(4) to Annex I. We have therefore not proposed such a limitation.

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[9] CESR also notes that the Court of First Instance has considered electricity to be a "good" for the purposes of article 37 (now article 31) of the Treaty – see for example the court's decision and the advocate-general's opinion in Case C-393/92, European Court reports 1994 Page I-01477.

[10] CESR notes that if it is later determined by the relevant judicial authorities that this is a "good" for the purposes of the Treaty of Rome, it will fall within the scope of paragraph C(7). Further the nature of the implementing measures is that they are intended as a means of keeping the Directive up to date, and thus can more speedily be updated to take account of developments in the markets.

A requirement that the underlying is capable of being traded for value would appear to add less to a requirement that the underlying is capable of delivery. It would seem to only catch goods that have no intrinsic value. However, we question how likely parties would be to enter into contracts falling within Sections C(5) to (7) in relation to such goods. This sort of test would be more likely to add meaning if the definition of "commodities" were not limited to goods.

Question 2.5.: If the definition of "commodities" is restricted to goods, should a requirement be imposed that there must be a liquid market in the underlying?

Question 2.6.: If not, should a requirement be imposed that, in addition to being capable of delivery, the underlying must be capable of being traded and if so, should there be a requirement for a liquid market?

Draft level 2 advice

BOX 2

The concept of a "commodity" should cover any goods of a fungible nature which are capable of being delivered.

For these purposes, goods may include raw materials, derivative products, by-products and standardised goods.

Examples of things which would be considered as commodities include (but are not limited to) things of the following types:

(a) precious metals (including gold and silver) and their ores and alloys;

(b) base metals (such as iron, lead, copper, zinc, tin, aluminium) and their ores and alloys;

(c) agricultural products (such as cocoa, sugar, grains, coffee, tea, fruit, livestock, livestock products, non-mineral oils and fats);

(d) energy supplies (such as oil, coal, gas, their derivative products and electricity); and

(e) raw materials (such as timber, cotton, jute, rubber and sisal).

The above groupings of commodities are solely intended for the purpose of illustration and are not intended to have wider significance.

For the purposes of the definition of "commodity":

"*delivery*" should be one of:

(i) physical delivery of the relevant goods themselves;

(ii) delivery of a document showing title to the relevant goods (or relevant quantity of the goods concerned); or

(iii) another method of transferring ownership of the relevant quantity of goods without physically delivering them (including notification of a trade to the operator of an energy supply network) and which entitles the recipient to production of the relevant quantity of the goods without more; and

"fungible" means that, for the purposes of an obligation, a unit of that asset of the relevant description is indistinguishable and wholly interchangeable with another unit of the same asset and description.

The concept of "commodity" should not include services or other items which are not goods (such as land or currencies), entirely intangible or involve only the transfer of rights, such as transmission or pipeline capacity.

3.1(2 & (3)) Commercial purpose and characteristics of other derivative financial instruments

DG Internal Market requests CESR to provide technical advice on possible implementing measures by 30/04/2005 on following issues:

(2) The conditions under which an option, future, swap forward rate agreement or other derivative contract related to commodities (which can be physically settled and is not otherwise covered by Section C.6) should be determined not to be for a commercial purpose.

(3) The conditions (other than cleared and settled through recognised clearing houses or subject to regular margin calls) for considering when a derivative contract of the type included in Annex I Section C 7 has the characteristics of other derivative financial instruments.

Explanatory text

General approach

For the reasons set out above, CESR proposes to address these two questions together.

The conditions referred to in these questions serve to distinguish between derivative contracts which are entered into as incidental to commercial merchant, producer or consumer operations relating to goods and materials, and those transactions that are speculative. In the former case it will commonly be the case that these contracts are for the purpose of limiting exposure to certain risks (primarily price and/or exchange rate fluctuations) which arise because of actual commercial usage of the goods and materials concerned. However, the contracts themselves may be very similar to those that are entered into for speculative purposes. As a result, transactions that do not meet these conditions should not be considered as giving rise to regulatory issues comparable to traditional financial instruments.

The key to distinguishing between commercial purposes and other purposes in transactions taking place away from an organised marketplace or trading facility (whether a regulated market, an MTF or another form) is the business intention of the participants. As a result only very few factors are likely to be determinative. However, there will be a number of other factors which are capable of providing strong indications of whether a commercial purpose underlies the transaction or does not. The negative indications are considered equally useful in operating the necessary distinction.

As mentioned by some of the respondents to the call for evidence on the second round mandates, it is difficult to devise a test that will allow these questions to be answered in an appropriate manner with any certainty. It is therefore likely that some tests can only be treated as indicia. It is important to note that they should not be elevated to the status of a concrete rule.

The services of the European Commission consider that the way CESR approaches this issue results in a regulatory structure that could lead to a situation where the same OTC contract could in certain circumstances fall within the scope of the Directive and not in others. Thus the same contract would be subject to different regulatory requirements depending on the legal nature of the counterparty. This will create an important problem for Investment Firms which will be regulated or not on the basis of the nature of their counterparty. The Commission services have expressed concerns as to whether this approach would be consistent with the line reflected in the Directive which consists in dealing with the supervision and regulation of commodity derivatives markets taking into consideration aspects of substance rather than formal ones.

Spot transactions

A number of respondents to the call for evidence indicated that spot transactions should be excluded from paragraph C(7) of Annex I. CESR recognises that this issue will also be an important factor in determining whether an instrument is a derivative contract at all and therefore capable of falling within other relevant paragraphs within section C of Annex I. The problem with this approach is that the normal settlement cycle will vary enormously from market to market depending on the practicalities of physically delivering the underlying and how delivery is effected. For example, it may take months to ship a cargo of copper across the world. However, the parties could agree to transfer ownership of that cargo at any time during that voyage.

One approach could be to refer to the shortest practicable period for settlement agreed to by market participants. However, there is a danger that this could result in "spot transactions" being deemed to include some relatively long settlement periods in markets where a number of participants habitually close out their position without delivery or taking delivery of the underlying.

The UK applies a test under which forward contracts are excluded from the scope of regulation if delivery is to be made within seven days, unless it can be shown that there existed an understanding that (notwithstanding the express terms of the contract) delivery would not be made within seven days. This does not mean that contracts with a longer settlement date should automatically be caught. It merely means that a further set of tests should be applied to determine whether or not that contract is caught. As these further tests are less clear cut, the 7 day test can be seen as providing a useful preliminary filter.

However, the cut off point could be seen as somewhat arbitrary, and the respondents to the call for evidence who referred to this test disagreed as to whether it should be included.

One possible reason for picking the seven day test could be that the settlement period in the UK spot foreign exchange markets was 2 business days and 7 days allowed for four bank non working days during the settlement period.

However, some spot markets may have a generally accepted settlement period of less than two business days. If participants in such a market enter into contracts with a settlement period that is longer than the generally accepted settlement period for the relevant market but less than two business days, it may be appropriate to apply the further tests to determine whether the applicable trade should be seen as not made for commercial purposes and having the characteristics of other derivative contracts.

CESR has therefore proposed a preliminary filter that only applies if the settlement period does not exceed the lesser of two business days and the generally accepted settlement period in the relevant market.

Question 2.7.: Should there be an initial filter to exclude contracts which are likely to be spot contracts? If so, do you agree with the proposed approach of excluding contracts whose settlement period does not exceed the lesser of two business days and the generally accepted settlement period in the relevant market?

Third country markets

In many contexts a derivative contract is likely to be regarded as made for investment purposes if it is made or traded on an investment exchange (such contracts fall, in any event, within Annex I, paragraph C(6)), or is made otherwise than on a regulated market or MTF but is expressed to be as traded on such a market or MTF or on the same terms as those on which an equivalent contract would be made on such a market or MTF. This would cover contracts formed on organised marketplaces or other trading facility in third countries (and which therefore will not meet the definitions of "MTF" or "regulated market") that bring together parties to enter into contracts. It would also cover off-exchange transactions which incorporate the same contractual features and terms as those contracts traded on a regulated market, MTF or third country marketplace or trading system.

Intention to deliver

A test that was reflected in a number of the responses to the call for evidence was that the seller delivers or intends to deliver the property and the purchaser takes or intends to take delivery of it. As such a test is based on intention, its practical application will, in the absence of documentary evidence, often depend on observing the pattern of behaviour of the parties.

Bearing in mind that the intention of the parties may change during the life of the contract, it may be appropriate to apply this test in relation to the time of formation of the contract.

In some contexts, the position will be very clear from the circumstances. In particular contracts for the future delivery of goods intended for domestic consumption will usually, under the intention to deliver test, not be within the scope of commodity derivatives under the Directive.

Producers, users and commercial merchants

Some of the respondents to the call for evidence suggested a test based on whether one or more of the parties is a producer of the commodity, is a commercial merchant of the commodity, or uses it in his business. This was suggested as an indicia to be considered in combination with the "intention to deliver" test.

Such a test may be of relevance where a producer enters into a physical contract for the purpose of hedging a commercial exposure to the underlying, but does not intend to take delivery of the underlying. This presupposes that hedging a commercial exposure is a "commercial purpose" for these purposes. However, bearing in mind Recital 4, it could be asked how such a contract differs structurally from a cash settled contract falling within section C(5) if there was never an intention to physically settle the contract.

Articles 2(1)(i) and (k) of the Directive include exemptions whose scope is determined by reference to the nature of the business of the parties to the contract. If a party who enters into a contract falls within either of these exemptions when doing so, they will not require authorisation under the Directive as an investment firm, even if the contract they enter into constitutes a financial instrument. It may be felt that taking account of the business of the parties to the contract in determining whether it is a financial instrument is duplicative of these exemptions.

However, while one or more of these exemptions may be available to the producer or user, there may be other consequences that would flow from the categorisation of the contract as a financial instrument. For example, it may mean that a party advising a producer on the sale of their produce would require authorisation as an investment firm, even though they are only advising on normal commercial transactions.

Therefore, the fact that a person entering into a contract for the sale of corn is a producer of corn may be said to be relevant in determining whether the contract is for a commercial purpose. However, it should not necessarily be determinative. For example, if the producer of a commodity enters into a contract for the sale of that commodity but does not intend to deliver the commodity, this may indicate that they do not have a commercial purpose in entering into the contract.

The responses to the call for evidence were divided as to whether such as test should be limited to producers and users or whether it should also cover commercial merchants, who stand between producers and users. Some merchants will clearly be performing commercial operations. However, it may be difficult to distinguish a genuine commercial intermediary from a pure speculator in some cases. It may be that the "intention to deliver test" provides a better way of dealing with this issue.

Question 2.8.: Should the status of the parties to the contract only be relevant for determining whether the exemptions in Articles 2(1)(i) and (k) or should it also be taken into consideration as an indicative factor for determining whether there is a commodity derivative as opposed to a commercial contract for the supply of commodities?

Question 2.9.: Should commercial merchants be required to rely on the intention to deliver test or should the producer and user indicating factor apply to them as well? If so how can a commercial merchant be differentiated from a speculator?

If an additional test for producers and users is applied, it is necessary to determine whether it is relevant that only one of the parties satisfies this criterion, or whether both must do so. This question also arises in relation to the intention to deliver test.

If one of the parties satisfies this criterion and the other does not, it is likely that the party that does would fall within one of the exemptions to the Directive (for example, Articles 2(1)(d), 2(1)(i) or 2(1)(k)), unless there are special circumstances (such as that party performing other investment services that fall outside of an exemption).

Assuming the party that does not meet these criteria is an investment firm, who will be required to take its position into consideration when calculating its capital requirements, it could be argued that in such a case the test should indicate that there are non-commercial purposes and that the contract has the characteristics of other derivative financial instruments so as to provide the investment firm with the benefit of the passport.

However, if such a criterion were only to be taken into consideration if both of the parties satisfied it, notwithstanding the availability of certain exemptions, it would be necessary to consider the effect this would have on the status of a third party providing advice, dealing services or trading platforms in relation to such contracts. For example, what should be the position of a person advising on and arranging the sale of a farmer's produce on a forward basis? Should this position vary depending upon the status and intent of the purchaser? However, such analysis should also bear in mind that this criterion would only apply as an indicating factor in conjunction with the intention to deliver test.

CESR recognises that it is very likely that in some transactions (for example in forward/future contracts for the sale or purchase of a commodity) one party may satisfy the tests for a commercial purpose and the other will not do so. This may, for example, be either because one party is a producer or consumer of the relevant commodity, or because one party intends to make delivery. In a case of this sort, one could apply the test to the instrument and apply the result to both parties, or one could apply the test differently according to the position of each party. Thus if an electricity generation company entered into a forward sale of electrical energy to an investment bank, it would be a financial derivative instrument in the hands of the latter but not of the former. CESR has not adopted this approach in its draft advice and favours an approach under which the status of the contract for both parties is based on a consideration of the status and/or intent of either of the parties.

Question 2.10.: Do you agree with an approach under which the status of the contract for both parties is based on a consideration of the status and/or intent of either of the parties?

Other factors

The proposed advice also refers to certain other factors referred to in the responses to the call for evidence.

In addition, the mandate given by the Commission to CESR notes the following:

> "*The Directive establishes some guidelines as to when those instruments could be considered as similar to the other financial instruments "per se" under the scope of the directive. These guidelines, such as being traded on a regulated market or MTF, being cleared through a recognised clearing house or being subject to regular margin calls, are not to be considered as exhaustive. The fact that an instrument does not comply with any of the guidelines should not prevent that instrument from being considered as a financial instrument if it has the characteristics of other derivative financial instruments.*"

Accordingly the proposed advice makes clear which factors should be considered determinative and which indicative. In particular, CESR is aware that certain markets for contracts involving physical delivery of goods allow for participants to manage the potential credit exposures arising in the course of commercial contracts. This is sometimes done through the use of clearing arrangements and may also use arrangements for the payment of security for the contractual obligations of the participants (often referred to as margin payments). The existence of such arrangements should not be seen to detract from the nature of the contractual arrangements being entered into. It would be unfortunate if the level 2 measures were to discourage the use of beneficial credit management tools in the commercial sector. For these reasons, although a number of responses to the call for evidence suggested it, CESR agrees with the approach indicated in the mandate that the use of a clearing house or margining is not conclusive as to the commercial or investment nature of the contract. Indeed, if there are a number of indicative factors, it is important to avoid giving any single one undue weight. Rather the test will be effective only if all of the indicative factors are considered together to determine the overall nature of the transaction.

<u>Draft level 2 advice</u>

BOX 3

Certain factors should be regarded as determinative of whether a contract (which would otherwise be a financial derivative contract) is or is not made for commercial purposes and has the characteristics of other derivative financial instruments, while others are merely indicators. When only indicative factors are present, all of those must be considered and the overall picture based on those indicators taken as the result – indicative factors should be considered to have equal weight.

(1) A contract not falling within Annex I, paragraph C(6), is to be regarded as made for commercial purposes and as not having the characteristics of another derivative financial instrument, if under the terms of the contract -

(a) delivery is to be made within the lesser of:

(i) two business days; and

(ii) the period generally accepted in the relevant market as the standard delivery period,

unless it can be shown that there existed an understanding that (notwithstanding the express terms of the contract) delivery would not be made within that period; or

(b) the contract is with or by the operator of an energy transmission grid or pipeline network, and is either to ensure security of energy supplies or is necessary to keep in balance the supplies and uses of energy at a given time.[11]

(2) A contract not falling within Annex I, paragraph C(6), is to be regarded as not made for commercial purposes and having the characteristics of another derivative financial instrument if the parties do not have both the legal capacity, and any necessary permits or licences, to make or take delivery of the commodity to which the contract relates.

(3) The following are indications that a contract (outside Annex I, paragraph C(6), and outside (1)) is made for commercial purposes, and does not have the characteristics of an other derivative financial instrument -

(a) one or more of the parties is a producer of the commodity or uses it in his business;

[11] Note: this is to cover the immediate trading which takes place in relation to energy trading hubs, where it is essential to maintain an equality of inputs and outputs from the delivery mechanism (for example, generation and supply of electricity or gas through a national or multi-national grid or pipeline mechanism).

