THE COMMITTEE OF EUROPEAN SECURITIES REGULATORS

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

- Aspects of the definition of Investment Advice and of the General Obligation to Act Fairly, Honestly and Professionally in the Best Interests of Clients
- Best execution
- Market Transparency

SECOND CONSULTATION PAPER

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11-13 avenue de Friedland - 75008 PARIS - FRANCE - Tel.: 33.(0).1.58.36.43.21 - Fax: 33.(0).1.58.36.43.30
Web site: www.cesr-eu.org

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INTRODUCTION

Background

1. 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 (Directive 93/22/EEC).

2. In accordance with 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).

3. 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*" ("second set of mandates").[1] In addition to confirming the provisional mandate, published on 20 January 2004, the Commission asked CESR to deliver its technical advice on additional mandates concerning some new areas of the Directive by 30 April 2005. These areas included the definition of "investment advice" and the general obligation to act fairly, honestly and professionally in the best interest of clients.

4. On 21 October 2004 CESR published its first consultation paper on its draft technical advice to the European Commission regarding the second set of technical implementing measures for the MiFID (CESR-04/562). The public consultation closed on 21 January 2005. CESR received a high number of responses (more than 90) concerning this first consultation on the second set of mandates.

5. This paper included draft technical advice under Article 19(1), in particular on measures concerning the provision of portfolio management services to retail clients. It also included draft technical advice on the definition of "investment advice" under Article 4(1)(4) of the Directive.

Areas Covered by this Consultation Paper

6. This consultation paper covers the following questions.

   a. The application of the **general obligation to act fairly, honestly and professionally in the best interest of clients** where the investment firm grants a credit or loan of money to a retail client, or arranges for a third party to do so. This consultation document presents a new proposal in this area.

   b. Whether the **definition of "investment advice"** should be limited to recommendations relating to specific financial instruments (eg "buy 500 shares in company x") or should be extended to also cover more generic recommendations (eg "you should invest in an equity UCITS fund" or "you should invest 50% of your money in equities and 50% in bonds"). This was one of the most debated issues arising out of the first consultation paper on the second round mandates. This consultation paper outlines CESR's developing thinking about this issue in the light

[1] On 20 January 2004, the Commission published "*The Provisional Mandate to CESR for Technical Advice on Possible Implementing Measures concerning the Future Directive on Financial Instruments Markets*". The Commission asked CESR to deliver its technical advice in form of an "articulated" text by 31 January 2005. CESR sent a feedback statement (CESR/05-025) together with the final CESR's technical advice on the first set of mandates (CESR/05-024c) on 31 January 2005.

of the responses to the first consultation document. This paper does not deal with other aspects of the definition of "investment advice" (such as the meaning of a "personal" recommendation). CESR will continue its work on these other aspects of the definition of "investment advice" during the period for the submission of responses to this paper.

c. **Best execution**. This paper addresses five mandates regarding investment firms' duty of best execution. We turn first to CESR's mandate under Article 19(1), which permits CESR to clarify that the best execution obligations under Article 21 apply to investment firms that provide the services of portfolio management and/or order reception and transmission. The paper turns next to the mandates under Article 21.

d. **Market Transparency**. This section combines the proposals on transparency which were included in the CESR consultation documents of June 2004 and of October 2004. It includes proposals relating to market transparency for Regulated Markets, MTFs and investment firms, including Systematic internalisers. In order to give a comprehensive picture of the proposed level 2 measures on market transparency, the structure of the proposed advice has been changed from the previous documents. The present document contains the following sections:

- Definition of Systematic internaliser
- Pre-trade transparency (including RMs, MTFs, Systematic internalisers and Limit orders display)
- Post-trade transparency
- Treatment of transactions which are large in scale compared to normal market size
- Publication of transparency information and consolidation of the information.

7. This second consultation will help CESR to define an appropriate regulatory intervention and to strike the right balance between the need to reduce the requirements placed on firms and the need for the protection of investors.

<u>Call for comments</u>

8. CESR invites comments on its views regarding the issues raised. Market participants are invited to accompany any request for changes with detailed reasoning and practical examples of the impact of the proposals.

<u>Consultation Period and Public Hearing</u>

9. Consultation closes on 4 **April 2005**. 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 consultations justifying its final choices vis-à-vis the main arguments raised during consultation. A public hearing will be held on 23rd March 2005 at CESR’s premises (11-13 avenue de Friedland, 75008 Paris). Registration is compulsory and can be made through the CESR website (www.cesr-eu.org) under the heading “hearings”.

Issues for consultation

CHAPTER 1

General Obligation to act fairly, honestly and professionally and in accordance with the best interests of the client (Article 19(1)) – lending to retail clients

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) of the Directive states a general principle of fair treatment of clients. Paragraphs 2 to 8 of Article 19 set out specific principles that apply within the scope of this general principle. The application of these principles is to be further elaborated in level 2 measures, which are the subject of advice by CESR.

CESR is 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. These implementing measures are not intended to be an exhaustive statement of the practical implications of the general obligation in Article 19(1) of the Directive, which is of wider application.

Existing CESR Standards for Investor Protection require an investment firm to verify that clients possess sufficient financial resources to settle the transactions, available also through appropriate credit facilities granted by the firm[2].

There are valid reasons why an investment firm may wish to provide (or arrange) credit or loan facilities for its client to allow the client to carry out transactions in financial instruments[3]. For

[2] Standard n. 74 of CESR Standards for Investor Protection states: "An investment firm must take reasonable care to verify that the customer has sufficient financial resources to settle the proposed transaction". Standard n. 76 provides that: "An investment firm may accept an order without having taken reasonable steps to verify the immediate availability of the funds (securities) necessary for carrying out the related purchase (sale) only if an adequate credit facility has been agreed beforehand".

example, such facilities may enable the client to take advantage of short term investment opportunities that would be missed if the client had to arrange for funds to be transferred into their accounts from elsewhere. They may also be used by the client to leverage his exposure to a particular financial instrument. Such techniques may change the risk profile and complexity of the relevant transaction. Depending on the circumstances, this increased risk and complexity may or may not be suitable for the client.

In view of the potential effect on the risk profile and complexity of the transaction to which it relates, CESR proposes that when providing a loan or credit of money to a retail client, an investment firm should be subject to an obligation to evaluate the suitability of that loan or credit.

The proposed advice would also apply where the investment firm arranges for a third party to grant the loan or credit. The fact that the credit or loan is provided by a third party does not prevent it affecting the risk profile or complexity of the transaction. Limiting the advice to loans or credits granted by the investment firm would also create an opportunity for the firm to avoid the requirement by arranging for a third party to advance the loan or credit.

One issue that arises is the relationship between this proposal and the requirements under Articles 19(4) to (6) of the Directive. Article 19(4) sets out a suitability standard, which applies in relation to the provision of investment advisory and portfolio management services. Article 19(5) sets out an appropriateness standard, which applies in relation to investment services other than investment advice and portfolio management. This is subject to Article 19(6), which allows an investment firm to provide the investment services of the execution and/or the reception and transmission of client orders to a client without the need to obtain the information or make the determination provided for under Article 19(5), provided certain conditions are met.

- One approach would be that if a loan or credit is provided or arranged, the suitability requirement would be applied to both the loan/credit and the underlying transaction, regardless of whether than transaction is subject to Article 19(4), (5) or (6).

- A second approach would be to rely on the differing levels of protection provided by Articles 19(4) to (6) and the operation of the general principle under Article 19(1), without further specific elaboration in relation to loans or credits.