(b) the seller delivers or intends to deliver the property or the purchaser takes or intends to take delivery of it, determined as at the moment of formation of the contract, where the following are indicators of the intention –

(i) the terms of the contract as set out explicitly between the parties;

(ii) any other terms of the contract, whether implicitly agreed between the parties or implied by law or custom or practice in the relevant market;

(iii) any course of dealings between the parties;

(iv) any history of behaviour in relation to equivalent transactions with other parties;

Question 2.11.: If both elements of (2) are present should this be conclusive or indicative? If indicative, if only one is present is that still an indicator?

(4) The absence of the factors in (2) is an indication that a contract (outside Annex I, paragraph C(6)) is not made for commercial purposes and that it has the characteristics of another derivative financial instrument.

(5) It is an indication that a contract is made for commercial purposes, and that it does not have the characteristics of another derivative financial instrument, that the price, the lot, the delivery date or other terms are determined by the parties for the purposes of the particular contract and not by reference (or not solely by reference) to regularly published prices, to standard lots or delivery dates.

(6) The following are indications that a contract is not made for commercial purposes, and that it has the characteristics of another derivative contract –

(a) it is traded on a third country marketplace or trading facility;

(b) it is expressed to be as traded on an organised market – that is a regulated market, MTF or third country marketplace or trading facility – even though not traded on the organised market concerned);

(c) performance of the contract is enforced by an organised market (as described in (a)) or a clearing house;

(d) there are arrangements for the payment or provision of margin;

(e) neither party is a producer, commercial merchant or user of the commodity;

(f) neither party expects to have a net (or gross) obligation for immediate physical delivery of the commodity at any time.

3.1(4) Definition of climatic variables, freight rates, emission allowances, inflation rates and official economic statistics

DG Internal Market requests CESR to provide technical advice on possible implementing measures by 30/04/2005 on following issues:

(4) The definition of climatic variables, freight rates, emission allowances, inflation rates, official economic statistics.

Explanatory text

The draft advice in relation to the meaning of "commodity" has adopted an approach limited to goods. CESR members are aware of trading which has developed which is akin to commodity derivative trading and which ought to be subject to similar standards of behaviour and protections.

For example, article 19 of Directive 2003/87/EC established a scheme for greenhouse gas emission allowance trading within the Community, and indicates that the transfer of emissions allowances is to take place by amendment of accounts at a central registry rather than by delivery of certificates. Article 19(3) of the Directive refers to the register being in the form of an electronic database, with more detail to be provided in the form of an implementing regulation. Therefore it would appear that emissions allowances under the Directive will not be capable of falling under the definition of a "commodity" in the draft advice above - as there is no "physical" asset, merely a transfer of rights. To the extent that trading in derivative instruments on greenhouse gas emission allowances is speculative, it is similar in nature to (and often is carried out alongside) trading in derivative instruments based on energy supplies.

A number of the responses to CESR's call for evidence argued that there was not a real need to provide detailed definitions of these concepts, as they were readily identifiable and understood in their own right.

CESR agrees that exhaustive definitions are unnecessary and inappropriate. In most cases there will be little difficulty in identifying whether a term falls within any of the categories of climatic variables, freight rates, emission allowances, inflation rates or official economic statistics. Accordingly CESR does not consider that it is necessary to provide definitions of these concepts in implementing measures.

Draft level 2 advice

BOX 4

The terms used in Annex I, paragraph C(10) are sufficiently certain and understandable, so that implementing measures for their definition is unnecessary.

3.1(5) Other categories of assets, rights, obligations, indices and measures

DG Internal Market requests CESR to provide technical advice on possible implementing measures by 30/04/2005 on following issues:

(5) Whether there are, at this time, other categories of assets, rights, obligations, indices and measures not otherwise mentioned in Section C, where contracts relating thereto should be determined to fall within Section C.10. CESR should explicitly detail those categories.

Explanatory text

The responses to the call for evidence highlighted the continuing development of the financial derivatives markets. In particular CESR's attention was drawn to derivative markets based on band width and supply capacity. There seems to be little useful distinction between supply, freight and storage capacities as concepts.

The mandate could be read as implying that only derivatives relating to the underlying expressly listed in the level 1 Directive or in any level 2 measures should be capable of being derivatives falling within section C(10) of Annex I. The draft advice contains suggestions based on such an approach. This approach would provide a relatively high degree of certainty as to the scope of this section. The ability to use further level 2 measures to add to the list would, subject to Article 64(3) of the Directive, provide a certain degree of flexibility to reflect market developments. However, CESR considers that it would be important for it and the Commission to identify a means of adding to a list of this sort as quickly as possible – CESR believes that innovation in the market should not artificially generate a distinction, between instruments within the scope of the Directive and those which are not, while a legislative process takes place over a number of months.

Other responses to the call for evidence indicated that section C(10) should be treated as a more open category, which could cover instruments that are not expressly listed in the level 1 or 2 text without the need for further level 2 measures. One of these respondents suggested certain criteria, which formed the basis of the draft suggestion CESR has set out below for comment. Such an approach would allow the Directive to automatically reflect market developments within the scope of the criteria, although there would be less certainty about its eventual scope. Careful consideration of these criteria will be required if this approach is to be adopted. If relatively narrow criteria were adopted to provide a balance between flexibility and certainty, types of underyling that do not fall within those criteria could still be brought within section C(10) if they are expressly identified in the level 1 or 2 measures. For example, the weather would not fall within the suggested criteria, but weather derivatives would be brought within section C(10) by virtue of being expressly mentioned in the level 1 text. This would lead to an approach of criteria for determining the types of underlying caught plus additional specifically identified underlyings; as opposed to the specifically identified underlyings being limited to the exemplification of the criteria.

Section C(10) of Annex I refers to " *…derivative contracts relating to … emission allowances…that must be settled in cash or may be settled in cash at the option of one of the parties …*" CESR understands that most contracts relating to emissions allowances currently provide for settlement through the amendment of the parties' position on the applicable register of emissions allowances, instead of being settled in cash (although a cash settled market may develop over time). CESR suggests that the level 2 measures should clarify that derivative contracts relating to emissions certificates that are settled by amendment of the parties' position on the applicable register of emissions allowances should also be capable of falling within section C(10).

CESR notes that the inclusion of concepts as within the categories of assets, rights etc should not automatically result in any derivative on those concepts falling within the scope of section C(10). This will depend upon the tests mentioned to determine the characteristics of derivative financial instruments.

<u>Draft level 2 advice</u>

BOX 5

Derivative contracts relating to emissions allowances that are settled by amendment of the parties' position on the applicable register of emissions allowances should also be capable of falling within section C(10).

Other specific categories of assets, rights, obligations, indices and measures not otherwise mentioned in Section C, where derivative contracts relating thereto should be determined to fall within Section C.10 are derivative contracts relating to the following:

(1) telecommunications bandwidth;

(2) commodity storage capacity;

(3) transmission capacity, whether cable, pipeline or other means;

(4) allowances, credits, permits, rights or similar assets which are directly linked to the supply, distribution or consumption of energy derived from renewable resources.

AND (IF A MORE FLEXIBLE SET OF CRITERIA IS ADOPTED AS AN ADDITIONAL CATEGORY)

[(5) assets, rights, obligations, indices and measures that have each of the following characteristics:

(a) the asset, right or obligation is transferable, whether or not physical delivery or an equivalent mechanism of delivery is applicable, or, in the case of an index or measure its underlying constituents are similarly transferable;

(b) historical information about the prices or values of the relevant asset, right or obligation, or the data used in the construction of the relevant index or measure, is publicly available;

(c) (if relevant) the manner in which the index or measure is constructed is published, so that the index or measure is readily verified, whether or not the index or measure is calculated and published by a third party; and

(d) the price, value or data (of the sort referred to in (2)) is available on an ongoing, regular and sufficiently frequent basis so as to provide transparency of pricing of any derivative contract.]

3.1(6) Characteristics of other derivative financial instruments

DG Internal Market requests CESR to provide technical advice on possible implementing measures by 30/04/2005 on following issues:

(5) The conditions (other than cleared and settled through recognised clearing houses, subject to regular margin calls or traded on a Regulated Market or an MTF) under which an option, future, swap forward rate agreement or other derivative contract relating to the underlying referred to in 4 and, if any, in 5 above should be determined to have the characteristics of other derivative financial instruments where the contract must be settled in cash or may be settled in cash at the option of one of the parties - otherwise than by reason of a default or other termination event -)

Explanatory text

The Commission has stated that in responding to these mandates, CESR should have regard to Recital (4) to the Directive. This states that it is intended to apply to derivatives which are constituted and traded in such a manner as to give rise to regulatory issues comparable to traditional financial instruments. Therefore, a consideration of the nature of other comparable financial instruments that are already included within the Directive is relevant to the preparation of this advice.

The Directive splits derivatives relating to commodities into three separate categories (sections C(5) to (7)). The first two: (a) cash settled commodity derivatives;[12] and (b) physically settled commodity derivatives traded on a regulated market and/or MTF, are automatically financial instruments. However, other physically settled commodity derivatives are only financial instruments if they are "not for a commercial purposes and have the characteristics of other derivative financial instruments."

[12] More precisely "derivatives that must be settled in cash or may be settled in cash at the option of one of the parties (otherwise than by reason of a default or other termination event)".

Section C(10) of Annex I also sets out a category of derivatives relating to climatic variables, freight rates, emission allowances or inflation rates or other official economic statistics ("specified others") or any other derivative contracts relating to assets, rights, obligations, indices and measures not otherwise mentioned in this Section ("general others"), but only if they have the "characteristics of other derivative financial instruments". There is no express reference to commercial purposes in this case.

While the Directive expressly refers to derivatives relating to specified others that are cash settled, no express reference to cash settlement is included for general others. Section C(10) also refers to whether the derivatives are traded on a regulated market or an MTF as one factor for determining whether the instruments have the characteristics of other financial instruments. This indicates that derivatives falling within Section C(10) may be cash settled or may be settled by the delivery of property and that they may or may not be traded on a regulated market or MTF.

Section C(10) therefore potentially covers a similar range of other instruments as the range of commodity derivatives covered by Sections C(5) to (7). Therefore, the structure of the provisions on commodity derivatives may be of relevance in determining when other derivatives have the characteristics of other derivative financial instruments. This approach also provides a suitable similarity of treatment and approach to instruments which may have some economic interaction, for example for derivative contracts relating to storage capacity for a commodity and those relating to the commodity itself.

This approach indicates that a derivative relating to another asset, right, obligation or index will have the characteristics of other derivative financial instruments if:

- it is settled in cash or may be settled in cash at the option of one or more of the parties (otherwise than by reason of a default or other termination event);

- it does not fall into the above category, but is traded on a regulated market and/or an MTF; or

- it does not fall into either of the above categories but is not a contract for a commercial purpose and has the characteristics of other financial instruments, where both such concepts are interpreted in the same way as for section C(7), with the necessary modifications in the case of an intangible underyling, to reflect the fact that settlement may involve a different mechanism to delivery (such as the assignment or novation of a contract or the amendment of a register).

For example:

- if a derivative contract relating to emissions allowances is settled in cash or may be settled in cash at the option of one or more of the parties (otherwise than by reason of a default or other termination event), it will have the characteristics of a derivative financial instrument;

- if a derivative contract relating to emissions allowances is traded on a regulated market and/or an MTF, it will have the characteristics of a derivative financial instrument; and

- if a derivative contract relating to emissions allowances only provides for settlement by amendment of the parties' position on the applicable register of emissions allowances, it will only have the characteristics of a derivative financial instrument if is not a contract for a commercial purpose and has the characteristics of other financial instruments, where both such concepts are interpreted in the same way as for section C(7), reading delivery as the amendment of the register of emissions allowances.

<u>Draft level 2 advice</u>

BOX 6

A derivative relating to a "specified other underlying" will have the characteristics of other derivative financial instruments if:

- it is settled in cash or may be settled in cash at the option of one or more of the parties (otherwise than by reason of a default or other termination event);

- it does not fall into the above category, but is traded on a regulated market and/or an MTF; or

- it does not fall into either of the above categories but is not a contract for a commercial purpose and has the characteristics of other financial instruments, where both such concepts are interpreted in the same way as for section C(7), with the necessary modifications in the case of an intangible underyling, to reflect the fact that settlement may involve a different mechanism to delivery (such as the assignment or novation of a contract or the amendment of a register).

For these purposes "specified other underlying" means those types of property, rights or obligations considered in the advice under paragraphs 3.1(4) and (5) above, that is climatic variables, freight rates, emission allowances, inflation rates and other official economic statistics, as well as telecommunications bandwidth, commodity storage capacity and transmission capacity, renewable energy credits [and underlyings satisfying the criteria specified in paragraphs 5(a) to (d) of the advice under mandate 3.1(5)].

Annex – Example online dictionary definitions of "commodity"

An article of commerce or a product that can be used for commerce. In a narrow sense, products traded on authorized commodity exchanges. The types of commodities include agricultural products, metals, petroleum, foreign currencies and financial instruments and indexes to name a few. www.nfa.futures.org/basic/glossary.asp

This refers to any product that is essentially undifferentiated. This means that there is no difference in the product regardless of which company you buy from. Milk is generally said to be a commodity. As long as the product meets the provincial health guidelines for milk, there is really no difference between producers or sellers. www.energyshop.com/energyshop/e-gloss.cfm

Anything bought or sold, any article of commerce that is non-differentiated. www.impact21group.com/glossary.htm

A raw material which is reasonably homogeneous and can be freely traded on a commodity market. The market is roughly divisible into metals, soft commodities (agricultural produce, further divisible between food and non-food items) and fuels. The weather, strikes and the operation of cartels, among other factors, have a substantial effect the prices of commodities. www.offshorewealth.com/glossarya-c.htm

General Obligation to act fairly, honestly and professionally and in accordance with the best interests of the client (article 19.1)

Extracts from Level 1 text

Article 19(1): Member States shall require that, when providing investment services and/or, where appropriate, ancillary services to clients, an investment firm act honestly, fairly and professionally in accordance with the best interests of its clients and comply, in particular, with the principles set out in paragraphs 2 to 8.

Extract from the mandate from the Commission

DG Internal Market requests CESR to provide technical advice on possible implementing measures by 30/04/2005 on obligation for the investment firms to act fairly, honestly and professionally when providing investment or ancillary services other than the service of execution of orders on behalf of clients.

Draft CESR advice

Explanatory text

Article 19(1) states a general principle of fair treatment of clients that applies not only to investment services but also "where appropriate" to ancillary services. Information owed or addressed to clients, as well as the client agreement and "know your customer" requirements are dealt with under paragraphs 2 through 8 of article 19, and the service of execution of client orders is dealt with under Article 21 ("best" execution) and Article 22(1) ("prompt, fair and expeditious" execution).

CESR is therefore requested to provide technical advice on possible implementing measures of paragraph 1 of Article 19 with respect to investment and ancillary services other than order execution, and with respect to issues other than those dealt with by paragraphs 2 through 8 of Article 19.

In the present consultation paper, CESR is proposing measures under Article 19(1) which complete the advice provided under other provisions of the Directive in relation to portfolio management. The two provisions in this area are closely based on the previous CESR Standards for Investor Protection (Standards 136 and 137) and would apply only to retail investors.

A third area that would appear to call for further advice on possible implementing measures under Article 19(1) is order handling and "best execution" or "venue selection" standards for investment firms providing either an order transmission service or a portfolio management service. CESR intends to address these issues shortly, in the next phase of consultation.

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

Draft Level 2 advice

BOX 7

1. An investment firm that provides portfolio management services to retail clients must define investment strategies for these services and carry out transactions in accordance with such strategies, taking into account the terms of the retail client agreement.

2. The transactions carried out by an investment firm that provides portfolio management services to retail clients must be exclusively motivated by the interests of such clients and in accordance with the management objectives set out in the retail client agreement.

Suitability test (Article 19(4))

Extract from Level 1 text

Article 19(4) - When providing investment advice or portfolio management the investment firm shall obtain the necessary information regarding the client's or potential client's knowledge and experience in the investment field relevant to the specific type of product or service, his financial situation and his investment objectives so as to enable the firm to recommend to the client or potential client the investment services and financial instruments that are suitable for him.

Extract from the mandate from the Commission

DG Internal Market requests CESR to provide technical advice on possible implementing measures by 30/04/2005 on following issues:

(1) Define the criteria for assessing the minimum level of information that should be obtained from the client regarding his knowledge and experience in the investment field, his financial situation and his investment objectives.

(2) Determine the criteria for assessing, on the basis of the information received, the suitability of the investment service or financial instrument for the client or potential client.

<u>Draft CESR advice</u>

<u>Explanatory text</u>

CESR considered whether to incorporate the main relevant principles set out in the CESR-Paper 'A European Regime of Investor Protection' (CESR/01-014d) into its advice. However, many amendments and adaptations of those Standards and Rules would have been necessary. The content of relevant provisions of the CESR Standards was often already laid down in Level 1 or other European Directives and we decided not to repeat corresponding provisions. Also, changes introduced by the European Parliament and the Council, resulted in differences of substance between the Level 1 Directive and the CESR Standards. Therefore, most of the CESR Standards neither match the Directive's approach, nor answer the mandates appropriately.

Criteria for assessing the minimum level of information

Article 19(4) requires the firm to obtain the information necessary to enable it to recommend suitable investment services and financial instruments. The use of the word "necessary" in the level 1 text implies that the extent of information to be obtained from the client may vary considerably depending on the circumstances of each case. For example, if the firm is providing a full financial advisory service, considering all of the client's financial affairs, extensive information may be necessary. In contrast, if the firm is only advising on a relatively small investment within a narrow range of low risk products, less information may be required.

Furthermore, Article 19(4) also makes it clear that only information regarding the client's or potential client's knowledge and experience "relevant to the specific type of product or service offered or demanded" must be obtained. Hence, investment firms must obtain from the client or potential client at least information on his knowledge and experience concerning the investment services and types of financial instruments he is interested in or which the investment firm intends to recommend (e.g. if the client is only interested in shares, the investment firm does not need to obtain other information on the client's knowledge and experience on derivatives such as options or futures; the investment firm does not need to obtain information on the client's experience with execution-only services if it does not intend to offer this service to the client).

If the client or potential client does not provide all information requested by the investment firm, the investment firm has to assess whether the information received is sufficient to provide the specific investment advice or portfolio management services envisaged, i.e. to comply with the suitability–test under Article 19(4) MiFID. However, the investment firm needs at least some information from the client or potential client, particularly on his investment objectives, in order to be able to recommend to the client or potential client the investment services and financial instruments that are suitable for him. If the information obtained from the client is not sufficient to conduct the suitability-test in relation to the specific investment advice or portfolio management service envisaged (for instance, advice on extremely complex derivative instruments or high risk portfolio management services), the investment firm may provide to the client the investment advice or portfolio management service which it considers suitable depending on the extent of information provided by the client or potential client. However, alternatively, the investment firm may provide other investment services such as services under Article 19(4) and Article 19(5).

Even though the service cannot generally be provided if the client does not provide any information, CESR considers whether in exceptional cases the investment firm could still provide the service of portfolio management or investment advice, if the client is not able to or refuses to provide information about his knowledge and experience, his financial situation or his investment objectives. One may feel that the investment firm may proceed subject to conditions designed to ensure an adequate level of investor protection (i.e. the investment firm assumes 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) and a notification to the client that the service is provided on the basis of this assumption. This is built on the assumption that investment advice or portfolio management could refer to financial instrument that entail a low level of risk to any category of client.

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?

However, the investment firm shall not invite the client not to provide any information.

The CESR advice reflects that the mandate asks CESR to advise on criteria for assessing the minimum level of information that should be obtained. The mandate does not ask CESR to advise on what the minimum information should be in any particular case.

In view of the wide range of financial instruments, clients, markets and services covered by the Directive, this is the correct approach. It is likely that prescribing a list of information to be obtained would be impracticable. Such a list would be too inflexible and would lead to too much information being required in some cases and not enough information being obtained in other cases. An obligation to obtain unnecessary information can be as much of a concern for the client as for the investment firm. The client will ultimately bear the cost of the advisory service. In addition, clients may be discouraged from obtaining investment advice if they feel they are being asked unnecessary questions. Thus, CESR limits its advice in this respect to guidelines and examples of the kind of information that could be obtained from the client or potential client if relevant and necessary in the particular case.

The approach of the advice is split in two parts:

- The first part substantiates the kind of information that the investment firm has to take into account.

- The second part lists factors that shall be taken into account regarding the extent to which the information has to be obtained.

Criteria for assessing the suitability

The level 1 text provides that the investment firm must obtain the necessary information in order to enable it to recommend investment services and financial instruments suitable for the client or potential client. Portfolio management services do not generally entail the provision of a recommendation on financial services or financial instruments. Instead, portfolio managers generally have discretion to enter into transactions without consulting their clients. CESR therefore believes the term "*recommendation*" in the level 1 text should be interpreted according to the aim of Article 19(4), which is to provide for a suitability-test for client transactions entered into by a portfolio manager as well as for recommendations made by an investment adviser or portfolio manager. We therefore use the term "*envisage*" to include recommendations and decisions to trade.

It is important to note that the mandate asks CESR to advise on the criteria for assessing suitability, rather than to prescribe what is suitable or appropriate in any given case. We therefore suggest criteria that investment firms shall take into account when they assess the suitability of their recommendations.

The investment firm has to conduct the suitability-test for each recommendation and portfolio managers have to observe that each decision to trade is in line with the financial instruments suitable for the client and his investment objectives. It is conceivable that the client also asks his advisor to execute specific transactions during a continuous advisory relationship or instructs his portfolio manager to add specific financial instruments to his portfolio after having agreed on the general guidelines for the portfolio. CESR is of the opinion that also in these cases, when the transaction is initiated by the client, the investment firm is obliged to check whether the financial instruments are suitable for the client unless it is clear that such transactions are to be effected outside of the scope of the advisory or portfolio management services, in which case Article 19(5) or (6), as applicable, will apply.

If the suitability-test is limited to recommendations or decisions to trade, it would not apply to inaction by the firm. However, a portfolio manager will generally be appointed to keep the client's portfolio under review. It should therefore take reasonable steps to review the suitability of the client's portfolio in addition to conducting the suitability-test in relation to each recommendation or decision to trade. This sort of arrangement is not confined to portfolio managers. In some instances, the firm will have accepted a similar responsibility for giving advice about the specific instruments to be held within a portfolio. In this case, the same obligations shall apply.

In order to address the risk of portfolio managers or advisers "churning" by recommending or entering into transactions with unnecessary frequency, the suitability-test must also be conducted in the light of any previous transactions recommended or effected by the firm.

<u>Draft Level 2 advice</u>

BOX 8

Criteria for assessing the minimum level of information from the client

1) For the purposes of Article 19(4):

    a) Information regarding the client's or potential client's knowledge and experience in the investment field relevant to the specific type of product or service may include information on the types of services, transactions and products the client is familiar with and his trading history, i.e. the nature, volume, frequency and timeframe of his transactions. It may also include information on the client's or potential client's profession and education.

b) Information regarding the client's or potential client's financial situation may include information on the financial capacity, the nature of the source and extent of his regular income and on his liquid net assets.

c) Information regarding the client's or potential client's investment objectives may include information on the temporal horizon of the client or potential client's future investments, as well as his preferences regarding risk-taking (risk profile), and may also include information about the purposes of the envisaged investment such as recurrent income general or specific growth targets and/or tax efficiency.

2) With respect to the extent to which the information has to be obtained by the investment firm, it must take into account the following factors:

   a) Whether the information is necessary and sufficient to enable the investment firm to provide the service to the client or potential client.

   i) The type and characteristics of the financial instrument that will be subject to the investment advice or the portfolio management service will be relevant in determining the nature and extent of the information that is necessary regarding the client's or potential client's knowledge and experience in the investment field.

   ii) The nature and extent of the service provided to the client and the risks involved in the envisaged transactions will be relevant in determining the nature and extent of information that is necessary regarding the client's financial situation (for example, limited information may be sufficient if the client or potential client has restricted the investment advice or the portfolio management service to a certain amount of his liquid assets and confirmed that the risk of partial or total loss does not exceed his financial capacity). In this respect, the investment firm should also take into account other relevant circumstances, such as whether the intended transactions will be paid from the client's own funds or will be financed with loans, to which extent these transactions are exposed to loss, margin or other risks such as the leverage effect of financial instruments which can affect the ability of the client to bear the risks of the envisaged transactions.

   b) Since a professional client is deemed to have sufficient knowledge and experience, the firm should not be required to obtain information on the professional client's knowledge and experience other than the information obtained to determine the client's professional status according to the procedure under Annex II of the Directive, unless and to the extent that the professional client has agreed with the investment firm to receive a higher level of protection as regards the conduct of business rules and not to be treaded as professional client.

3) The investment firm must not invite the client to not provide information.

4) An investment firm shall be entitled to rely on the information provided by the client or potential client, unless it is manifestly inaccurate or incomplete.

5) Where an investment firm provides investment advice, or acts as a portfolio manager, for a retail client on a continuing basis, it must take reasonable care to keep the client profile under review, also taking into consideration any development of the relationship between the investment firm and the client. Where an investment firm provides investment advice to a retail or client on an occasional basis, it must undertake a review of the client profile whenever the retail client seeks advice.

   The retail client must be advised that he should inform the investment firm of any major changes affecting his knowledge and experience in the investment field relevant to the specific type of product or service, his financial situation and his investment objectives. Should the investment advisor or portfolio manager who is in charge of the service for the client become aware of a major change in the situation previously described by the retail client, he must request additional information to update the information on the client's knowledge and experience, his financial situation and his investment objectives.

A professional client is responsible for informing the investment firm of major changes affecting his financial situation and his investment objectives. The investment firm shall update the client profile in accordance with the information received.

Criteria for assessing the suitability

6) For assessing the suitability the investment firm shall take into account the following factors in light of the information disclosed to it by the client or potential client:

   a) The envisaged transactions must be in line with the investment objectives of the client or potential client.

   b) Regarding the envisaged transactions, especially their complexity, the investment firm must take into account the knowledge and experience of the client or potential client.

   c) The greater the level of risk involved in the envisaged transaction the more important the financial situation of the client or potential client will be in determining suitability. This may include the careful assessment whether the specific type of financial instrument or service is in the line with the financial capacity of the client or potential client and does not endanger the economic existence of the client or potential client.

7) The envisaged transaction may be considered as unsuitable for the client or potential client, *inter alia*, because of the risks of the financial investments involved (e.g. derivatives), the type of transaction (e.g. sale of options), the characteristics of the order (e.g. size or price specifications) or the frequency of the trading.

8) The suitability-test must be conducted for each personal recommendation or decision to trade. It must be conducted in the light of any previous transactions. A series of transactions that are each suitable when viewed in isolation may be unsuitable if the recommendations or decisions to trade are made with a frequency that is not the best interests of the client.

9) Where an investment firm provides investment advice to a client on the basis that it will keep that client's portfolio under review or acts as a portfolio manager, it must take reasonable steps to ensure that the portfolio in relation to which it has been appointed remains suitable.

Appropriateness test (Article 19(5))

Extract from Level 1 text

Article 19(5) - Member States shall ensure that investment firms, when providing investment services other than those referred to in paragraph 4, ask the client or potential client to provide information regarding his knowledge and experience in the investment field relevant to the specific type of product or service offered or demanded so as to enable the investment firm to assess whether the investment service or product envisaged is appropriate for the client.

In case the investment firm considers, on the basis of the information received under the previous subparagraph, that the product or service is not appropriate to the client or potential client, the investment firm shall warn the client or potential client. This warning may be provided in a standardised format.

In cases where the client or potential client elects not to provide the information referred to under the first subparagraph, or where he provides insufficient information regarding his knowledge and experience, the investment firm shall warn the client or potential client that such a decision will not allow the firm to determine whether the service or product envisaged is appropriate for him. This warning may be provided in a standardised format.

Extract from the mandate from the Commission

DG Internal Markets requests CESR to provide technical advice on possible implementing measures by 30/04/2005 on following issues:

(1) Define the criteria for assessing the minimum level of information that should be obtained from the client regarding his knowledge and experience in the investment field.

(2) Determine the criteria for assessing, on the basis of the information received, the appropriateness for the client or potential client of the investment service or product envisaged as well as the content of the related warnings.

Draft CESR advice

Explanatory text

Since Annex II to the Directive stipulates that a professional client "per se" is a client who possesses the experience, knowledge and expertise to make its own investment decision and to properly assess the risk that it incurs, CESR is of the opinion that information regarding the knowledge and experience of professional clients "per se" does not need to be requested. These professional clients are deemed to have sufficient knowledge and experience unless a non-professional treatment (i.e. a higher protection) is agreed upon. Regarding clients who may be treated as professional clients according to the criteria and procedure under Annex II paragraph II, the investment firm does not need to obtain more information on their knowledge and experience than needed for the assessment whether to classify these clients as professionals. CESR therefore believes that an investment firm should be deemed to have satisfied its obligations under Article 19(5) in relation to a professional client by determining the professional status of that client, unless it is agreed that a higher degree of protection should be provided.

Hence, there should be a clear delineation between retail and professional clients. Before providing investment advice or portfolio management under Article 19(4), or other services under Article 19(5), a firm will need to establish whether the client is a retail or professional client. Where a firm establishes that a client is a professional client in accordance with the requirements of Annex II, it is reasonable to put the onus on the client to determine whether the product or service envisaged is appropriate for him.

Article 19(5) makes clear that the investment firm is only obliged to ask for information regarding the client's or potential client's knowledge and experience "relevant to the specific type of product or service offered or demanded". Thus, the investment firm needs to obtain from the client information regarding his knowledge and experience concerning the investment services offered and types of financial instruments he is interested in or which the investment firm offers to trade (e.g. if the client is only interested in shares, the investment firm does not need to obtain information on the client's or potential client's knowledge and experience on derivatives such as options or futures).

Criteria for assessing the appropriateness

Taking into account the different regulatory approaches for investment advice/portfolio management under Article 19(4) MiFID and other services under Article 19(5) MiFID, the latter requires a test whether a specific financial instrument falls within parameters that are appropriate according to his knowledge and experience. Depending on the knowledge and experience of the client, these parameters could include limitations such as certain types or descriptions of financial instruments (e.g trading in contracts for differences or buying call options on listed equities) or limits on the total exposure of the client. The parameters should be defined in such a way by the investment firm that any transactions falling within those parameters would be appropriate for the client in accordance with the requirements of Article 19(5).

Content of the related warnings

According to Article 19(5) second subparagraph, the investment firm shall warn the client or potential client if it considers that the product or service envisaged is not appropriate for the client or potential client. The third subparagraph of Article 19(5) requires that the investment firm warns the client or potential client where he elects not to provide information or provides insufficient information on his knowledge and experience that such decision will not allow the firm to determine whether the service or product envisaged is appropriate for him.

Since the content of the related warnings to be provided is already clarified by level 1, CESR is of the opinion that an advice on the content of the related warnings is redundant. In order to serve as proper warning, it should be as short and concise as possible. Additionally, since the Directive and the level 2 measures will need to be translated in numerous languages, we do not think that it is appropriate to prescribe the exact wording of the content of the related warnings.

Draft Level 2 advice

BOX 9

Minimum Level of information to be obtained from the client

1. For the purposes of Article 19(5) the information regarding the client's or potential client's knowledge and experience in the investment field relevant to the specific type of product or service may include information on the types of services, transactions and products the client is familiar with and his trading history, i.e. the nature, volume, frequency and timeframe of his transactions. It may also include information on the client's or potential client's profession and education.

2. The information to be requested from the retail client or potential retail client on his knowledge and experience depends on the type of product envisaged and the service to be provided by the investment firm.

3. Since a professional client is deemed to have sufficient knowledge and experience, the firm should be deemed to have obtained sufficient information about the client's knowledge and experience for the purposes of Article 19(5) by determining that the client qualifies as a professional client, unless a non-professional treatment is agreed.