- A third approach, which forms the basis of the draft technical advice set out below, would be to provide that Article 19(1) entails the imposition of a suitability requirement whenever an investment firm provides or arranges a credit or loan for the purpose of allowing a retail client to carry out a transaction in a financial instrument, but to focus the suitability determination on the loan or credit and not the transaction to which it relates.

Another issue relates to the amount and type of information that should be obtained by the investment firm for the purposes of performing the determination. Should it relate to the financial situation of the client or should it also relate to other factors, such as their knowledge and experience?

The draft technical advice proposes a number of important limitations to the scope of this suitability obligation.

- The proposed advice would only apply where the loan or credit is granted for the purpose of enabling the retail client to carry out a transaction in a financial instrument and in the course of, or in connection with, the provision of investment services by the investment firm. The obligation would therefore not apply to the general lending activities of investment firm unless these take place in connection with, or in the course of providing, an investment service.

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[3] This was also reflected in paragraph 3(i) of CESR's advice to the Commission under Article 19(7) of the Directive (CESR/05-024c). This states that, where applicable, the retail client agreement must contain the terms of any credit or loan to be granted to the client by the investment firm to allow him to carry out a transaction.

- The suitability obligation would not apply in relation to professional clients, as they are deemed to have sufficient knowledge and experience to exercise their own judgement [4].

- There may be some other circumstances in which a retail client may become indebted to an investment firm where the application of a suitability requirement would be inappropriate. The draft advice includes some possible exemptions from the suitability requirement. CESR invites comments on whether such exemptions are appropriate and if so, the form and scope that they should take. For example:

  - an investment firm might cover a limited period of late payment. Such an exemption could apply in relation to any transaction in financial instruments or only to transactions in certain financial instruments (for example, transferable securities, money market instruments and units in collective investment undertakings).

  - an investment firm may cover a margin call made against a client. Should a maximum period apply to the the provision of cover without a suitability determination? What would happen at the end of the period? Would the firm need to close out the transaction or perform the suitability determination?

Draft Level 2 advice

BOX 1

1. Before an investment firm, in the course of, or in connection with, the provision by it of an investment service, lends money or grants a monetary credit to a retail client for the purpose of allowing the retail client to carry out a transaction in a financial instrument, or arranges for a third party to do so, the investment firm must:

(a) obtain from the retail client at least the necessary information about the retail client's financial situation so as to be able to determine that such loan or credit is suitable for the retail client; and

(b) take reasonable steps to ensure that, on the basis of an adequate assessment of the information disclosed by the retail client, the arrangements for the loan or credit and the amount concerned are suitable for the type of transaction proposed or that the retail client is likely to enter into.

2. The obligation in paragraph 1 does not apply when:

(a) an investment firm settles a transaction of the retail client (in transferable securities, money market instruments or units in collective investment undertakings) because he has failed to pay or has paid late; or

(b) an investment firm covers a margin call made on a retail client for a period of no longer than five business days.

Question 1: Do you agree with the proposed advice in this area, including the proposed limitations on the scope of the obligation?

Question 2: Do market participants consider that investment firms have to obtain the necessary

[4] See the first paragraph of Annex II to the Directive.

information about the retail client's investment objectives in addition to his financial situation?

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CHAPTER 2

The definition of investment advice (Article 4(1)(4)) – generic and specific advice

Background

In its draft advice published on 21 October 2004, CESR proposed implementing measures under Article 4(1)(4) of the MiFID on the definition of "investment advice".

On the scope of the definition of investment advice, CESR recognised that personal recommendations might be very specific, i.e. recommending one or more financial instruments, or more generic, i.e. recommending types of financial instruments. The latter recommendation would include asset allocation and financial planning services.

Having discussed the advantages of either solution (cf. CESR/04-562, pages 11 et seq.), CESR asked whether it would be reasonable to restrict investment advice to recommendations of specific financial instruments or whether it would be appropriate to cover generic information including financial planning and asset allocation (*question 1.3.*).

The majority of respondents preferred the narrower approach, while a minority felt that it is necessary to include generic recommendations. The issue was discussed at the CESR meeting in Luxembourg; where it was decided to consult again on this important issue providing additional considerations on the implications of either approach.

Guiding principles

CESR believes that the advice should conform to the following principles:

- the approach should strike an appropriate balance between the need to protect clients and potential clients and the desirability of providing firms with commercial freedom in the way they structure their services; and

- the approach should also ensure an appropriate perimeter for the regulatory regime (both in terms of the scope of the authorisation requirement and the scope of the passport), bearing in mind the other applicable provisions in the Directive.

Structure and scope of this paper

We therefore take the opportunity to further outline the advantages and disadvantages of including or excluding generic recommendations in the definition of investment advice and the respective implications of both solutions. We first discuss the implications of this question in terms of the application of conduct of business requirements for investment firms that fall within the scope of authorisation. We then discuss the implications of this question for the scope of the authorisation requirement and of the passport.

This paper does not deal with other aspects of the definition of "investment advice" (such as the meaning of a "personsal" recommendation). CESR will continue its work on these other aspects of the definition of "investment advice" during the period for the submission of responses to this paper. As a result of this focused approach, this section of the paper is structured as a policy discussion without draft technical advice.

The application of conduct of business requirements

If generic advice falls within the definition of investment advice, the provision of a generic personal recommendation by an investment firm will constitute the provision of an investment service. If the definition of investment advice is limited to specific personal recommendations, an investment firm will not provice an investment service until it provides a recommendation in relation to a specific financial instrument.

Implications for a full advisory relationship

This is important if one considers that a full advisory relationship with a client is likely to progress from a discussion of asset classes to a discussion of specific instruments. If generic advice falls within the definition of investment advice, it is possible that the initial discussion of asset classes in such a relationship would involve the provision of investment advice and trigger the consequential conduct of business requirements. If the definition of investment advice is limited to specific investment advice, the consequential conduct of business requirements would generally only be likely to be triggered at the point at which the subsequent discussion of specific instruments commences.[5]

The key regulatory requirements for these purposes are those set out under Articles 19(3), (4) and (7) of the Directive. Article 19(3) requires certain information to be provided to the client about the investment firm and its services before the commencement of the provision of the investment service. Article 19(4) requires the investment firm to obtain certain information from the client in order to enable it to determine the suitability of the investment service and financial instrument for the client. Article 19(7) concerns the agreement between the client and the investment firm. In the case of a retail client, CESR's advice on the first set of mandates proposes requirements for the minimum content of the agreement and obtaining the client's consent to it.[6]

The imposition of these requirements on firms at an earlier stage of the relationship might discourage firms from having generic discussions with clients. CESR's advice provides some flexibility for investment firms to provide advisory services on the basis of a general framework agreement and information provision (although it does not require them to do so). CESR anticipates that many firms will conduct their services on the basis of such general arrangements and that once these are in place, they would reduce the practical implications of treating generic advice as an investment service. These practical implications are therefore in practice more likely to be a concern in relation to new or prospective clients. However, the increased level of commercial uncertainty surrounding a new or prospective client relationship may increase the commercial impact of requiring compliance with the aforementioned conduct of business requirements from the point at which generic advice is first provided.

However, the inclusion of generic personal recommendations within the definition of investment advice would provide clients with the protection of the aforemention conduct of business requirements at an earlier stage of their relationship with the investment firm. It may also be that there would be practical difficulties in determining when the conversation moved from a generic advisory to a specific advisory basis.

The relevance of implicit specific recommendations

If the definition of investment advice is limited to specific recommendations, some recommendations that appear to be generic could still fall within the definition of investment advice by virtue of the fact that they are implicit recommendations relating to specific financial instruments. For example, a recommendation to invest in an equity UCITS may involve an implicit specific recommendation if it is made by an investment firm that only distributes one equity UCITS. The treatment of implicit recommendations was raised in the responses to the first consultation on the second set of mandates and CESR is considering these responses for the purpose of preparing its final technical advice to the Commission.

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5 In either case, the investment firm will only be providing investment advice if the other aspects of the definition are satisfied. These are beyond the scope of this paper and the above discussion therefore only focuses on the point at which there is a reasonable possibility that the activities of the firm will involve the provision of investment advice.

6 CESR's call for opinions on the professional client agreement has recently ended (CESR/04-689). In this document, CESR asked for comments on whether there should be level 2 requirements concerning the agreement to be used when an investment firm provides investment advice to a professional client. CESR is currently considering the responses to this paper.

The consequences of providing generic advice if it is not investment advice

If generic advice is excluded from the definition of investment advice, what is the position where a firm provides specific advice after providing generic advice? CESR does not believe it would be possible for investment firms to use the exclusion of generic advice from the definition of investment advice to circumvent the suitability requirement. If unsuitable generic advice is given by an investment firm and that generic advice is closely linked to that firm's subsequent specific advice, the scope of the suitability obligation would not be limited to whether the specific financial instruments were suitable within the parameters of the generic advice. For example, if an investment firm gives a client unsuitable advice to buy securities within sector A, that is closely linked to subsequent advice to buy securities x, y, z within sector A, the scope of the suitability obligation would not be limited to whether the specific securities were suitable within the parameters of sector A. It would be necessary to consider whether the recommendation to invest in sector A was itself suitable.

However, the client would not benefit from this protection where the investment firm provides generic advice but does not go on to provide specific advice (for example because the firm only provides advice at a generic level (with or without an execution service) or because the client terminates the conversation before any specific advice is provided). If the advice was unsuitable, the client would only be protected by the full scope of the conduct of business requirements referred to above if generic advice falls within the definition of investment advice. However, in many practical cases, CESR understands that the investment firm will go on to recommend specific transactions in financial instruments.

Question 1: Do you believe that investor protection considerations require the application of the above conduct of business requirements from the point at which generic advice is provided or do you believe that sufficient protection is provided in any event to allow the definition of investment advice to be limited to specific recommendations?

The scope of the authorisation requirement and the passport

A different aspect of this question is the interrelation between the scope of the authorisation requirement under MiFID and the scope of the passport.

If generic recommendations are covered by the definition of investment advice, the scope of the authorisation requirement, and the attendant regulatory requirements, will be increased. This increase needs to be weighed against other limitations on the scope of the authorisation requirement. For example, Article 5(1) of the Directive requires the performance of investment services or activities as a regular occupation or business on a professional basis to be subject to prior authorisation. This authorisation requirement would not apply where the person in question performs investment services, but does not do so as a regular occupation or business on a professional basis.

This is supplemented by certain specific exemptions in Article 2(1) of the Directive. For example, Article 2(1)(c), which applies where an investment service is provided in an incidental manner in the course of providing a professional activity that is regulated by legal or regulatory provisions or a code of ethics which do not exclude the provision of that service. Article 2(1)(j) applies to persons providing investment advice in the course of providing another professional activity not covered by MiFID provided that the provision of such advice is not specifically remunerated.

A further relevant exemption is provided by Article 3 of the Directive (albeit on an optional basis). Where used, this exemption is subject to a number of conditions, including that the investment firm is not allowed to hold client assets and is not allowed to provide any investment service except the reception and transmission of orders in, and the provision of investment advice in relation to, transferable securities and units in collective investment undertakings. In addition, the activities of the persons falling within the Article 3 exemption must be regulated at national level. Therefore, even where Article 3 applies, the definition of investment advice will still be relevant to the scope of national regulatory requirements.

The exclusion of generic advice from the definition of investment advice is potentially relevant to the scope of the passport. This will depend in part on whether generic advice should be seen as falling within one or more of the ancillary services (for example, the ancillary service of "investment research and financial analysis or other forms of general recommendation relating to transactions in financial instruments.") This question does not fall within the scope of CESR's mandate. However, it would seem a strange result if the passport were to cover the provision of specific advice but not the generic advice that paves the way for the provision of the specific advice.

Question 2: Do you believe that considerations relating to the scope of the passport and the scope of the authorisation requirements point towards the inclusion or exclusion of generic advice from the definition of investment advice?

CHAPTER 3

Best execution (Articles 19(1) and 21)

Extracts from Level 1 text

Article 19(1): Conduct of business obligations when providing investment services to clients

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

Article 21: Obligation to execute orders on terms most favourable to the client

1. Member States shall require that investment firms take all reasonable steps to obtain, when executing orders, the best possible result for their clients taking into account price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order. Nevertheless, whenever there is a specific instruction from the client the investment firm shall execute the order following the specific instruction.

2. Member States shall require investment firms to establish and implement effective arrangements for complying with paragraph 1. In particular Member States shall require investment firms to establish and implement an order execution policy to allow them to obtain, for their client orders, the best possible result in accordance with paragraph 1.

3. The order execution policy shall include, in respect of each class of instruments, information on the different venues where the investment firm executes its client orders and the factors affecting the choice of execution venue. It shall at least include those venues that enable the investment firm to obtain on a consistent basis the best possible result for the execution of client orders.

Member States shall require that investment firms provide appropriate information to their clients on their order execution policy. Member States shall require that investment firms obtain the prior consent of their clients to the execution policy.

Member States shall require that, where the order execution policy provides for the possibility that client orders may be executed outside a regulated market or an MTF, the investment firm shall, in particular, inform its clients about this possibility. Member States shall require that investment firms obtain the prior express consent of their clients before proceeding to execute their orders outside a regulated market or an MTF. Investment firms may obtain this consent either in the form of a general agreement or in respect of individual transactions.

4. Member States shall require investment firms to monitor the effectiveness of their order execution arrangements and execution policy in order to identify and, where appropriate, correct any deficiencies. In particular, they shall assess, on a regular basis, whether the execution venues included in the order execution policy provide for the best possible result for the client or whether they need to make changes to their execution arrangements. Member States shall require investment firms to notify clients of any material changes to their order execution arrangements or execution policy.

5. Member States shall require investment firms to be able to demonstrate to their clients, at their request, that they have executed their orders in accordance with the firm's execution policy.

<u>Overview</u>

1. This paper addresses five mandates regarding investment firms' duty of best execution.

2. We turn first to CESR's mandate under Article 19(1), Mandate 3.3.1. Among other things, this mandate permits CESR to clarify that the best execution obligations under Article 21 apply to investment firms that provide the services of portfolio management and/or order reception and transmission.

3. The paper turns next to the first mandate under Article 21, Mandate 3.4.1. This mandate asks CESR for advice regarding criteria that firms will use to determine the relative importance of the factors relevant to the execution of orders, as set forth in Article 21(1).

4. Next, CESR addresses the Commission's mandates regarding the selection and review of execution venues in Mandates 3.4.2 and 3.4.4. We discuss these mandates together because the factors relevant to the selection of execution venues are the same factors that firms must consider when they review execution venues.