4. An investment firm shall be entitled to rely on the information on the knowledge and experience provided by the retail client or potential retail client, unless it is manifestly inaccurate or incomplete.

5. The retail client must be advised that he should inform the investment firm of major changes affecting his knowledge and experience in the investment field relevant to the specific type of product or service.

6. The investment firm must not invite the retail client not to provide the information that is to be requested under Article 19(5).

Criteria for assessing the appropriateness

7. For assessing the appropriateness of the service or product envisaged, the investment firm shall define, on the basis of the information obtained from the retail client, appropriate investment parameters (e.g. types of instruments, types of transactions and types of orders in which the retail client has sufficient knowledge of or experience).

8. Since a professional client is deemed to have sufficient knowledge and experience, the envisaged product or service should be deemed to be appropriate in the case of a professional client.

9. The envisaged transaction must be in line with the defined investment parameters for the respective retail client. The second paragraph of Article 19(5) shall apply if the envisaged transaction is not in line with the defined investment parameters for the respective retail client.

Execution only (Article 19(6))

Extract from Level 1 text

Article 19(6) - *Member States shall allow investment firms when providing investment services that only consist of execution and/or the reception and transmission of client orders with or without ancillary services to provide those investment services to their clients without the need to obtain the information or make the determination provided for in paragraph 5 where each of the following conditions are met:*

-- the above services relate to shares admitted to trading on a regulated market, or in a equivalent third country market, money market instruments, bonds or other forms of securitised debt (excluding those bonds or securitised debt that embed a derivative), UCITS and other non-complex financial instruments. A third country market shall be considered as equivalent to a regulated market if it complies with equivalent requirements to those established under Title III. The Commission shall publish a list of those markets that are to be considered as equivalent. The list shall be updated periodically,

-- the service is provided at the initiative of the client or potential client,

-- the client or potential client has been clearly informed that in the provision of this service the investment firm is not required to assess the suitability of the instrument or service provided or offered and that therefore he does not benefit from the corresponding protection of the relevant conduct of business rules; this warning may be provided in a standardised format,

-- the investment firm complies with its obligations under Article 18.

Extract from the mandate from the Commission

CESR, when establishing the criteria for determining when a service is provided at the initiative of the client should take careful consideration of the content of Recital 30.

DG Internal Markets requests CESR to provide technical advice on possible implementing measures by 30/04/2005 on

-The criteria for determining what is to be considered a non-complex instrument for the purposes of this rule;

-The criteria for determining when a service is provided at the initiative of the client

- The content of the related warnings.

Draft CESR advice

Explanatory text

According to the mandate under Article 19(6), the CESR advice is restricted to a recommendation of criteria for the determination of the terms "non-complex instruments" and "at the initiative of the client", as well as advice on possible implementing measures on the content of the related warnings. Additionally, the execution-only business is defined differently on level 1 than in the CESR Paper 01-014d on harmonisation of conduct of business rules. For these reasons, the relevant CESR rules are not appropriate for answering the mandate.

Non-complex instruments

When determining criteria for what is to be considered a non-complex instrument, it is important to note that markets are open and constantly changing and firms should be able to develop new products and instruments to meet market and consumer demand. The criteria for non-complex instruments should therefore be considered as high level principles that are flexible and should leave enough space to allow for the emergence of new types of instruments.

Article 19(6) uses the wording "other non-complex financial instrument" whereas the mandate under Article 19(6) requires the determination of the criteria for what is to be considered as non-complex instrument. Assuming that a non-complex instrument must be a specific kind of a financial instrument, it has to fall within one of the categories of financial instruments mentioned in Annex I, Section C. Since money market instruments (Annex I, Section C 2) and UCITS (Annex I, Section C 3) are explicitly mentioned in Article 19(6) as instruments permitted for the service under Article 19(6), they have to be considered as non-complex. This conclusion is underlined by the fact that an investment firm is also allowed to provide the service under Article 19(6) in respect of "other" non-complex instruments. The reference to "other" could only mean that the aforementioned instruments are considered to be non-complex. Bonds and securitised debt are only admitted to the service under Article 19(6) when they do not embed a derivative. Since straight derivatives are not mentioned in Article 19(6), all derivatives have to be considered as complex instruments according to the scheme and purpose of the restrictive preconditions of Article 19(6).

Hence, financial instruments explicitly listed in Article 19(6) are "per se" non-complex. Other financial instruments covered by section C 1 of Annex I which are not listed in Article 19(6) should be subject to the test set out in the advice to determine whether or not they are non-complex.

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

At the initiative of the client

Article 19(6) allows investment firms to provide investment services that only consist of execution and/or the reception and transmission of client orders with or without ancillary services without the need to obtain the information or make the determination provided for in Article 19(5) where some specific conditions are met. One of these conditions is that the service is provided" *at the initiative of the client or potential client*". The Mandate asks CESR to take Recital 30 into consideration when determining the criteria for a service provided at the initiative of the client or potential client.

According to Recital 30, a service should be considered to be provided at the initiative of the client unless the **client demands** it **in response to a personalised communication** from or on behalf of the firm **to that particular client**, which contains **an invitation** or is **intended to influence** the client **in respect of a specific financial instrument or specific transaction.** A service can be considered to be provided at the initiative of the client notwithstanding that the **client demands it on the basis of any communication** containing a **promotion or offer of financial instruments** made by any means that by its very nature **is general and addressed to the public or a larger group or category of clients and potential clients.**

The advice adapts the main guidelines provided by Recital 30 on the notion "a service at the initiative of the client" to the execution-only environment. The underlying principle of Recital 30 seems to be that an investment service shall, on principle, be regarded as having been provided at the initiative of the client, unless specific circumstances are met.

Considering that Article 19(6) does not require the firm to request client information as provided for in Article 19(5) and the client acts autonomously at his own risk, the notion of investor protection has been incorporated in Article 19(6) by the limitation that the investment service can only be provided "at the initiative of the client or potential client".

The provision of the execution-only service should therefore not be allowed if the own initiative of the client to use this service has been impaired by a personalised communication from or on behalf of the investment firm to that particular client and this communication contains an invitation or is intended to influence the client in respect of a specific financial instrument or specific transaction. Besides this example, the influence by the investment firm may be so extensive that, as a result, the client is induced to use the execution-only service though this is not based on his free will. Thus, it may be felt, that the use of aggressive commercial practices like "undue influence" could likewise exclude that the execution-only service is provided "at the initiative of the client.

This approach takes the considerations into account which are laid down in the Proposal for a Directive on unfair business-to-consumer practices in the Internal Market (Interinstitutional File 2003/0134 COD), the UCPD. The UCPD deals in general with aggressive commercial practices such as undue influence which significantly impair or are likely to significantly impair the average consumer's freedom of choice or conduct with regard to the product and thereby cause the consumer or are likely to cause him to take a transactional decision that he would not have taken otherwise. According to the UCPD, "*undue influence*" means "exploiting a position of power in relation to the consumer to apply pressure, even without using or threatening to use physical force, in a way which significantly limits the consumer's ability to make an informed decision. The incorporation of the considerations of the UCPD concept of "undue influence" in the level 2 advice may give further guidance on the notion of "at the initiative of the client".

In considering whether "undue influence" is applied, particularly the methods and the manner of the communication, including its timing, location, nature and persistence, and the level of pressure applied by the investment firm would have to be taken into account.

According to this approach, undue influence could also be exerted on the client or potential client even if a personalized communication does not refer to a specific financial instrument or specific transaction because there is hardly any difference between a personalised communication inviting the client to use the execution-only service to buy shares of company X or to use the execution-only service to buy shares (including those of company X) if undue influence has been used by or on behalf of the investment firm.

However, investment firms should be able to provide the service under Article 19(6) without unnecessary restrictions on advertising their business. Since the CESR advice under Article 19(2) includes detailed regulations on fair, clear and not misleading marketing communications, it should be clear to the client or potential client that, reacting upon such general communications, he has freely chosen to contact the investment firm for further inquiries about the execution-only service.

The advice therefore intends to make clear that the personalised character of a communication addressed to a particular client is not by itself sufficient to interdict the service. Rather, the personalised communication must fulfil specific criteria, i.e. it must contain an invitation or be intended to influence the client in respect of a specific financial instrument or specific transaction or the will of the client or potential client must have been impaired by undue influence.

Alternatively, one may feel that a reference to undue influence is not necessary in the context of Article 19(6) MiFID because the use of undue influence will be subject to the general regulation under the UCPD and that Recital 30 to the Directive contains adequate detail on the meaning of "at the initiative of the client" under Article 19(6) of the Directive.

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?

Alternatively, do you think that the consideration of this overarching principle is not necessary because the use of undue influence could be subject to the general regulation under the UCPD and that CESR should base its advice more strictly on Recital 30 or refer entirely to this Recital advising the Commission that it is not necessary to adopt Level 2 measures in this area?

Content of the related warnings

As one of the preconditions of the service under Article 19(6), the Directive requires that the client or potential client has been clearly informed that in the provision of the service under Article 19(6) the investment firm is not required to assess the suitability of the instrument or service provided or offered and that therefore he does not benefit from the corresponding protection of the relevant conduct of business rules. The investment firm is allowed to provide this warning in a standardised format.

Since the level 1 text is perfectly clear with respect to the content of the related warnings, it does not seem to be appropriate to prescribe the exact wording of the related warnings or to impose additional preconditions to the application of Article 19(6).

According to this reading of level 1, it seems to be evident that additional level 2 measures are not necessary in this respect. Moreover, the mandate of the European Commission asked CESR to strike the right balance between a comprehensive set of rules and excessive intervention in order to avoid overregulation (*see 2.3. of the mandate*). Thus, CESR proposes to provide the advice to the EU Commission, not to implement any level 2 measures regarding the content of the related warnings.

Draft level 2 advice

BOX 10

Definition of "non-complex instrument"

Non-complex instruments shall mean all non-derivative financial instruments:

a) that are frequently transferable, redeemable or otherwise realisable at prices that are frequently available,

b) that do not involve any actual or potential liability for the client that exceeds the amount of his contribution [including any commitment that represents a genuine contribution to the acquisition costs of the financial instrument]" and

c) *where information on:*

(i) their structure; and
(ii) the costs and expenses for acquiring, holding and realising the client's investment in them,

is easily accessible, and likely to be understood, by the average retail client.

"At the initiative of the client"

1) The execution-only service shall be considered to be provided at the initiative of the client if no undue influence has been applied by or on behalf of the investment firm and the client demands it

a) without prior communication of the investment firm with the client or potential client, or

b) on the basis of any communication containing a promotion or offer of financial instruments made by any means that by its very nature is general and addressed to the public or a larger category of clients or potential clients, or

c) in response to a personalised communication from or on behalf of the firm to that particular client or potential client which neither contains an invitation nor is intended to influence the client in respect of a specific financial instrument or specific transaction.

2) The execution-only service shall, however, not be considered to be provided at the initiative of the client if the client demands it in response to a personalised communication from or on behalf of the firm to that particular client which contains an invitation or is intended to influence the client in respect of a specific financial instrument or specific transaction.

Content of related warnings

Regarding the content of the related warnings, no Level 2 measures should be implemented.

CESR

Transactions executed with eligible counterparties (Article 24)

Extract from Level 1 text

Article 24(2):

Member States shall recognise as eligible counterparties for the purposes of this Article investment firms, credit institutions, insurance companies, UCITS and their management companies, pension funds and their management companies, other financial institutions authorised or regulated under Community legislation or the national law of a Member State, undertakings exempted from the application of this Directive under Article 2(1)(k) and (l), national governments and their corresponding offices including public bodies that deal with public debt, central banks and supranational organisations.

Classification as an eligible counterparty under the first subparagraph shall be without prejudice to the right of such entities to request, either on a general form or on a trade-by-trade basis, treatment as clients whose business with the investment firm is subject to Articles 19, 21 and 22.

Article 24(3)

Member States may also recognise as eligible counterparties other undertakings meeting pre-determined proportionate requirements, including quantitative thresholds. In the event of a transaction where the prospective counterparties are located in different jurisdictions, the investment firm shall defer to the status of the other undertaking as determined by the law or measures of the Member State in which that undertaking is established.

Member States shall ensure that the investment firm, when it enters into transactions in accordance with paragraph 1 with such undertakings, obtains the express confirmation from the prospective counterparty that it agrees to be treated as an eligible counterparty. Member States shall allow the investment firm to obtain this confirmation either in the form of a general agreement or in respect of each individual transaction.

Article 24(4)

Member States may recognise as eligible counterparties third country entities equivalent to those categories of entities mentioned in paragraph 2.

Member States may also recognise as eligible counterparties third country undertakings such as those mentioned in paragraph 3 on the same conditions and subject to the same requirements as those laid down at paragraph 3.

Extract from the mandate from the Commission:

DG Internal Market requests CESR to provide technical advice on possible implementing measures by 30/04/2005 on the procedures that eligible counterparties "per se" have to follow in order to request a more protective treatment from the part of the investment firm, either on a general form or on a trade by trade basis.

DG Internal Market requests CESR to provide technical advice on possible implementing measures by 30/04/2005 on:

- The criteria, including quantitative thresholds, that would allow considering an undertaking as an eligible counterparty and
- The procedures for obtaining their express confirmation to be treated as eligible counterparties.

Draft CESR Advice

Explanatory Text

Article 24 of the Directive sets out a regime based on general principles for transactions executed or brought about by investment firms for eligible counterparties. That provision establishes that investment firms authorized to execute orders on behalf of clients and/or deal on own account and/or receive and transmit orders may enter into transactions with, or bring about transactions for, eligible counterparties without being obliged to comply with the obligations under Articles 19, 21 and 22(1). An eligible counterparty relationship is typical of trading between investment firms, banks and other entities that are not investment services providers, but are directly active market participants.

CESR is therefore requested to provide technical advice on possible implementing measures in relation to: paragraphs 2 and 3 of Article 24 with respect to procedures that eligible counterparties "per se" have to follow in order to request a more protective treatment; the criteria, including quantitative thresholds, that would allow undertakings to be considered as eligible counterparties and the procedures for obtaining their express confirmation to be treated accordingly.

The reasoning behind the eligible counterparties regime should be that investor protection as defined in Articles 19, 21 and 22(1), is unnecessary in some business relationships, given the dimension, nature, knowledge and experience of financial markets that characterize some entities (many corporates are able to deal on equal terms with authorized investment firms). However, an investor of this type may decide that it needs additional assurance for some or all of its business transactions, and this matter should be dealt with by negotiation with the relevant firm.

It explicitly follows from Article 24 that an eligible counterparty relationship is only capable of applying in relation to:

- transactions brought about or entered into by an investment firm in the course of executing orders on behalf of clients, receiving and transmitting orders and/or dealing on own account; and
- any ancillary services directly related to those transactions.

Recital 40 to the Directive makes it clear that eligible counterparties should be considered as acting as clients. Article 24 only provides for the disapplication of Articles 19, 21 and 22(1) and does not prevent an eligible counterparty falling within the definition of a client for other purposes. Therefore, other relevant provisions of the Directive that apply in relation to the provision of services to clients will continue to apply. For example, if an investment firm holds financial instruments belonging to an eligible counterparty while providing services falling within Article 24(1) of the Directive, the requirements relating to the holding of client financial instruments under Article 13(7) of the Directive will continue to apply.

Eligible counterparties "per se" are identified in Article 24(2) as: investment firms, credit institutions, insurance companies, UCITS and their management companies, pension funds and their management companies, other financial institutions authorized or regulated under Community legislation or the national law of a Member State, undertakings exempted from the application of the Directive under Article 2(1)(k) and (l), national governments and their corresponding offices including public bodies that deal with public debt, central banks and supranational organisations.

The category of eligible counterparties "per se" is very close to the one set out in Annex II, I(1) of the MiFID for the professional regime, where, by their nature, certain entities are qualified as professional clients.
However, there are a few differences concerning:

- UCITS which is a more narrow concept than "Collective investments schemes" foreseen in the paragraph 1 e) of Annex II of MiFID;
- Undertakings exempted from the application of this Directive under Article 2(1)(k) and (l), which is a different concept than the one used in the number 1 g) of Annex II of the MiFID, "Commodity and commodity derivatives dealers".