5. Finally, the paper explains CESR's advice regarding the Commission's mandate on disclosure, Mandate 3.4.3. CESR proposes a number of specific requirements here that are intended to elicit meaningful, concrete information from investment firms about their execution policies and arrangements.

Mandate

6. Extract from the European Commission mandate to CESR for technical advice on possible implementing measures concerning the Directive on Markets in Financial Instruments.

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

7. Article 19(1) of the Directive establishes a general obligation for investment firms to act fairly, honestly and professionally when providing investment or ancillary services to their clients. This obligation applies to all types of services.

> 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.

Explanatory Text

8. Among other things, the mandate under MiFID Article 19(1) provides a basis for Level 2 advice applying the obligations under MiFID Article 21 to investment firms that provide the services of portfolio management and/or order reception and transmission.[7] MiFID Article 21 sets out several high-level obligations for firms when executing orders on behalf of clients. Among other things, an investment firm must:

- take all reasonable steps to obtain the best possible result for orders executed on behalf of clients, taking into account several specified factors, as well as any other consideration relevant to execution of the order;

- put effective arrangements in place for complying with the foregoing obligation;

- as part of those arrangements, establish an "execution policy" which (i) allows the firm to obtain the best possible result for the execution of client orders, in accordance with Article 21(1) and (ii) includes information about the execution venues that the firm uses and factors affecting the choice of those venues;

[7] Also see CESR's proposed advice under Article 19(1) in its second consultation paper, published in October 2004 (CESR Ref. 04-528).

- monitor the effectiveness of the firm's order execution arrangements in general and its execution venues in particular, and correct any deficiencies that are identified;

- provide appropriate information to the firm's clients about its order execution policy; and

- obtain prior client consent to its execution policy and obtain prior express consent if the firm wishes to execute client orders outside a regulated market or MTF.

9. An investment firm may arrange for the execution of orders on behalf of its clients directly, by acting itself to conclude orders at an execution venue[8] or indirectly, by selecting an intermediary investment firm either to execute the orders or to transmit them to a third investment firm for execution.[9] Investment firms that provide the service of portfolio management or reception and transmission of orders may be said to execute indirectly insofar as they select intermediaries to transmit or conclude orders on behalf of their clients.

10. CESR believes that clients should benefit from the protections of Article 21, regardless of whether their orders are executed directly or indirectly. However, Article 21 applies to investment firms "when executing orders" on behalf of clients and there has been a variety of views about whether an investment firm is "executing an order on behalf of a client" when it accesses execution venues indirectly.

11. Furthermore, Recital 33 provides that the best execution obligation "should apply to the firm that has the contractual or agency obligations to the client." Therefore, firms that execute orders on behalf of portfolio managers[10] and order transmitters are not subject to the obligations of Article 21 with respect to the clients of those firms unless the executing firms also have direct contracts or agency relationships with those clients. A similar problem arises if a portfolio manager or order transmitter uses an entity in a third country to execute its client orders if the executing entity is not subject to the requirements of MiFID. As a result, if the obligations of Article 21 are not applied to portfolio managers and order transmitters, then many of their clients will not enjoy any of the protections of Article 21.

12. In its concept paper, CESR noted that for investment firms that provide the service of portfolio management or order reception and transmission, the requirements of Article 21 may apply under Article 21 itself or under Article 19(1). Now, the Commission has provided an opportunity to clarify this question by issuing a mandate that permits CESR to provide Level 2 advice under Article 19(1) imposing the requirements of Article 21 on firms that execute indirectly.

13. In formulating this advice, CESR has set itself two objectives. First, it wishes to establish the principle that regardless of how a firm decides to organise its trading process, if it has a contractual or agency relationship with clients that results in the execution of orders on their behalf, then it must take all reasonable steps to obtain the best possible result for the execution of those orders by complying with all the requirements of Article 21. Second, CESR has endeavoured to craft its Level 2 advice in such a way that it does not impose unreasonable burdens on firms that choose to use other investment firms to execute their client orders.

14. To this end, the concept paper asked whether and how the requirements of Article 21 should differ when applied to investment firms that execute client orders indirectly. Respondents

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8 In Box 2 below, the draft advice includes a definition of the term "execution venue."

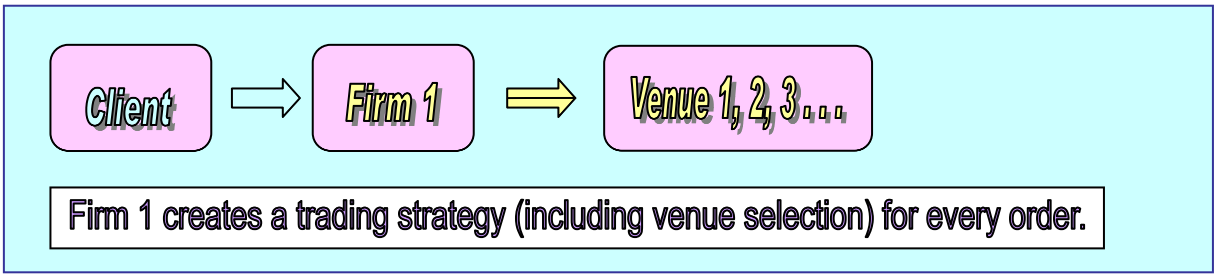
9 For purposes of this discussion, an intermediary is an investment firm that accepts orders from other investment firms on behalf of their clients and either executes them at an execution venue (other than itself) or transmits them to a third firm for execution (or possibly, but not likely, further reception and transmission). However, an investment firm that acts as counterparty to another firm's client orders or crosses them with orders from its own clients is acting not as an intermediary but as an execution venue. This is important because an investment firm that selects another investment firm to act as an execution venue for its client orders is subject directly to all of the requirements of Article 21 in selecting that venue. Furthermore, depending on the circumstances, the investment firm that is acting as an execution venue also may be executing a client order and therefore also may be subject to Article 21 itself.

10 CESR uses the term "portfolio manager" to refer to investment firms that manage portfolios and to management companies when providing portfolio management services on a discretionary, client-by-client basis. (See Article 66 of MiFID which refers to article 5, para 3 of the UCITS directive).

offered several observations. To summarise the discussion, CESR has found it helpful to diagram the main points.