Entities identified in Article 24(2) are to be treated as eligible counterparties "per se" for the relevant transactions. This classification is without prejudice to the ability of the investment firm, upon request and if it wishes, to treat the above mentioned entities as clients in relation to whom Articles 19, 21 and 22(1) apply. The default situation of eligible counterparties "per se" is the eligible counterparty regime. This regime comprises the right of such entities to request, on a general form or on a transaction by transaction basis, a higher level of protection. Therefore, it is the responsibility of the eligible counterparty to ask for a higher level of protection, leaving the firm with the decision of acceding, or not, to that request.

If an investment firm accepts to provide a more protective treatment to an eligible counterparty "per se", the "professional clients" regime shall apply by default. The latter may request an even higher level of protection and if the firm accedes to that request, it will be classified as retail client.

One concern that has arisen in CESR was that the existence of the eligible counterparty regime should not affect the obligations investment firms owe to other clients under the Directive. An example of such a case is where an investment firm ("F1") executes an order on behalf of a client ("C") with a counterparty that is also an investment firm ("F2"). As F1 is an investment firm, it will be an eligible counterparty "per se". If the services provided by F2 fall within the scope of Article 24(1) and F1 and F2 do not agree that a higher degree of protection is appropriate, F2 will not owe F1 any obligations under Articles 19, 21 and 22(1) in respect of those services. However, the fact that F2 is not subject to the obligations under Articles 19, 21 and 22(1) in relation to its dealings with F1 does not relieve F1 of its obligations to C under those Articles (unless C is also an eligible counterparty and the services F1 provides to C fall within the scope of Article 24(1)).

The investment firm's intervention in the opt-in process should involve not only the decision whether or not to accede to the request of the eligible counterparty "per se", but also, as a transitional measure, information responsibilities. The investment firm should inform the eligible counterparty "per se", that on the basis of the available information, it is being classified as such and that a variation in the terms of protection can be requested.

This transitional information requirement reflects the fact that the eligible counterparties regime will represent an innovation in most Member States. However, the information requirement should not apply where the undertaking has been classified by that firm as having a similar status to that of an eligible counterparty "per se" under the domestic regime of a Member State that operated a similar regime before the transposition of the Directive by that Member State.

In addition, Member States may recognise as eligible counterparties undertakings other than those mentioned in Article 24(2) provided they meet certain requirements, including quantitative thresholds. If investment firms wish to enter into transactions with, or receive and transmit orders for, such undertakings pursuant to the eligible counterparties regime, they must previously obtain an express confirmation from the client stating that it wants to be treated as an eligible counterparty.

This draft advice first addresses the issue of the procedural rules for opting-in and opting-out of a more protective treatment, and then, in a separate section below, addresses the criteria that undertakings must satisfy in order to be capable of being treated as eligible counterparties.

<u>Draft Level 2 advice</u>

BOX 11

Opt-in regime (Eligible counterparties "per se" classified as professional clients or retail clients).

If an investment firm provided investment services to an eligible counterparty falling within one of the categories listed in the first paragraph of Article 24(2) before the transposition of the Directive, it must inform that entity, before providing any services to that entity after the transposition of the Directive, that, on the basis of the information available to it, the entity is deemed to be an eligible counterparty “per se", and will be treated as such unless both parties agree otherwise.

The investment firm must also inform the relevant eligible counterparty that it can request to be treated as a client in order to secure a higher degree of protection and that it is the responsibility of the entity to make such a request.

This information requirement shall not apply to the extent that the undertaking has been classified by that firm as having a similar status to that of an eligible counterparty under the domestic regime of a Member State before the transposition of the Directive by that Member State.

Upon request, an investment firm may accept to treat an eligible counterparty “per se”, either as a professional client or a retail client, in which case the entity shall be classified as a “professional client” or a “retail client” as appropriate, and benefit from the protections of the applicable conduct of business regime.

The firm must promptly make a record, and notify the client in writing, of the classification established (whether the client has been classified as a professional or retail client) and specifying any limitations that apply to the classification (for example, whether this applies to one or more particular products and/or transactions).

Opt-out Regime

An investment firm may treat undertakings that fall outside Article 24(2) as eligible counterparties, provided the investment firm verifies they meet the pre-determined thresholds defined in the next section and observes the following procedure where the client informs the investment firm that it wishes to be treated as an eligible counterparty (either generally or in respect of a particular investment service, transaction or type of product):

– the investment firm (if it accepts to treat a client as an eligible counterparty pursuant to Article 24(3)) must promptly make a record, and notify the client in writing, of the classification established, specifying any limitations that apply to the classification (for example, whether it applies to one or more particular products and /or transactions);

– the investment firm must promptly give the client a clear written information, to the extent the classification applies, of the protections it will loose and investor compensation rights it may lose; and

– the investment firm must obtain a statement from the client in writing and in a separate document from the contract, that he is aware of the consequences of losing such protections.

Investment firms must implement appropriate written internal policies and procedures for the categorisation of eligible counterparties in accordance with the applicable requirements. The latter are responsible for keeping the firm informed about any change that could affect their current categorisation.

Explanatory text

The Directive foresees the possibility of Member States recognising as eligible counterparties other undertakings, provided they meet certain pre-determined requirements. These requirements, including quantitative thresholds, have to be proportionate, i.e. they have to allow for the existence of counterparties in the relevant markets and adapt to the real needs in terms of investor protection.

In selecting the criteria for defining the quantitative requirements, CESR has decided to propose, for the sake of coherence, to use the quantitative criteria already present in the Directive, for the definition of the professional regime: balance sheet total, net turnover and own funds (on a company basis).

Article 24(3) sets out a provision that allows member states to choose to recognise as eligible counterparties other undertakings that meet predetermined criteria.

It results from the drafting of Article 24(3) that the professional regime is the default status of such undertakings. They will therefore only be treated as eligible counterparties if they expressly confirm that they wish to be treated as such. This proposal places the burden of the risk evaluation on the undertaking. Such undertakings are therefore assumed to be able to decide the classification under which they would like to do business and to properly manage the risk involved, either in the professional, or in the counterparty regime.

The consequences of setting the quantitative thresholds for the eligible counterparties regime at the professional clients regime level and not higher should be carefully considered. The immediate and most evident consequence is that a higher number of undertakings will be able to choose whether they wish to do business under the eligible counterparty regime. On the other hand, these entities may be encouraged to accept treatment as eligible counterparties via attractive financial conditions or other incentives, which could lead them to take risks they have not properly evaluated.

CESR considered the adoption of other criteria, further to the proportionate quantitative thresholds. That would have been of particular relevance if we had proposed a narrower regime, with higher thresholds. Since the scope of the regime proposed is quite broad, the definition of qualitative criteria does not seem necessary.

Draft Level 2 advice

BOX 12

Proportionate requirements

An investment firm may treat an undertaking who would otherwise be a professional client as an eligible counterparty provided the relevant criteria (and the opting-out procedure mentioned above) are fulfilled.

Proportionate quantitative thresholds:

In the course of the above assessment, as a minimum, two of the following three criteria should be satisfied :

– balance sheet total: EUR 20.000.000,

– net turnover: EUR 40.000.000,

– own funds: EUR 2.000.000.

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.

SECTION III – MARKETS

DISPLAY OF CLIENT LIMIT ORDERS (Article 22.2)

Extract from Level 1 text

Article 22.2 : Member states shall require that, in the case of a client limit order in respect of shares admitted to trading on a regulated market which are not immediately executed under prevailing market conditions, investment firms are, unless the client expressly instructs otherwise, to take measures to facilitate the earliest possible execution of that order by making public immediately that client limit order in a manner which is easily accessible to other market participants. Member States may decide that investment firms comply with this obligation by transmitting the client limit order to a regulated market and/or MTF. Member States shall provide that the competent authorities may waive the obligation to make public a limit order that is large in scale compared with normal market size as determined under Article 44 (2).

Extract from the mandate from the Commission

DG Internal Market requests CESR to provide technical advice on possible implementing measures by 30/04/2005 on the different arrangements through which an investment firm can be deemed to have met its obligation to disclose not immediately executable client limit orders to the market in a manner which is easily accessible to other market participants.

Draft CESR advice

Explanatory text

The purpose of Article 22.2, which applies to firms that execute orders on behalf of clients, is to facilitate and accelerate the execution of client limit orders which firms do not immediately execute under prevailing market conditions. The display of these non-executed limit orders provides the client with additional opportunities for the order to be executed at that price or even to receive price improvement. In addition, limit orders contain price information which can contribute to price discovery. The display of such unexecuted orders increases the level of pre trade information available to market participants, facilitates the trading of client orders and contributes to their best execution.

Visibility and Accessibility test

Article 22.2 requires firms to "take measures to facilitate the earliest possible execution of that order by making public immediately that client limit order in a manner which is easily accessible to other market participants".

CESR considers that, in the context of Article 22.2, "easily accessible" should meet two tests. First, the non-executed limit order should be displayed so as to reach the largest possible audience of market participants ("visibility test"). Secondly, as the aim is to facilitate the "earliest possible execution of the order", the "visibility test" of the order should be supplemented by the ease and speed with which the order is accessible and executable, i.e. capable of being traded once new market conditions allow for its execution. The disclosure of the order and its accessibility are two different concepts but would need to be taken into account jointly.

Arrangements through which an investment firm can be deemed to have met its obligations

Article 22.2 states that Member States may consider that a firm has discharged its obligations when:

- It transmits the client limit order to a regulated market and/or
- It transmits the client limit order to an MTF.

The publication of standard client limit orders where an existing RM and/or MTF offers an order book, is straightforward, on the grounds that transmission of the client limit order to that venue would make it both “visible” under the pre trade transparency requirements for RMs /MTFs and potentially easily executable, once it becomes executable in terms of market price.

Where the limit order is sent to a quote driven market operated by a RM or MTF and is not immediately executable against the quote of any market maker in that share, the pending, unexecuted limit order would not be visible and accessible to market participants as required by Article 22.2. unless the order is made visible and executable in another manner. Although not a general practice at the moment it is possible that quote driven markets may in future provide an additional facility for disclosing such orders, in which case firms may be better able to meet the requirement of article 22.2.

The article does not exclude other possible arrangements for firms to meet their obligation to disclose client limit orders. Indeed, where existing RMs and MTFs provide no opportunity to display and make accessible non-executed limit orders (as may or may not also be the case with quote driven markets), an investment firm will need to use alternative arrangements, such as publishing the limit order on its website or through any third party system it uses for advertising information. Furthermore, alternative types of arrangements would also need to be considered in respect of non-standard orders (such as non standard settlement arrangements) where the existing RMs or MTFs are unable to accommodate the specific conditions attached to the order or the financial instrument.

Where the investment firm decides not to transmit a client limit order to a RM or an MTF, or is unable to meet its obligations by doing so, it should satisfy itself that the venue to which the limit order is transmitted or on which it is displayed, will achieve similar results in terms of both visibility and accessibility tests. The venue should therefore permit the limit order to be displayed in a way that is visible to other markets participants and the characteristics of that venue, or the information provided in respect of execution options, should provide the greatest possible opportunities for the limit order to be rapidly and easily executed as soon as permitted by market conditions.

Furthermore, under Article 21.1, firms are under the obligation to execute orders on terms most favourable to the client ("Best execution" obligation). The requirement to display non executable client limit orders does not provide any kind of safe-harbour for best execution obligations and firms should fulfil best execution obligations when choosing how and where to display a non executed client limit order.

The arrangements used by a firm for limit order display should be detailed in the order execution policy required under Article 21.

Draft Level 2 advice

BOX 13

1. An investment firm can be deemed to have met its obligation to disclose any client limit order it has not immediately executed in a way which is easily accessible to other market participants when the order is made visible to other market participants and when the order can be easily and rapidly executed once market conditions allow.

2. The obligation would be met where the limit order is sent to a Regulated Market (RM) or a Multilateral Trading Facility (MTF) which runs a public order book. The transmission of the limit order to a quote driven RM or MTF would not fulfil the obligation set out in Article 22.2 unless the client limit order could be made visible and rapidly executable in some other manner.

3. Where the investment firm does not transmit the limit order to a RM or an MTF, it may comply with the obligation set out in Article 22.2 by transmitting that limit order to, or displaying it on, an appropriate venue that achieves similar results, i.e. that makies the order visible to other market participants and provides it with the greatest opportunities to be rapidly and easily executed once market conditions allow.

4. When choosing how and where to display a non executed client limit order firms should fulfil their obligation to execute orders on terms most favourable to the client under article 21.1 ("Best execution" obligation).

5. The arrangements used by a firm for limit order display should be detailed in the order execution policy under Article 21.2.

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

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

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

1. Definition of Systematic Internaliser

Extract from Level 1 text

"Systematic internaliser" means an investment firm which, on an organised, frequent and systematic basis, deals on own account by executing client orders outside a regulated market or an MTF.

Extract from the mandate from the Commission:

CESR is requested to provide technical advice on the criteria for determining when an investment firm deals on own account on an organised, frequent and systematic basis by executing client orders."

<u>Draft CESR advice</u>

<u>Explanatory text</u>

Article 4.1.7. defines a systematic internaliser as an investment firm which "on an organised, frequent and systematic basis deals on own account by executing client orders outside a regulated market or MTF". The key words in this definition – "frequent", "organised" and "systematic" – have to be fulfilled collectively and imply that the only internalisers that are intended to fall within the scope of Article 27 are those which engage in internalisation on an ongoing commercial basis or on a scale which requires a business enterprise of commercial proportions. (The obligations under Article 27 will not apply to firms which deal on own account solely on an OTC basis and the characteristics of those transactions include that they are ad-hoc and irregular, carried out with wholesale counterparties, are part of a business relationship which is itself characterised by dealings above standards market size and are carried out outside the systems usually used by the firm concerned for its business as a systematic internaliser.)

"Organised" and "systematic" relates to the organisational aspects of firms that internalise and CESR views them as being subject primarily to a qualitative assessment. CESR's proposal therefore defines the concept of systematic internaliser in organisational terms and considers that fulfilment of the proposed characteristics will provide a strong indication that a firm should be regarded as a systematic internaliser. In setting the proposed criteria, any reference to installation of a technical platform as a necessary precondition for internalisation has been deliberately omitted. This is because an investment firm can engage in systematic internalisation not only through its own technical platform but also by using other kind of in-house or external systems or other facilities (e.g. its own phones, call centres, etc).

This leaves the issue of whether it is necessary to add any further interpretation to the term "frequent" and, if so, what. If a quantitative approach were to be taken, there would appear to be three main options: to establish a threshold of trading frequency; to establish a threshold for the percentage of a firm's trading that is internalised; to establish a threshold related to overall market share. However, CESR has some reservations about recommending a quantitative route if there appears to be a workable "qualitative" alternative. In particular a "market impact/market share" approach is likely to be complex to put in place and to maintain.

At this point, CESR therefore tends to favour an approach that avoids setting a numerical threshold. Its starting point is that if a firm has made the investment in the organisational and risk management structures implied by the proposal, it will almost certainly have done so with a view to internalising significant amount of business and doing so on an active and ongoing basis. On that basis, it may be sufficient for "frequent" to capture the concept of a firm that internalises on a regular and continuous basis.

CESR has also given consideration to how a systematic internaliser should cease its activities as a systematic internaliser either in one, several or all shares. On one hand a systematic internaliser, as a part of its business strategy, should be able to decide to stop conducting this activity in a given stock. On the other, it should not be able to discontinue trading in a share from one minute to the next. It is necessary to strike a balance between the legitimate interests of systematic internalisers and their clients and other market participants. A systematic internaliser wishing to stop systematic internalisation in a given share should advise the market in advance. For the announcement, the investment firm should use the same publication channel as for the publication of its quotes. The obligations arising from article 27.3 would remain valid during this notice period.

Draft Level 2 advice

BOX 14

Definition and Differentiation

1. Investment firms that engage in internalisation as a matter of deliberate and regular policy are to be considered as systematic internalises for the purposes of article 4.1. The following aspects should be considered as an indication that the investment firm is a systematic internaliser:

- The use of a business model in which internalisation has an identifiable commercial role;

- The existence of rules, protocols, procedures and/or practices governing the internalisation process;

- The assignment or use of personnel and/or an automated technical system for the purpose of carrying out internalisation, whether or not the personnel or systems are used exclusively for that purpose.

2. When a firm intends to cease acting as systematic internaliser (in one or several shares) it should announce its intention to do so in advance. For the announcement the investment firm should use the same publication channel that it uses to publish its quotes.

Questions

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?

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

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?

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?

2. Scope of the Rule (Article 27.1)

Extract from Level 1 text

"Member States shall require systematic internalises in shares to publish a firm quote in those shares admitted to trading on a regulated market for which they are systematic internalises and for which there is a liquid market".

Extract from the mandate from the Commission

"DG Internal Market requests CESR to provide technical advice on possible implementing measures by 30/04/2005 on what is to be considered a liquid market in an individual share for the purpose of article 27".

<u>Draft CESR advice</u>

<u>Explanatory text</u>

The definition of what is to be considered a liquid market for the purpose of article 27 is a key element in the pre-trade transparency regime set out by the Directive. The scope of article 27 in respect of the shares covered should try and find the appropriate balance between:

- The central role of pre-trade transparency in, among other things, helping to integrate separate/fragmented liquidity pools, aid competitive price formation and lower search costs for participants; and

- The need to take into account the risks born by systematic internalisers as a result of being required to continuously display quotes in shares for which they are internalisers.

The Level 1 text of the Directive is quite general and does not specify on what basis a liquid market for a share must be defined. It does not indicate if it should be determined on the basis of a single marketplace's/Member State's liquidity or on the basis of EU-wide liquidity. For the purpose of calculating the arithmetic average value of the orders executed in the market for a particular share (for the purpose of determining its Standard Market Size), all orders executed in the EU will have to be taken into account. This could be interpreted to imply that the same approach should be used also in the determination of liquidity. However, in many shares trading is still concentrated in one marketplace or in one Member State. This could support the interpretation that a share should be considered to be liquid if there is at least one liquid marketplace/market for that share anywhere in the EU.

The definition of a liquid market should also take into account the variety of markets in EU Member States where the liquidity of the most traded shares can potentially be significantly different. The overall size and state of activity can be significantly different. Absolute figures relating to the most liquid shares in one market may not be considered to fulfil the "liquidity test" of another market. Additionally, in several markets trading activity may be highly concentrated in a limited number of shares.

This being the case, it is important to understand the consequences of different approaches. On one hand, if liquidity is measured on an EU-wide basis, in practice there would be only a few or even no liquid shares in the smallest markets. Alternatively, if liquidity is determined in relative terms (e.g. taking into account the "most liquid" shares of each market), it would mean that the shares deemed liquid in smaller markets would, in absolute terms, be much less traded than those selected from "bigger markets". In addition, it would mean excluding in "bigger" markets some shares which in absolute terms are traded more actively than those included from smaller markets.

In any case, CESR is of the opinion that all shares determined to be liquid – be it on the EU-wide or "narrower" basis – would be subject to the quote disclosure rule in all Member States. This means that a systematic internaliser would have to fulfil the requirements of Article 27 in all these shares, even if they were not liquid in its home Member State.

It should also be noted that the use of the term "liquid" in the context of Article 27 is to determine those shares which would be subject to Article 27 obligations. A share deemed liquid for Article 27 purposes should not therefore be assumed "liquid" for other purposes (e.g. qualifying as potential investments for certain types of investors with different restrictions)

Possible methods to define liquid shares

CESR would like to stress that there are several ways to define liquid shares, each with different implications. For example, using a simple proxy is likely to simplify the process but is unlikely to provide exact results, whereas the use of more sophisticated criteria is likely to provide "better" results but will create additional work in terms of data collection/availability and calculation work. Taking into account the very different nature of markets around the EU, CESR has therefore not considered it possible to put forward a single proposal at this stage. Instead different methods are described and their pros and cons evaluated. Based on the responses to the consultation, CESR will continue work in order to evaluate the criteria as well as define more concrete thresholds for some of the methods. We are therefore keen on hearing the views of market participants as to what they would consider an appropriate measure(s) of liquidity.

The principal methods considered by CESR can be divided into two categories, one based on certain pre-determined criteria and the other based on the use of proxies.

<u>Liquidity determined based on pre-determined criteria</u>

In identifying these criteria, the definition of liquidity needs to be considered in the context of Article 27. Article 27 requires systematic internalisers to maintain a firm quote at prices that reflect prevailing market conditions throughout normal trading hours and (subject to the exemptions specified in the article) for that quote to represent the firm's best dealing price in that size. It is therefore important that the shares in which firms are obliged to maintain quotes have sufficient liquidity to provide them with reasonable opportunity to lay off their risks rapidly and with little market impact.

The following criteria have been identified by CESR as possible to define liquid shares. Some of the criteria could be applied individually, whereas others are better suited to being used in combination with other criteria.

a) Trading methodology - Since Article 27 requires systematic internalisers to publish quotes on a continuous basis, CESR considers that shares which are not traded in a continuous trading system (i.e. are traded only through periodic auctions) should not be deemed liquid for this purpose.

b) Trading activity of a certain stock - In order to be deemed liquid, a stock should be traded daily (on those days when the trading is possible, e.g. when it is not suspended).

c) Average number of trades per trading day - The minimum average number of trades per day could be calibrated in a way to reflect a desired average time interval between trades. For example, the threshold could be set so that on average there would be a trade every minute (which for an eight hour trading day would equal to 480 trades per day). However, this method could require a substantial amount of work to take fully into account differences in trading hours. Additionally, using an average number of trades would not necessarily mean that the trades would be equally distributed during trading hours.

d) Daily turnover in a share - While being easy to calculate, this measure may be affected by the substantially differing prices of shares across EU markets and would not readily accommodate the needs of different sized markets.

e) Size of the spread - (calculated as a difference between bid and offer compare to mid price). This method has been used in several academic studies and it seems to be quite a reliable measure of the overall level of liquidity. However, for the purposes of Article 27 it would have to be calculated individually for each stock which will require a substantial amount of data and calculations. Also, it does not take into account the depth of the market and may depend quite heavily on the current market situation.

f) Market impact (as an upgraded option of the previous method) - CESR has addressed potential methods for defining block sizes in the first consultation paper and one of the suggested methods was market impact. There is quite a wide understanding that it gives reliable results although it is clear that calculating it is very computing intensive and the data needed is not currently available in most markets.

g) Relative activity in different shares - Instead of setting an absolute threshold, CESR could take into account the relative activity in shares. It seems to be quite common in most markets for a (rather) small number of shares to account for a (rather) large share of overall trading. Taking this as evidence of liquidity, a criterion could be set whereby liquid shares would be those (in descending order of turnover) representing a certain percentage (e.g. 95 %) of total trading in a particular market. The necessary data would be quite easily available. However, such a criterion does not measure (real) liquidity in individual shares, so it is unlikely that it could be used it as single criterion. It may also give quite different results depending on market structure and the distribution of trading activity between shares.

h) Other "relative" criteria – A further possibility would be to measure the turnover in a share compared to its market capitalisation (the velocity or turnover rate). This would give an indication as to how often a share is traded but would not give reliable information unless turnover was compared to those shares which are in practice available for trading (free float). However, the definition of free float in EU markets varies significantly, so before such criteria could be used, a harmonised definition of free float would be required.

Use of proxies

Indices

CESR has discussed the use of indices as proxies in the determination of liquid shares because indices typically include the most liquid shares in each market. In turn, inclusion in an index normally increases liquidity in a share. The benefit of this option would be simplicity. In addition, the updating of the list of liquid shares would be done automatically.

However, this proxy raises the following questions and these would need to be adequately answered before going further in this direction.

(i) The first issue relates to the choice of index. CESR does not consider national indices as such to be a relevant option for determining liquid shares. There is currently little consistency as to the percentage of the overall trading volume captured by the "senior" index in each Member State. In some cases, not all the shares in that index might be regarded asliquid; in others, the index may exclude a significant number of liquid shares. Thus different results would be created in different Member States. An alternative to national indices would be EU-wide indices. There are several EU-wide indices based on different criteria. The rationale would be to exclude sectoral indices and other indices that may exclude some liquid shares to avoid any one sector being over-represented in the index.

(ii) Some indices are set up and maintained by independent third parties. In other cases, the index is set up and maintained by an exchange. This would potentially be a source of conflict of interest as the composition of the index might have a direct impact on the internalisers who compete with exchanges.

(iii) Typically, indices take into account only exchange traded volumes. This might not be consistent in the long run with the concept of "market" used in article 27.

(iv) Finally, it remains to be seen how consistent this approach would be with the Commission's view that transparency should be the rule with only limited exceptions.

Tradable indices

A variation of the index approach would be to use indices that underlie exchange-traded derivatives (options and/or futures). The assumption in this case is that all indices (including national ones) that are accepted as underlyings in exchange traded derivatives are more likely to include only liquid shares. Further analysis might be required, at least in the case of index derivatives whose trading volume is low.

Existence of a derivative

Another possibility for a simple proxy would be to define a share as liquid if it is used as an underlying in an exchange traded derivative (future/option). The difficulty with this method is that the criteria for selecting shares as underlyings in different derivatives exchanges are not comparable. Thus in some derivatives exchanges relatively more illiquid shares are accepted as underlyings than in some other exchanges. The possibility for conflicts or interests between regulated markets and internalisers exists also in this option.

Definition of the initial list of liquid shares and its revision

The Commission mandate makes a clear reference to a liquid “market” and thus, in principle, any assessment to be made should take into account all trading methodologies (RMs, MTFs, systematic internalisers and non-systematic internalisers). However, the initial list of liquid shares will have to be drawn up before the directive comes into force.

If a proxy approach is not used, it will be necessary to consider, at least in this initial phase, taking only those transactions executed on regulated markets into account when applying the criteria, provided that:

- this is not expected to create a major bias; and
- this is consistent with the scope of “market” that will be used for the first calculation of the average order values and SMSs (if not, then the two should be aligned).

The initial drawing up of the list of liquid shares and the periodic review therafter could be done either by each competent authority, based on precise criteria, or by CESR members jointly.

Questions to the consultees:

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

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

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?

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?

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?*

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

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

Draft CESR advice

BOX 15

As described above, CESR is seeking guidance from the consultees on different options before making more detailed proposals.

CESR

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

Extract from Level 1 text

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 standard market size for each class of shares shall be a size representative of the arithmetic average value of the orders executed in the market for the shares included in each class of shares.

The market for each share shall be comprised of all orders executed in the European Union in respect of that share excluding those large in scale compared to normal market size for that share.

The competent authority of the most relevant market in terms of liquidity as defined in Article 25 for each share shall determine at least annually, on the basis of the arithmetic average value of the orders executed in the market in respect of that share, the class of shares to which it belongs. This information shall be made public to all market participants.

Extract from the mandate from the Commission

"DG Internal Market requests CESR to provide technical advice on possible implementing measures by 30/04/2004 on

- Defining the classes in which liquid shares should be grouped as well as the criteria for its revision if necessary"
- Defining what is to be considered an order large in scale compared to normal market size.
- Defining the standard market size ("SMS") for each class of shares as well as the criteria for its revision if necessary.
- 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.
- Determining the arrangements through which competent authorities shall make public to all market participants the class of shares to which each share belongs."

<u>Draft CESR advice</u>

<u>Explanatory text</u>

Calculation of the average order value

Once the subset of shares for which there is a liquid market (and which will be subject to the pre-trade transparency requirements) has been determined, these shares must be divided into classes on the basis of the arithmetic average value of the (qualifying) orders executed in the market for each share.

The competent authority provided for in Article 25 will be responsible for calculating the average value of the orders executed in the EU in order to classify the different shares. It will also have to disclose the classification of each share.

Calculation period

The period used for calculation should be long enough to guarantee the statistical representativeness of the result. It should adequately reflect more permanent changes in the average order values for each share and be (largely) unaffected by temporary or short-term changes in trading patterns. Additionally the adjustment process should not create an undue burden for market participants. In order to balance the different needs, CESR suggests that a calculation period of 12 months could be considered appropriate.

Basis for calculations

In order to calculate the average order size, orders executed which are large in scale compared to normal market size are excluded. Since Article 27 MiFID is different in scope from Articles 29, 30, 44, 45 and refers to orders executed rather than transactions an argument could be made for defining an order large in scale compared to normal market size in Article 27 in a different way from the other provisions. However, in the interest of consistency and simplicity CESR considers it appropriate and feasible to use the same block regime as for other [pre-trade] provisions in the Directive.[13]

Another issue relating to classification is whether the basis for calculations ("orders executed") should be interpreted to refer as completed transactions rather than to separately executed buy and sell orders. The level 1 text refers to "orders executed" and based on preliminary work in the expert group, depending on market structure there can be significant difference between those terms[14]. Majority of CESR members are of the view that reference to transactions is more appropriate due to the fact that this information is easily available on the basis of post-trade information or Article 25 of the MiFID, whereas if executed orders are used, the data is not directly available on the basis of MiFID. That view is shared by the Commission. Other CESR members underline that the text of the directive is without any ambiquity in its refernce to orders executed and consider that use of "orders executed" will generate a Standard Market Size that more accurately reflects the role of large orders in the trading mix.

Furthermore, the first calculation of the average value of executed transactions must be completed before the Directive comes into force and will therefore have to be made on the basis of incomplete information. In particular, it will not be possible at the outset to calculatethe average value of transactions on the basis of EU-wide data. For this reason, CESR believes that a transitional period will be necessary where the calculations will be carried out on the basis of regulated market data only.

Definition of the classes in which liquid shares should be grouped

The directive requires shares to be grouped into classes. This is to facilitate the application of the quotation rule by allotting a common SMS to shares with a broadly similar average size of executed orders. The process should not lead to the establishment of an artificially low number of classes of shares that could result in disproportionately high or low SMSs for any individual share.

The classes should fulfil at least the following criteria:

- their number should be low enough to enable the market participants to properly manage the quote disclosure rule;
- their number should be high enough in order to achieve a representative SMS for the shares with both the lowest and highest average values of executed orders within each class; and

[13] It should be noted that in the first Consultation Paper CESR has asked whether the block size shoudl be tha same for pre and post-trade transparency. The proposal regarding article 27 will need to take reflect CESR´s final consideration in this respect.

[14] A simple example will clarify the point: let’s assume a buy order of 1.000 shares is matched with 10 orders of 100 shares each. In this case will be generated 10 contracts of 100 shares each. Using trades as a measure will give an estimate of 100, since there are ten trades of 100 shares. But if we take into account all the information available we have a total of 11 orders (1 on the buy and 10 on the sell side) for a total of 2000 shares. Computing the average size of the order we’ll have: 2000/11 which gives a little bit less than 182 shares (181,82).

- particular attention should be paid to the definition of the class including the shares with the highest average order value.

CESR will continue work on defining the classes, together with its work on block trades, and will come forward with more concrete proposals at a later stage.

Definition of SMS for each class of shares

According to the directive, the defined SMS for each class of shares shall be a size representative of the arithmetic average value of orders executed for the shares included in each class of shares. Hence, the SMS is not intended to be the exact average value of all orders executed in a class. However, the SMS should be fixed so as to accommodate shares at both ends of each class. The process should avoid situations in which, for instance, shares at the lower end of a class would be subjected to a disproportionately high SMS because most of the shares in that class had their average value close to the upper end of the scale.

Article 27 para.1 subpara.4 MiFID states that the grouping of shares into classes should be based on the value of orders executed. However, CESR has also considered whether the SMS for each class of shares could also be expressed as a number of shares. This would involve converting the SMS for each class into a number of shares for each share within that class.

Arguments in favour of defining SMS as a monetary value are that the calculation process is relatively straightforward, it would make comparisons across countries and stocks easier and it would be less affected by single stock-related events. In favour of defining SMS as a number of shares is the fact that doing so might better fit the current market practice for quoting in a number of .shares rather than by value Additionally, if this were to remain normal practice, it could provide more certainty for systematic internalisers as with a monetary value a transaction for, say, 1,000 shares may, depending on the movement of the share price, be within or outside SMS during the course of one trading day, sometimes triggering an obligation to quote sometimes not.