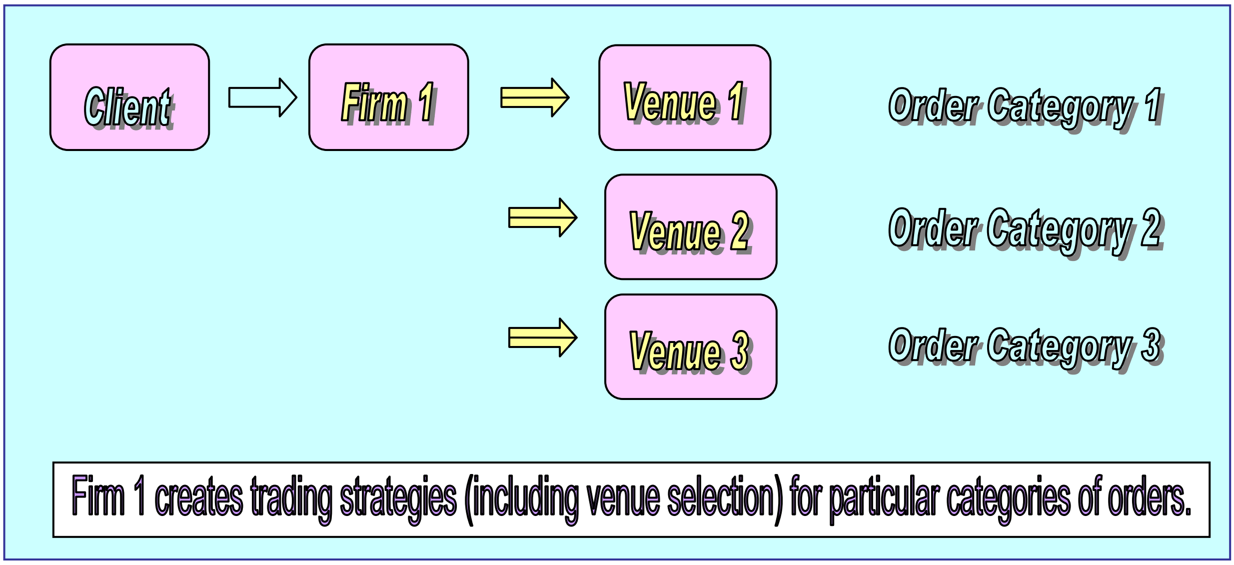
15. When an investment firm executes client orders itself, it retains complete discretion over how the orders are executed. For some types of trading, firms may exercise this discretion on a case-by-case basis, for example, when executing large institutional orders.[11] This type of arrangement is represented by Figure 1 below.

Figure 1



16. For other types of trading, an investment firm that executes client orders by accessing execution venues directly reasonably might determine its trading strategy and/or venue choice only on a periodic basis. Depending on the circumstances, it might not be reasonable to require that this decision be reviewed for every order the firm receives. This type of arrangement is represented by Figure 2.

Figure 2



17. When an investment firm arranges for the execution of client orders indirectly via one or more intermediary investment firms, it too may retain significant discretion over how orders are executed. For example, it may instruct the executing firm on which execution venue to use. Equally, it may instruct the firm to execute immediately or to trade patiently. Many large portfolio managers, for example, retain this level of discretion over the trading process.

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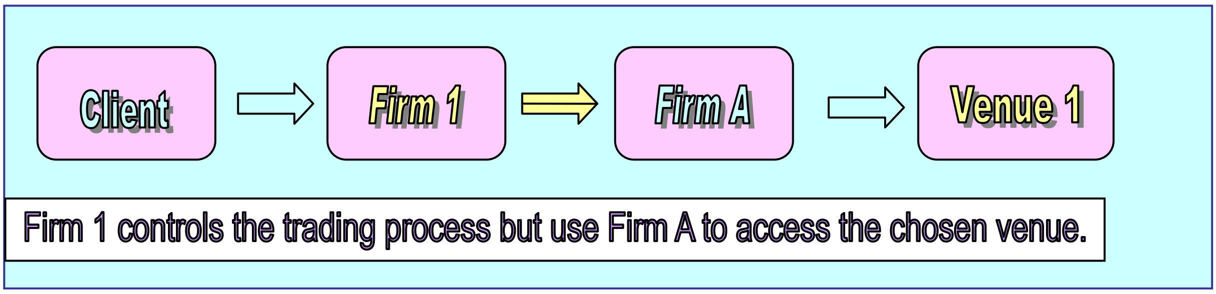
11 CESR notes that some portfolio managers also may opt to access execution venues directly, in which case, they execute the orders. With respect to those orders, the requirements of Article 21 would apply to the portfolio manager directly.

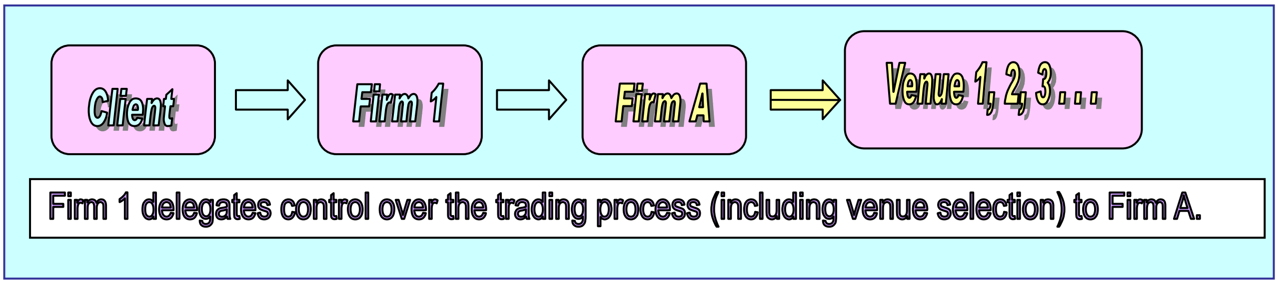
Similarly, large broker-dealers[12] may use local investment firms simply to gain access to execution venues that they cannot access directly, while retaining substantial control over every other aspect of execution. This sort of partial delegation also occurs in intragroup relationships, where one company within a group uses another, separately authorised company to access, for example, a foreign execution venue. These types of arrangements are represented by Figure 3 below.

Figure 3



18. Conversely, CESR understands that many other investment firms (including many smaller portfolio managers and brokers) may delegate much more control over the trading process to the investment firms that execute their client orders. (This type of arrangement also may be found in intragroup relationships). See Figure 4 below.

Figure 4



19. These four diagrams are intended to represent points on a spectrum of possible arrangements that investment firms may make with respect to the execution of client orders. CESR understands that many firms use a combination of these arrangements, executing some orders themselves, using just the execution facilities of intermediaries for other orders and, for a third category of orders, delegating more discretion over the trading process to intermediaries.

20. Some respondents to the concept paper asked whether applying the requirements of Article 21 to portfolio managers and order receivers and transmitters would create an inappropriate duplication of regulation by imposing a duty of best execution on the portfolio manager / order receiver and transmitter and the intermediary. CESR does not believe that this would be the case. As these diagrams demonstrate, firms that use intermediaries to execute client orders nevertheless may retain some discretion over the trading process and, in any case, firms exercise discretion in selecting their intermediaries.

21. It would be a perverse outcome if investment firms were able to avoid a duty of best execution by interposing an additional party into the chain of execution. If the investment firm that has the direct relationship with the client did not owe a duty of best execution to its client, a significant portion of trading on behalf of clients would not be subject to a duty of best execution owed directly to the ultimate client. This would detract not only from client protection but also from price formation and market efficiency.

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[12] CESR uses the term "broker" to refer to investment firms that execute and/or receive and transmit orders on behalf of clients. CESR uses the term "dealer" to refer to investment firms that deal on own account.

22. Furthermore, an investment firm should not be permitted to do business with an intermediary unless it can assure itself that the intermediary achieves the best possible result for its client orders on a consistent basis. The firm should owe this duty to its client regardless of whether the intermediary also has a contractual or agency obligation to the investment firm's client.

23. Thus, in CESR's view, an investment firm that delegates trading decisions to intermediary investment firms should be responsible for assuring that those intermediary firms enable it to meet the requirements of Article 21. For example, an investment firm that uses execution intermediaries should (i) take all reasonable steps to select intermediaries that are most likely to deliver the best possible result for the execution of its client orders, (ii) monitor the results that it is achieving to identify any deficiencies in its execution arrangements, including a determination of whether its intermediaries are obtaining the best possible result on a consistent basis and (iii) correct any deficiencies that the monitoring and review uncover. Thus, Article 21 does not require an investment firm to duplicate the elements of its trading process that it has delegated to an intermediary. But CESR does expect firms to take all reasonable steps to select the best intermediaries, to monitor their own performance and the performance of intermediaries they use and to correct any deficiencies that the monitoring may uncover.