Revision of the groupings/calculations

In order to take into account changes in trading patterns, certain calculations will need to be revised periodically. According to the directive, competent authorities will be responsible for revising the calculation of average order size for a share as well as for its subsequent re-classification

In the interest of legal certainty and the stable functioning of systematic internalisers, CESR favours establishing annual revision cycles for the re-grouping of shares. To ensure a unified regime, the average value of the transactions should also be calculated on an annual basis, parallel to the grouping of shares into classes.

The Directive makes no provision for the updating of the parameters of the different classes and the SMS for each class suggesting that these are deemed to be more stable and are to be fixed in level 2 rules. However, CESR is seeking the views of the consultees as to whether there is a need for revision of the classes and SMS as well.

"Ad hoc" *revisions of the average value of transactions.*

It was also proposed in the responses to the call for evidence that CESR should contemplate "ad hoc" reviews of the average value of transactions in individual shares between formal revisions when there has been an extraordinary event, such as a takeover bid, public offering, merger or other event that has an effect on the average order values of the shares.

In CESR´s opinion, these "ad hoc" revisions are necessary to ensure that shares remain appropriately classified and that classifications reflect the real average order values of shares. The competent authority should therefore have discretion to recalculate the average value in response to such events.

New issues

CESR has also considered how to address new issues (i.e. IPOs) as the data needed to group newly issued shares into a class (and thus determine its SMS) is initially missing. CESR's has identified two possible options to deal with such scenarios. Firstly, the competent authority for the regulated market where the share is first admitted to trading could determine to which class a share belongs (and thus its SMS) after the share has traded for three months. This would be in preference to leaving the determination of an SMS for a newly issued share until the current revision cycle comes to an end (which could be a period of just under a year, once annual revision cycles are established). Alternatively, an SMS could be established from the first day of trading by using a proxy approach based on peer stocks (i.e. with similar market capitalisation, free float etc). However, this would involve a deviation from the prescribed method of defining SMSs in the MiFID.

Coming into force

Once a competent authority has calculated the average order size for a share and the share has been grouped into a class with an SMS, the result should be communicated to the markets.

In order to give enough time for market participants to prepare themselves CESR is proposing that the new SMS for a share should become effective two weeks after the competent authorities have made it public to all market participants.

Publication of the class of shares to which each share belongs

Competent authorities are responsible for making publicly available the class of shares to which each share belongs. Consequently, there should be a system that guarantees full access to this information across all EU countries.

After the end of each revision period, each competent authority responsible for a particular share on the basis of Article 25(2) should release an announcement at least in its web-page to make public the class to which each share belongs. Additionally and/or alternatively, all the information to be disclosed could be gathered into a single point (e.g. CESR website) to ensure easy access for all.

In the case of ad hoc revisions, the competent authority should, once it has decided to recalculate the average value, inform market participants in advance that the ad hoc revision will take place, indicating when any new classification of the share will become effective.

Draft Level 2 advice

BOX 16

1. Calculation of the average order size

To be able to calculate the arithmetic average value of the orders executed in the market, understood as “general market” (EU-wide basis) for a given share, the competent authority must receive information on all trades made in the EU in that share.

2. Orders large in scale compared to normal market size

An order executed large in scale compared to normal market size for the purposes of Art.27 MiFID shall refer to the same block size established for transactions large in scale compared with normal market size for the purposes of Art.29, 30, 44, 45 MiFID.

3. Definition of classes

CESR will consider further how to set the parameters for the classes of shares in conjunction with its work on block trades. However, the parameters should be defined in such a way as to ensure that the number of classes is manageable for systematic internalisers while at the same time allowing for a representative SMS to be established for all shares within the class

4. Definition of SMS for each class of shares

The SMS for each class of shares shall be fixed at Level 2.

5. How to fix the SMS

The SMS for each class of shares shall be fixed as a monetary value

OR

The SMS for each class of shares shall be fixed as a monetary value and the converted into a number of shares

6. "Revision of grouping and calculation"

Revision cycles for the grouping of shares into classes

The revision of the grouping of shares shall be undertaken annually.

Grouping of shares and Initial Public Offerings ("IPOs")

The competent authority for the regulated market where a share was admitted to trading shall determine an initial SMS by grouping the share into a class after the share is traded for three months, unless the current revision cycle comes to an end before the expiry of that period.

OR

The competent authority for the regulated market where a share was admitted to trading shall determine an initial SMS by grouping the share into a class from the first day of trading by using a proxy based on peer stocks (i.e. with similar market capitalisation, free float etc.).

7. Coming into force

The SMS shall become effective two weeks after the competent authority made the class into which the share was grouped and the resulting SMS public to all market participants.

8. Publication of the information

After the end of each revision period, each competent authority responsible for a particular share on the basis of Article 25(2) should make the information available in an easily accessible manner, including at least on its website.

Questions:

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?

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?

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?

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?

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?

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

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)?

4. Obligations of the Systematic Internaliser

4.1 Obligation to quote and publication, updating and withdrawal of quotes

Extract from Level 1 text

Systemic internalisers shall make public their quotes on a regular and continuous basis during normal trading hours.

The quotes shall be made public in a manner which is easily accessible to other market participants on a reasonable commercial basis.

"The price or prices shall also reflect the prevailing market conditions for that share."

…"They shall be entitled to update their quotes at any time. They shall also be allowed, under exceptional market conditions, to withdraw their quotes."

Extract from the mandate from the Commission

DG Internal Market requests CESR to provide technical advice on possible implementing measures by 30/04/05
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.

- Specifying the criteria for determining when a the price or prices reflect prevailing market conditions;

- 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.

Explanatory text

This part of the mandate contains basically two requirements for systematic internalisers:

1) the publication of quotes on a regular and continuous basis during normal trading hours; and

2) systematic internalisers have to make quotes public in a way that the quotes are "easily accessible" to market participants so that the market can be aware of the prices offered by them.

At the level of the directive, there is a link with the updating and withdrawal of quotes (also mentioned in the same paragraph of Article 27.3).

Publication of quotes on a regular and continuous basis during normal trading hours.

The publication of quotes on a regular and continuous basis seems to imply that when a systematic internaliser quotes in a specific share, it must do so continuously. Quotes should therefore be published 100 % of the time during the firm´s normal trading hours, those trading hours being decided and made public by the firm.

Access

The publication of the quote should ensure that the quote is easily accessible.

The mandate lists three possibilities. The general requirements for all three options should be that:

a) publication of the quotes is on a real time basis,

b) the quotes are easily accessible without incurring high costs for market participants;

c) the systematic internaliser remains responsible for publication of the quotes, irrespective of the channel that is used for publication.

The fllowing are more detailed remarks on the three possibilities:

a) Through the facilities of a Regulated Market: this would require a contractual arrangement with the RM that the RM makes the quotes easily and in real time accessible to the investor;
b) Through the offices of a third party: similar to a), but with a third party other than a RegulatedMarket, e.g. a data vendor;
c) Through proprietary arrangements: It is up for discussion whether publication on the website of a systematic internaliser meets the "easily accessible"-test, in particular whether it sufficiently addresses the risks arising from fragmentation of information. In the Consultation Paper on the first set of mandates, CESR concluded (nr. 40 on page 94) that publication (Post-Trade Transparency) just on the firm's own website was unlikely to meet the "easily accessible" test, as investors would have to search through a large number of websites, and that an investment firm must choose a publication mechanism which publishes the post-trade transparency information in a form which is easily consolidatable.

4.2. Specifying the criteria for determining when the price or prices reflects market conditions

<u>Draft CESR advice</u>

<u>Explanatory text</u>

Article 27 requires systematic internalisers in shares, who by definition, can be expected to play an active role in the markets, to contribute to market transparency in a meaningful way. Although systematic internalisers are free to minimise their exposure to the market through management of their quote size(s), they are required to maintain a quote price (or prices) that reflect prevailing market conditions.

CESR takes the view that in a market environment that is being liberalised to facilitate competition, no purpose is served in attempting to prescribe precisely how or when a price would reflect prevailing market conditions. Rather, the competent authorities should, as part of their supervisory work, evaluate whether the quotes published by internalisers meet the requirement of reflecting market conditions. CESR is therefore proposing a more general requirement that published quotes should be close to prices on other relevant markets and that systematic internalisers should maintain a record of quoted prices.

When considering what should be considered as a relevant market, a firm may wish to take into account those execution venues included in its execution policy.

<u>Updating of quotes</u>

Firms meeting the definition of systematic internaliser provided for in Article 4(1)(7) should not be able to disregard the transparency requirements in Article 27 whenever trading in shares admitted to trading on a regulated market for which they are systematic internalisers and for which there is a liquid market

The level 1 text states that systematic internalisers may update their quotes at any time. In fact, it is important that a systematic internaliser is unhindered in its ability to update its quotes as it must publish prices that reflect the prevailing market conditions. This would suggest that a systematic internaliser should update its quotes when market conditions change (i.e. the market moves) or it comes across new information which changes its view of the value of the relevant share. While it would not be reasonable to impose a minimum time limit to price updating, a firm should not update its quotes in a capricious or discriminatory manner.

Withdrawal of quotes

The option to withdraw quotes is an exception to the obligation of SIs to publish quotes. The use of the word "exceptional" can mean anything from unusual to extraordinary. However, in this context it implies that the exemption has to be very limited.

CESR notes that IOSCO has conducted extensive work on the co-ordination of trading suspensions and halts in its report on Trading Halts and Markets Closure in respect of exchanges/regulated markets.

While CESR notes that the activity of systematic internalisers differs from regulated markets in that they put their own capital at risk, the directive is clear that systematic internalisers may withdraw their quotes only in exceptional circumstances. It should also be noted that in the MiFID, there are separate provisions on suspending the trading by market operator or competent authority.

CESR has considered two possibilities for determining when a systematic internaliser may withdraw its quotes. The first is to allow systematic internalisers to withdraw their quotes in circumstances which might lead a regulated market to suspend trading, even where the regulated market had chosen not to do so. The other option would be to make a link between the decision of a regulated market (or competent authority) to suspend trading and allow internalisers to withdraw their quotes only when trading is suspended on a regulated market. In the latter case "automatic trading halts" would not be taken into accouont.

Draft Level 2 advice

BOX 17

1. Publication of quotes

A quote is published on a regular basis when a systematic internaliser publishes a quote throughout 100 % of its normal trading hours as a systematic internaliser, details of which must be predetermined and made transparent to investors.

[Concerning accessibility of quotes CESR will revise its proposals on accessibility of pre-trade information on RMs and MTFs based on the outcome of the first consultation. The requirements established in respect of pre and post trade transparency will be used as the basis for the requirements relating to systematic internalisers (unless there are justified reasons for adopting a different approach]

2. Reflecting market conditions

A price or prices reflect prevailing market conditions when the price or prices are close to comparable quotes on other relevant markets. A systematic internaliser must maintain a record of its quoted prices.

3. Withdrawal of quotes

Systematic internalisers may withdraw quotes whenever trading on a regulated market is suspended and outside the trading hours of regulated markets for comparable reasons.

4. Updating of quotes

A systematic internaliser should be able to update its quotes in order to publish prices that reflect the prevailing market conditions – namely it should be entitled to update its quotes where the market conditions change or it comes across new information which changes its view of the relevant share. Therefore, an internaliser should be able to update its quotes as often as it is able to justify the change

Questions:

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?

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"?

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

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?

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?

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?

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?

"Handling of client orders and executing the orders"

Extract from Level 1 text

Where a 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 in compliance with the provisions of Art 22, except where otherwise permitted under the conditions of the previous two subparagraphs.

Extract from mandate from the Commission

DC Internal Market requests CESR to provide technical advice on possible implementing measures by 30/04/05 on specifying the general criteria for the handling of client orders in case that systematic internalisers publish multiple quotes.

Draft CESR advice

Explanatory text

The Directive permits systematic internalisers to quote in a number of different sizes in respect of a particular share. Article 27 provides that where a systematic internaliser quotes in ascending bands (from 1 share) it should execute orders at the price of the size band within which the order falls (or, if it elects to execute an order below SMS but above its largest quoted size, at the price of its largest quoted size, subject to the possibility of price improvement where permitted.)

In circumstances where a systematic internaliser quotes in different and non-contiguous sizes (for example, 1 - 5,000 shares and 10,000 shares), the Directive permits it, when it receives an order between its quoted sizes, to execute it at one of the quoted prices in a manner compliant with Article 22.

Article 22.1 requires a firm executing orders on behalf of clients to implement procedures and arrangements which provide for the prompt, fair and expeditious execution of client orders. Where a firm is acting as systematic internaliser, the procedures and arrangements that it has implemented in order to comply with Article 22(1) should therefore ensure the fair and consistent treatment of orders that fall between its quoted sizes.

Draft level 2 advice

BOX 18

It is CESR's view that no further advice is needed to clarify the manner in which firms should execute orders when they publish quotes in sizes that are not contiguous.

Questions

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?

Extract from Level 1 text

Systematic internalisers may, in a non-discriminatory way, limit the total number of transactions from different clients at the same time provided that this is allowable only where the number and/or volume of orders sought by clients considerably exceeds the norm.

Extract from the mandate from the Commission

DG Internal Market requests CESR to provide technical advice on possible implementing measures by 30/04/05 on:

- The criteria for determining what constitutes considerably exceeding the norm in order to limit the total number of transactions from different clients.

Draft CESR advice

Explanatory text

The Directive requires quotes displayed by systematic internalisers to be firm. However, it also recognises that systematic internalisers require certain protections if they are to provide liquidity in a prudentially responsible manner. In addition to permitting systematic internalisers to update and withdraw their quotes, the Directive also allows them, in specified circumstances, to limit their exposure from multiple orders.

In the case of transactions from different clients, systematic internalisers may limit the total number of transactions at the same time only when the total number and/or volume of the orders sought by clients considerably exceeds the norm. This could be interpreted to mean that the systematic internaliser may limit the number of transactions that it executes at the same time at the quoted price(s) or that alternatively, it may limit the number of orders that it receives at the same time. In practise, it is unlikely that firms operating automated systems will receive large number of orders at exactly the same time as orders will tend to be time stamped to a millisecond. Furthermore, it would be difficult to determine whether orders were received "at the same time" in repect of a phone-based investment firm. It is therefore CESR´s view that the intention is to allow systematic internalisers to limit the number of orders that they execute simultaneously at the quoted price(s).

Rather than identifying a single EU wide figure, CESR believes that the determination of what considerably exceeds the norm should be left to the discretion of individual systematic internalisers, as they will be best placed to identify the maximum number and/or volume of orders that they are able to prudently accommodate, as a matter of course, at the same time. This approach will also allow for variations (if any) in the scale and extent of systematic internalisation in different member states, as well as making it unnecessary to revise the criteria.

A systematic internaliser should therefore establish, and document, an internal policy relating to the number and/or volume of orders sought by clients that it can manage prudently without exposing itself to undue risk, taking into account the value of the transactions, the capital the firm has at risk and the prevailing market conditions.

Furthermore, a systematic internaliser should communicate to its clients in writing (for instance, in its general terms and conditions) that it reserves the right to limit the total number of transactions from different clients that it executes at the same time.

A systematic internaliser should limit the number of orders that it executes only where absolute necessary. In practice, it is likely that firms will have a strong commercial incentive to honour all commitments to trade since failure to execute orders will, in all probability, result in them rapidly losing bisiness.

On occasions when a systematic internaliser decides, in line with its internal policy, to limit the number and/or volume of orders that it executes, it should maintain an audit trail that documents the reasoning behind its decision, as well as the arrangements by which it ensured the equitable treatment of its clients.