24. CESR also wishes to emphasise that if an investment firm reserves trading decisions to itself, it should be obliged to comply with Article 21 regarding those decisions, even if it does not actually "execute" orders on behalf of its clients. Thus, if an investment firm instructs a broker about where or how to execute a client order, then the investment firm must take all reasonable steps to assure that its instructions are enabling it to obtain the best possible result for the execution of client orders, it must monitor its execution results for the success or failure of those instructions and it must correct any deficiencies in its order execution arrangements that the monitoring may reveal. Conversely, as provided in Article 21(1), a broker that receives instructions about how to execute a client order must follow those instructions.

25. Some respondents argued that Article 21 of the Directive was drafted for 'sell side' firms only, in particular brokers and dealers. They argued that the service of portfolio management is not a transaction service and should not be regulated as such. Others argued that a portfolio manager's mandate speaks to maximising yields and "not to guarantee[ing] the best possible result of transactions, even on a consistent basis".

26. The diagrams help to demonstrate the difficulties that arise in attempting to generalise about how much discretion a firm may exercise with respect to its trading processes based on whether it executes client orders itself or places them with another investment firm for execution. Furthermore, in relation to the service of portfolio management, CESR does not see any conflict between a manager's obligation to deliver performance and the efficient execution of client orders. On the contrary, poor execution, including unnecessarily high transaction costs, can have a significant adverse impact on fund performance. This was reflected in the concept paper.

27. Five respondents reported that portfolio managers currently take research and market intelligence, for example, into account when choosing which intermediaries to include in their execution policy. One of these respondents argued further that the directive should not affect the ability of firms to do so. However, another respondent stated that its members monitor intermediaries that offer these arrangements to ensure that they also achieve best execution.

28. CESR does not propose that portfolio managers should be prevented from acquiring research or other goods and services from execution venues or investment firms that execute client orders. However, the offer of these services may amount to an inducement for a portfolio manager to direct its client orders to a particular execution venue or investment firm in preference to another, where the cost of these services is met out of commission charges borne directly by the client and not by the portfolio manager. CESR therefore does not believe that, in these circumstances, a portfolio manager should favour intermediaries that provide these inducements but fail to deliver the best possible result for the execution of client orders. Inducements such as research must be a secondary consideration. That is, if competing intermediaries offer comparable "execution quality" (*i.e.*, they each can deliver the best possible result for the execution of client orders, or particular types of orders), a portfolio

manager may then choose one over the other because it offers such inducements. However, the availability of these inducements should not be the primary consideration.[13]

29. This means that portfolio managers must have a method for evaluating the execution quality that each intermediary provides and for determining which execution venues or intermediaries enable the firm to obtain the best possible result for the execution of its client orders on a consistent basis (see discussion under Mandates 3.4.2 and 3.4.4 below).

30. *Questions for Comment*:

a) *How do firms compare venues (or intermediaries) that offer inducements with those that do not?*

b) *Where the fees and commissions that firms pay to execution venues or intermediaries include payment for goods or services other than execution, please indicate the circumstances in which firms might determine how much of these commissions represents payment for goods or services other than execution? Under what circumstances do firms consider the entire commission as payment for execution?*

BOX 1

1. Member States shall require investment firms providing the service of portfolio management to comply with the obligations under Articles 21 and 22(1) of the Directive when carrying out decisions to deal on the basis that

a) references to orders shall be treated as references to decisions to deal by the investment firm on behalf of its client;

b) references to execution shall be treated as references to the investment firm instructing another to execute or transmit the order;

c) references to execution venues shall be treated as including investment firms that execute orders on behalf of clients and investment firms that receive client orders and transmit them for execution, subject to paragraph (d)

d) the reference to execution venue in paragraph 1(a)(v) of the Advice given under Article 21(3) of the Directive shall be treated as excluding investment firms that (i) execute orders on behalf of clients except when they execute client orders by dealing on own account or by crossing one client order with another client order or (ii) receive and transmit client orders; and

e) cross references shall be read accordingly.

2. Member States shall require investment firms providing the service of order reception and transmission to comply with the obligations under Articles 21 and 22(1) of the Directive when carrying out client orders on the basis that:

a) references to execution shall be treated as references to the investment firm instructing another to execute or transmit the order;

b) references to execution venues shall be treated as including investment firms that execute orders on behalf of clients and investment firms that receive client orders and transmit them for execution, subject to paragraph (c);

c) the reference to execution venue in paragraph 1(a)(v) of the Advice given under Article 21(3) of the Directive shall be treated as excluding investment firms that (i) execute orders on behalf of clients except when they execute client orders by dealing on own account or by

[13] See section on Mandates 3.4.2 and 3.4.4 below for a discussion of how firms evaluate whether execution venues or intermediaries are enabling a firm to obtain the best possible result for the execution of client orders on a consistent basis.

crossing one client order with another client order or (ii) receive and transmit client orders; and

d) cross references shall be read accordingly.

Mandate

31. Extract from the European Commission mandate to CESR for technical advice on possible implementing measures concerning the Directive on Financial Instruments Markets.

3.4.1 Criteria for determining the relative importance of the different factors to be taken into account for best execution (21.1)

DG Internal Market requests CESR to provide technical advice on possible implementing measures by [30/04/2005] on the criteria that the investment firm should take into account when executing clients' orders for determining the relative importance of the factors such as price, costs, speed, likelihood of execution and settlement, size and nature of the order and any other relevant consideration. Those criteria should take into account the retail or professional nature of the client.

32. Article 21(1) of the Directive requires firms to take all reasonable steps to obtain the best possible result for the execution of client orders, taking into account several express factors, as well as "any other consideration relevant to execution of client orders". Mandate 3.4.1 asked CESR to advise on the criteria that firms should consider in determining the relative importance of these factors.

33. In the concept paper, CESR recommended that investment firms be required to consider the characteristics of their clients (including the retail or professional nature of the clients), orders and venues, in determining the relative importance of these factors. Commentary was quite favourable on the proposal. However, some respondents suggested that it would be helpful to distinguish the characteristics of client orders from the characteristics of the instruments themselves. CESR believes that this change would lend some additional clarity.

34. Some respondents asked CESR to clarify that this list of characteristics is not exhaustive. However, the additional criteria proposed by respondents constituted either an elaboration of the proposed criteria or an elaboration of a factor set out in Article 21(1) of the Directive.

35. For example, respondents mentioned as additional "criteria":

~ Likelihood of successful clearing and settlement (a characteristic of venues); and

~ Need for confidentiality (a characteristic of some orders).

36. CESR intends the Level 2 criteria to provide a common framework within which investment firms can analyse and express their order execution arrangements. Therefore, CESR does not wish to give firms freedom to invent criteria themselves. Furthermore, the scope that Article 21(1) of the Directive gives firms to consider "any other factors relevant to execution" should enable them to address the issues relevant to any particular aspects of the execution services that they provide.

37. Some respondents seem to have read the examples CESR provided in the explanatory text of the concept paper in relation to client, order and venue characteristics to be requirements for all investment firms. CESR wishes to clarify that the explanatory detail was intended to provide examples and that CESR understands that these examples may not be relevant to all investment firms or to every type of order.