Draft level 2 advice

BOX 19
1. A systematic internaliser should develop and document an internal policy relating to the number and/or volume of orders sought by clients that it can manage prudently without exposing itself to undue risk, taking into account the value of the transactions, the capital the firm has at risk and the prevailing market conditions.
2. A systematic internaliser should communicate to its clients in writing that it reserves the right to limit the total number of transactions from different clients that it executes at the same time, for instance, in the firm´s general terms and conditions.
3. Where a systematic internaliser decides to limit the number and/or cvolume of orders that it executes, in line with its internal policy, it should maintain an audit trail that documents the reasoning behind its decision not to do so, as well as the arrangements by which it ensured the equitable treatment of its clients.

Questions:

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?

Extract from Level 1 text

Furthermore, systematic internalisers may execute orders they receive from their professional clients at prices different than their quoted ones without having to comply with the conditions established in the fourth subparagraph, 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.

Extract from the mandate from the Commission

DG Internal Market requests CESR to provide technical advice on possible implementing measures by 30/04/05 on 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 the current market price.

Draft CESR advice

Explanatory text

The Directive provides an exemption from the requirement to execute orders up to SMS at the quoted price for certain orders received from professional clients. This exemption recognises the significant role in today's markets of more complex trades and trades that are executed on the basis of factors other than immediacy and the prevailing market price.

As suggested in the mandate from the Commission, a transaction where execution in several securities is part of one transaction shall refer to a portfolio transaction. Such transactions sometimes include securities other than shares (e.g.bonds) and may also include other financial instruments.

Such transactions would be impracticable for systematic internalisers to conduct within the general quote rules of Article 27. This is for two main reasons. First, investment firms normally tender for such transactions with only generic information about the portfolio, i.e. without knowledge of all the individual securities (or other financial instruments) that comprise the portfolio or even the direction of the trade (i.e. whether it is a buy or a sell). This absence of pre-trade details about individual securities reduces the risk of information leakage before the trade and the possibility that firms bidding to execute the trade might exploit that knowledge. In addition, a portfolio is normally priced as a percentage of the aggregate (and, at the time, unknown) mid-market value of its constituent stocks, not on the basis of the currently quoted best bid or offer prices of individual components. The application of the dealing rules under article 27 to such transactions would reduce institutional ability to conduct such trades and in CESR's view this would increase investor dealing costs for no overall market benefit.

In relation to orders from professional clients where execution is influenced by conditions other than the current market price, CESR considers that such orders should include (whether individually or as part of a linked trading strategy) all orders other than those containing a simple instruction to buy or sell immediately at the best available price (i.e. a market or equivalent order) or at a specified price as soon as the market price permits (i.e. a limit order or equivalent). CESR has proposed this approach in preference to providing a list of the types of orders to be regarded as subject to conditions other than the current market price in order to allow for future innovation and the emergence of new order types.

Draft level 2 advice

BOX 20

1. A transaction where execution in several securities is part of one transaction for the purposes of Article 27 of MiFID shall refer to a transaction which involves 10 or more securities grouped together into a basket and traded as a single lot against a specific reference price.

2. Orders from professional clients subject to conditions other than the current market price for the purposes of Article 27 shall refer to all orders other than those containing a simple instruction to buy or sell immediately at the best available price (i.e. a market or equivalent order) or at a specified price as soon as the market price permits (i.e. a limit order or equivalent).

Questions:

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?

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

The size customarily undertaken by a retail investor

Extract from Level 1 text

"Systematic internalisers shall execute the orders they receive from their professional clients in relation to the shares for which they are systematic internalisers at the quoted prices at the time of reception of the order. However, they may execute those orders at a better price in justified cases provided that this price falls within a public range close to market conditions and provided that the orders are of a size bigger than the size customarily undertaken by a retail investor".

Extract from the mandate from the Commission

CESR

DG Internal Market requests CESR to provide technical advice on possible implementing measures by 30/04/05 on: specifying the criteria for determining what is a size customarily undertaken by a retail investor

Draft CESR advice

Explanatory text

The objective should be the adoption of criteria that allows a clear, simple and uniform identification of the size customarily undertaken by a retail investor. Any criteria with the above characteristics:

- will allow intermediaries operating as systematic internalisers to be clear as to the minimum size of order from professional clients that is eligible for price improvement;
- will make regulators' enforcement activities easier and more effective and
- will avoid market distortion and reduce the likelihood of abusive practices.

Two major approaches were considered to identify the CRS. According to the first one the CRS would be identified on the basis of information from market data on orders and/or the acquisition of information from intermediaries. Due to the present unavailability of such data and the costs/difficulties related to its collection from intermediaries, CESR favours the second approach, namely an estimate based on criteria informed by such evidence on retail transactions as is available.

In setting the CRS, a choice needs to be made as to whether the size should be "national" i.e. based on typical retail size in each Member State, or whether a European typical size should be preferred. Keeping in mind the considerations arising from cross-border trading and having sought the view of the Commission, CESR is of the opinion that a single European size threshold should be preferred

Furthermore, the size can be fixed individually for each share, for classes of shares or as a single figure applicable for all shares. In CESR´s view an individual figure for each stock is likely to make the system too complicated and it is also not evident at this stage whether using the SMS will adequately reflect the differences in typical retail sizes.

Based on samples from several CESR members, the estimated size of "a typical retail order" indicates considerable differences between markets (and even within one market based on the method of trading). Smallest figures seem to be around 2.000 – 3.000 euros with the highest ranging above 10.000 euro and, in one case, even 40.000 euro. It should be noted however that there are no uniform requirements for reporting (or even defining) retail transactions. Therefore it is difficult to validate those figures and/or have reliable figures around EU.

In EU legislation there are at least the following thresholds which are targeted to issues relating to retail investors: In the investor Compensation Directive the limit for compensation is 20.000 euro and in the Prospectus Directive a prospectus is not required with respect to offers addressed to investors who acquire securities for a total consideration of at least 50.000 euro and offers of securities whose determination per unit amounts to at least 50.000 euro..

Concerning the level at which to set the threshold, CESR members have divided views. Some feel that in order to protect investors and avoid discriminatory treatment the figure should be set at the highest (or close to it) size of retail trades in the EU. Others believe that in order to find an appropriate balance between the protection of retail investors and negotiating freedom for professional investors (who often also need to deal in relatively small sizes) the figure should represent a size up to which a typical retail investor might customarily deal, ie. rather closer to the average.

Irrespective of the approach chosen, the CRS should be expressed in monetary values, as a CRS expressed in terms of number of shares would give rise to unjustified differences in the value of the orders which are not eligible for price improvement, which would vary according to the different market value of the underlying share.

Draft level 2 advice

BOX 21

Before making more concrete proposals on the matter CESR is seeking the views of the consultees on the basic options and on the best way to find appropriate data regarding the order size customarily undertaken by a retail investor.

Questions:

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

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?

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?

ANNEX 1

PROCESS AND WORK PLAN

1. On 20 January 2004, the European Commission published its first set of provisional mandates requesting CESR's technical advice on possible implementing measures for the MiFiD by 31 January 2005 (Ref. CESR/04-021). A second set of mandates from the Commission was published by the Commission on 25 June 2004 ("*The formal request for Technical Advice on Possible Implementing Measures on the Directive on Markets in Financial Instruments*"). In addition to confirming the provisional mandate, published 20 January 2004, the Commission asked CESR to deliver its technical advice in form of an "articulated" text concerning some new areas of the Directive by 30 April 2005.

2. The mandate from the Commission asks that CESR should have regard to a number of principles and a working approach agreed between DG Internal Market and the European Securities Committee in developing its advice. These are as follows:

   - CESR should take account of the principles set out in the Lamfalussy Report and mentioned in the Stockholm Resolution of 23 March 2001.

   - CESR should respond efficiently to the content of the mandates by providing comprehensive advice on all subject matters covered by the delegated powers included in the relevant comitology provision of the level 1 Directive as well as in the relevant Commission request included in the mandate. On the basis of the experience gained in the context of the preparation of the technical advice for the level 2 measures for the Prospectus and the Market Abuse Directives, the Commission has realised that mandates to CESR must be very clear and precise for the items that have to be covered by the advice required are concerned.

   - Acting independently CESR will determine its own working methods, i.e. by creating expert groups depending on the content of the provisions dealt with. Nevertheless, horizontal questions should be dealt with in a way ensuring coherence between the work carried out by the various expert groups.

   - CESR should address to the Commission any questions they might have concerning the clarification on the text of the draft Directive or other parts of Community legislation, which they should consider of relevance to the preparation of its technical advice.

   - The technical advice given by CESR to the Commission will not take the form of a legal text. However, CESR should provide the Commission with an "articulated" text which means a clear and structured text, accompanied by sufficient and detailed explanations for the advice given, and which is presented in an easily understandable language respecting legal terminology used in the field of securities markets.

   - CESR should provide an advice which takes account of the different opinions expressed by the market participants during the various consultations. In case it deviates form the opinion generally expressed it should inform the Commission and justify their position. Particular attention should be paid of the level of detail required by market participants to be included in level 2 legislation.

3. CESR decided to establish three Expert Groups in order to be able to deliver CESR's technical advice to the Commission in an appropriate and timely way:

   - Expert Group on Intermediaries: The Expert Group is chaired by Mr Callum McCarthy (Chairman of the UK's Financial Regulator, the Financial Services Authority [FSA]); rapporteur of the group is Mr Carlo Comporti. This Expert Group covers the mandates related to: article 4 on the definition of investment advice and the list of financial instruments; article 19.1 on the general obligations to act fairly, honestly and professionally; article 19.4 on the suitability test; article 19.5 on the appropriateness test; article 19.6 on the execution only business and article 24 on the transactions executed with eligible counterparties.

- **Expert Group on Markets:** This Expert Group is chaired by Mr Karl-Burkhard Caspari (Vice President at the German Regulator, the Bafin); rapporteur of the group is Mr Jari Virta. This Expert Group covers the mandates relating to: article 22.2 on limit order display and article 27 on pre-trade transparency of internalizers.

- **Expert Group on Cooperation and Enforcement:** This Expert Group is chaired by Mr Michel Prada (President of the French Securities Regulator, the Autorité des Marchés Financiers [AMF]); rapporteur of the group is Mr Alexander Karpf.

  A Steering Group has been established to consider horizontal issues and to ensure overall consistency in the advice prepared by each Expert Group. This Group is composed of the three chairmen of the experts groups and chaired by CESR's Chairman, Arthur Docters Van Leeuwen.

4. In line with CESR's commitment to transparent working procedures and in order to have the technical input for the Expert Groups from external experts already at an early stage, CESR formed a specific Consultative Working Group of market participants drawn from across the European Markets. They are not intended to represent national or a specific firms' interest and do not replace the important process of full consultation with all market participants. The Consultative Working Group has already met twice with the Expert Groups and provided most valuable assistance to them for developing drafts of this consultation paper. The Consultative Working Group will continue to offer its views and advice to CESR as work progresses.

   The following 21 external experts are members of the Consultative Working Group:

   Dr Heiko Beck, General Counsel DekaBank Deutsche Girozentrale
   Dr Michele Calzolari, Chairman of Assosim and CEO of BIPIELLE SIM
   Mr Jean-François Conil-Lacoste, CEO of Powernext SA
   Mr Henri de Crouy-Chanel, Administrateur Délegué of Aurea Finance Company
   Mr Peter De Proft, Member of the Executive Committee of the Bank Nagelmackers
   Mr Mark Harding, Group General Counsel of Barclays Bank Plc
   Mr Brian Healy, Director of Trading of the Irish Stock Exchange
   Mr Henrik Hjortshøj-Nielsen, Senior vice president Nykredit
   Mrs Marianne Kager, Chief Economist of Bank Austria
   Mr Socrates Lazaridis, Vice-President of the Athens Stock Exchange
   Mr Jacques Levy-Morelle, Secretary General of Solvay SA
   Mr Gyorgy Mohai, Advisor to the Budapest Stock Exchange
   Mr Peter Norman, Executive President of Sjunde AP-fonden
   Mr Anthony Orsatelli, CEO of CDC Ixis
   Mr Joao Martins Pereira, Compliance officer and Adviser to the Board of Directors of Banco Espírito Santo
   Mr Frede Aas Rognlien, Chief Legal Counsel in the Association of Norwegian Stock broking Companies
   Mr Roger Sanders (OBE), Joint Chairman of FSA-SBPP Deputy Chairman of the Association of Independent Financial Advisers
   Dr Jochen Seitz, Senior expert for European Regulatory Affairs from Deutsche Börse Group
   Mr Juan Carlos Ureta, Chairman and CEO of Renta 4
   Mr Renzo Vanetti, CEO of SIA S.p.A
   Mr Jan-Willem Vink, General Counsel ING Group

5. CESR has undertaken to consult widely all interested parties according to the principles set out in the Final Report of the Committee of Wise Men and as set out in CESR's "Public

Statement on Consultation Practices" (Ref. CESR/01-007c). The first step in CESR's consultation process began with the launch of a Call for Evidence from all interested parties on 29 June 2004 (Ref. CESR/04-323). Views from all interested parties on any or particular parts of the mandates were invited by 29 July 2004. CESR received more than 40 responses from a wide range of market participants, which are available on CESR's website. These responses were taken into consideration by the two Expert Groups in the development of the consultation paper.

6. The work plan for handling the first set of mandates, which has been accomplished up to now, can be found below. After publication of the consultation paper, the next important step in the consultation process is going to be an open hearing to be held at CESR on 19 November 2004, to which all interested parties are invited.

CESR

Indicative CESR Work Plan for the first set of provisional mandates under the MiFiD

PROVISIONAL MANDATES — 20 January 2004

CESR issues a "call for evidence" (1 month) — 20 January 2004

Meeting(s) with the Consultative Working Group — 28-29 January 2004

Deadline for comments to the "call for evidence" — 19 February 2004

Possible preliminary Consultation based on Concept Paper, in particular transaction reporting and co-operation — March 2004

Meeting(s) with the Consultative Working Group — April 2004

Consultation papers approved by CESR Open Consultation, 3 month period — June 2004

WORK COMPLETED

Open hearing — July 2004

Deadline for comments — Early September 2004

Internal evaluation of comments & re-drafting

2nd Consultation papers (where necessary), (1 month) — End October 2004

Possible 2nd open hearing — November 2004

Deadline for possible second consultation — November 2004

FINAL APPROVAL — End January 2005

Indicative CESR Work Plan for the second set of mandates under the MiFiD

2nd SET OF MANDATES — 29 June 2004

CESR issues a "call for evidence" (1 month) — 29 June 2004

Deadline for comments to the "call for evidence" — 29 July 2004

Meeting(s) with the Consultative Working Group — 3 September 2004

Consultation papers approved by CESR Open Consultation, 3 months period — 21 October 2004

Open hearing 19/11/2004

Deadline for comments — 21 January 2005

2nd Consultation papers (where necessary) — Early March 2005

Possible 2nd open hearing

Meeting(s) with the Consultative Working Group — Mid March 2005

Deadline for possible second consultation — End March 2005

FINAL APPROVAL OF TECHNICAL — End April 2005

ANNEX 2

LIST OF RELEVANT WORK ALREADY CONDUCTED BY CESR IN THIS AREA

Already in the past, CESR undertook a number of initiatives in areas now covered by the MiFiD, which were taken into account in the EU legislative process as to the MiFiD, and also included in the MiFiD, to a considerable extent. In addition, a large number of these initiatives will also be used for CESR's work on the technical advice for Level 2 measures as requested by the Commission.

- Standards on Investor Protection ("A European Regime of Investor Protection - The Harmonization of Conduct of Business Rules" [CESR/01-014d], "A European Regime of Investor Protection – The Professional and the Counterparty Regimes" [CESR/02-098b])

- Standards for Alternative Trading Systems (CESR/02-086b)

- Standards for Regulated Markets under the ISD (99-FESCO-C)

- First Interim Report by the Review Panel on the Status of Implementation of the CESR Standards on Investor Protection and for Alternative Trading Systems (CESR/03-414b)

- Report of CESR on Market Transparency and Efficiency (CESR/02-179b)

- The Regulation of Alternative Trading Systems in Europe – A paper for the EU Commission (FESCO-00-064c)

- Implementation of Article 11 of the ISD: Categorisation of Investors for the Purpose of Conduct of Business Rules (00-FESCO-A)