38. In the concept paper, CESR attempted to provide a brief overview of how the factors specified in Article 21 might affect a firm's execution arrangements in practice. This discussion led some respondents to caution against any further explanation of the factors relevant to execution of a client order because "the number of differentiation criteria are legion." Others asked for more detail. Several provided additional examples of listed factors while others identified additional factors.

39. The great majority of respondents endorsed the view that CESR should not attempt to determine the relative importance of the factors in its advice under Article 21(1) of the Directive. Instead, respondents argued that CESR should propose criteria and allow investment firms to implement those criteria in a manner appropriate to their businesses. CESR agrees that each investment firm should be able to tailor its execution policy to its strategies and goals, provided it fulfils the regulatory objective of enabling the firm to achieve the best possible result for the client on a consistent basis. As stated in the concept paper, "It is important to emphasise that Mandate 3.4.1 does not invite CESR to determine the relative importance of the factors. That job is left to investment firms". However, CESR considers that in the case of a service provided to a retail client, if the investment firm gives or might give a factor other than price or cost more importance than any of price or cost for the purposes of Article 21(1) of the Directive, an explanation of why this is in the best interests of its retail clients should be given to the retail clients (see draft advice under box 4).

40. However, some respondents argued that Article 21 leaves it to investment firms to define what best execution is and how to achieve it, so long as these decisions are clearly disclosed to clients. While CESR recognises that the Level 2 advice must be flexible enough to work well across a range of clients, instruments, and markets, it is too much to say that best execution means whatever an investment firm says it means. The Level 1 text contemplates that there is a best possible outcome and investment firms must be held accountable for taking all reasonable steps to achieve it.

41. The concept paper asked market participants for specific examples about how investment firms apply the factors in Article 21(1) of the Directive to determine the best possible results for their clients. Firms provided interesting commentary that illuminated the wide range of different circumstances to which the principles will apply in practice. These discussions support CESR's initial conclusion that prescriptive Level 2 measures are unlikely to provide a workable regulatory solution and that flexible principles are therefore more appropriate.

42. In the concept paper, CESR asked about the relevance of implicit costs, such as market impact and opportunity cost.[14] Respondents differed on this question. Some argued that implicit costs are always relevant while others stated the analysis of implicit costs is not always part of their trading process, *e.g.* retail size trades in large liquid markets. CESR believes that implicit costs are simply an example of the wider category of "cost" mentioned in Article 21(1). As such, Article 21 leaves it to each firm to make reasonable judgements about the relative significance of implicit costs for its trading process. CESR also believes that firms must have scope to make judgements about how best to address implicit costs. However, where implicit costs are likely to affect execution results, Article 21 requires that a firm's execution arrangements take account of them in a reasonable manner.

43. Some respondents questioned whether it is possible to perform the analysis required by Article 21(1) of the Directive for financial instruments other than shares. CESR emphasises that Article 21 applies to all financial instruments, as that term is defined in the Directive, not just shares. Therefore, even in non-equity markets, investment firms will be expected to take all reasonable steps to deliver the best possible result when they execute client orders.

44. CESR does understand, however, investment firms may require different information and techniques to evaluate execution quality in different markets. Respondents noted that investment firms already use a variety of tools to evaluate price quality in non-equity markets. In the bond markets, for example, investment firms may evaluate dealers based on a combination of post-trade reporting, pre-trade polling and statistical analysis. In more liquid bond markets (including government debt markets), transparency in the form of quote montages is improving all the time. Respondents reported that bond and swap pricing also may be estimated based on yield curves and credit quality.

45. CESR also observes that, in practice, non-equity markets are not always less liquid than markets for shares. Some non-equity markets have high levels of liquidity (*e.g.*, some markets in

[14] Implicit costs are principally of two types: market impact – the adverse price movement which can occur once the information in a transaction has become known to the market place; and opportunity cost (also referred to as implementation shortfall) – the cost implicit in a decision to trade on a phased or patient basis that arises when the market moves before the trade or investment strategy can be fully implemented.

interest rate swaps), providing many opportunities to compare prices. Conversely, equity instruments can be illiquid, making it more difficult to obtain competing quotes. In each of these cases, firms must adapt the "reasonable steps" approach to suit the circumstances in which the financial instruments are traded.

46. CESR acknowledges that Article 21 presents challenging issues of application and interpretation, many of which have been highlighted by respondents to the concept paper. However, CESR does not believe that these issues can be resolved successfully via Level 2 advice. Instead, CESR expects that there will be much work to do at Level 3 to assure that Member States develop convergent views about the approaches that firms take to best execution. CESR understands that this work will be especially pressing with respect to the application of Article 21 to non-equity markets.

Box 2

1. An investment firm must take account of the following criteria in determining the relative importance of the factors listed in Article 21(1):
   a) the characteristics of its clients;
   b) the characteristics of the orders to be executed on behalf of its clients;
   c) the characteristics of the financial instruments that are the subject of those orders; and
   d) the characteristics of the execution venues to which those orders can be directed.
2. For purposes of the advice under Article 21, "execution venue" means the entity that finally concludes a client order and may include regulated markets, MTFs, systematic internalisers, investment firms and other entities that deal on own account and equivalent entities in third countries. When an investment firm deals on own account to execute a client order or crosses client orders, then the firm itself is the execution venue.

Mandate 3.4.2 and 3.4.4

3.4.2. Trading venues to be included in the order execution policy (21.2)

3.4.4. Obligation to monitor and update the order execution policy (21.3)

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

the criteria for determining the venues that enable investment firms to obtain on a consistent basis the best possible result for executing the client orders; and

factors that may be taken into account by an investment firm when reviewing its execution arrangements and the circumstances under which changes to such arrangements may be appropriate.

47. Article 21(4) requires investment firms to monitor the effectiveness of their order execution arrangements and execution policy in order to identify and, where appropriate, correct any deficiencies. Article 21(4) also calls upon firms to assess, on a regular basis, whether the execution venues included in the order execution policy provide for the best possible result for the client or whether they need to make changes to their execution arrangements. Therefore, the following discussion distinguishes monitoring of execution arrangements from selection and review of execution venues.

48. The following examples were suggested as factors an investment firm should consider in selecting, monitoring and reviewing venues. However, the concept paper also noted that CESR did not view the list to be exhaustive.

~ Execution performance over time, in the markets generally and for the investment firm, in particular;

~ The venue's ability to manage the factors referred to in Article 21(1) of the Directive; and

~ Price, liquidity, fees, commissions and explicit costs, average size of orders, types of market participants, settlement capabilities, trading capabilities.

49. The paper explained that the significance of these factors depends on the types of clients and orders an investment firm handles, as well as its business model. However, the paper cautioned that firms should not use their business model to justify exclusion of a venue that would enable the investment firm to achieve the best possible result on a consistent basis.

50. Commentary was quite favourable on the proposals. However, respondents raised many interpretive questions relating to the implementation of the mandates and specifically how these obligations would work in different markets.

Requirements for Selecting and Reviewing Execution Venues

51. Article 21 requires investment firms to include in their execution policies venues that allow them to obtain on a consistent basis the best possible result for the execution of their client orders. It also requires firms to assess on a regular basis whether the execution venues included in the order execution policy enable the firm to obtain the best possible result for the client.

52. In response to a question in the concept paper, some respondents stated that, at least theoretically, they can access every venue across the globe (directly or indirectly), while other respondents supplied the names of the specific venues they access today. Most respondents agreed that the number of venues accessed was, and should continue to be, driven by commercial incentives and market structures.

53. Respondents also mentioned that the number of venues they access depends on the size and nature of the investment firm and whether it was operating within the equity, fixed income and/or derivative markets. The majority of respondents did not believe that the number of venues they access will increase after the implementation of the Directive.

54. The Level 1 text does not mandate that an investment firm connect to all possible venues. It requires that:

~ an investment firm take all reasonable steps to obtain the best possible result; and

~ that the venues included in the order execution policy shall include at least those that enable the investment firm to obtain, on a consistent basis, the best possible result for the execution of client orders.

55. Some respondents asked whether a firm could satisfy the requirements of Article 21 if it only accessed one venue. In our view, this is a difficult question to answer in the abstract, as it depends so completely on the facts and circumstances of the particular situation. However, CESR wishes to emphasise that even if a firm accesses only one execution venue, it nevertheless must comply with the requirements in Article 21 with respect to the selection and review of execution venues.

56. Question for Comment: Please suggest situations and circumstances in which a firm might

satisfy the requirements of Article 21 while using only one execution venue.

Factors Used by Investment Firms for Selecting and Reviewing Execution Venues

57. Respondents listed a variety of factors they consider when selecting and reviewing execution venues and intermediaries, all of which depend on the nature and size of the investment firm and whether its clients are retail or professional.

58. Factors respondents assess in selecting execution venues include:

~ immediacy;	~ potential price improvement / price;
~ order volume;	~ client preference;
~ service at execution venue; and	~ access costs.[15]

59. Factors respondents assess when selecting execution intermediaries include:

~ execution quality;	~ ability to avoid market impact;
~ operational efficiency;	~ credit worthiness;
~ reputation; and	~ service quality.

Costs

60. The responses showed a particular focus on costs as a factor in venue selection and review. For example, respondents reported that they consider the following costs in evaluating execution venues:

- transaction fees	- settlement costs	- broker fees
- currency expenses	- order fees	- execution fees
- regulatory costs	- staff costs	
– costs of using a particular clearing and settlement system		
– cost of using another clearing firm to clear trades if direct clearing is not warranted		
– technology costs for implementation, integration and connection		

61. One respondent explained that for UK retail brokers, costs are constant and therefore do not affect venue selection.

62. Another respondent suggested that firms could charge a different commission to their clients for each venue that they access. While CESR questions how realistic this fee structure really is, the comment did raise a question about how this business model should be analysed for purposes of Article 21. That is, would Article 21 require firms to execute the order by choosing that venue that enables the firm to deliver the best possible result to the client, taking into account differences in the firm's own commission? In this situation, CESR would regard the difference in the firm's own commissions as a consideration relevant to execution of the order. Thus, the firm would be obliged to execute on the venue that delivered the best possible result for the client, net of the firm's own commission. However, if a firm charges the same commission for access to all venues, then its commissions do not enter into the analysis of what is the best possible result. CESR also wishes to make clear that Article 21 does not regulate the amount of the commissions that a firm itself charges to its clients. CESR does not consider these charges to be "costs" for purposes of Article 21 and Article 21 does not require firms to consider how the impact of their own commissions on the total result to the client compares with the commissions charged by their competitors.

15 Some respondents included in the category of access costs any connection fees, such as internal IT costs.

Implicit Costs

63. Respondents who discussed factors for 'institutional' size trading differed on the measurement of implicit costs; some argued that the advice should mandate that investment firms consider this information, while others suggested that it should be the investment firm's choice to consider it or not. One retail broking firm indicated that it did not consider implicit costs (although for retail size orders, market impact is usually not an issue).

64. In the concept paper, CESR proposed that investment firms should consider all relevant factors when assessing whether a particular venue achieves the best possible result. Therefore, where implicit costs are relevant to the investment firm's assessment, they should be considered. CESR does not think it is useful to write prescriptive level 2 advice requiring all investment firms to consider particular costs in a specific way. The level 1 text makes it clear, however, that firms must take into account any costs that affect the total execution results for their clients. For example, if implicit costs, such as market impact, in relation to an order or a series of orders are relevant to the service provided by the firm, then clearly the firm should take these implicit costs into account in determining how to get the best possible result. But the significance to be given to this factor, as against all the others, must be for the investment firm to judge.

Access Costs

65. A number of respondents raised the question of access and related technology costs as an important factor when selecting and reviewing execution venues. They suggested that reviews should be commercially driven and that at times access costs outweigh benefits. Respondents further argued that the Level 2 text should not mandate investment firms to access venues where it would not be commercially viable to do so.

Question for consultation: Do market participants consider that the distinction between internal and external costs is relevant? Does the investment firm have to take into account also internal costs? If so, which ones?

Monitoring of Arrangements

66. The criteria an investment firm should consider in selecting and reviewing the venues to be included in its execution policy overlap significantly with the criteria that an investment firm should consider in deciding how to monitor its execution arrangements overall. The primary distinction is that review of venues focuses on the execution results that venues deliver, while monitoring of a firm's arrangements focuses on the total execution results that the firm has achieved.

67. Respondents cited a myriad of monitoring arrangements that varied as between types of market, and as between jurisdictions within the same market. For example, some firm's monitoring arrangements included the use of systems that constantly monitor prices across a range of execution venues, and transaction cost analysis from third party vendors – particularly by investment management firms. Other respondents indicated that they currently do not do any monitoring.

68. Those respondents from jurisdictions with concentration rules stated that they do not have any specific arrangements in place. These respondents argued that execution on the regulated market equates with best execution and therefore no monitoring is required. However, for non-equity and international markets, one such investment firm stated that the execution sales desk monitors execution quality and, for non-equity markets, monitoring of execution quality is part of the real time process of selecting the trading venue / market / counterparty.

69. A national trade association of portfolio managers stated that large investment managers use the services of transaction cost analysis providers, while a group of trade associations stated that within the fixed income market, execution quality can be monitored by reference to benchmark yields, published credit ratings and other factors such as illiquidity premiums. They argued that other dimensions of execution quality, such as market impact, are only possible to evaluate once the trade has occurred.

CESR

70. One European trade association suggested that investment firms' current systems, which vary across the EU based on local regulatory requirements, should be used, as far as possible, in fulfilling any monitoring obligation and that the obligation should be flexible enough to cope with the variety of investment firms and markets in which they operate.

71. The above responses show that investment firms currently monitor execution quality differently across financial markets. CESR believes that the firms should be allowed the necessary freedom to monitor in a manner that is appropriate to the markets and financial instruments they operate in, instead of specifying the particular methods that must be used to discharge that obligation. What is important is that the monitoring be designed to test effectively whether a firm is obtaining the best possible result for the execution of its client orders on a consistent basis. However, CESR notes that this requirement comes directly from the Level 1 text and does not require a Level 2 measure.

Frequency of Monitoring

72. Responses indicated that practices with regard to frequency of monitoring varied. One respondent reported that it monitors execution quality on a daily basis, but a group of trade associations said that firms do not routinely monitor execution quality on a trade by trade basis and that any monitoring would be focused on retail clients. A trade association for portfolio managers indicated that monitoring by portfolio managers is ongoing, typically with formal reviews between fund managers and dealer, once a quarter. Several national and European trade associations argued that the frequency of monitoring should be driven by commercial rather than regulatory factors.

73. Respondents generally agreed that the frequency of monitoring depends on the instruments, clients, markets and investment services in question. One group of trade associations mentioned that monitoring tools for equities and some fixed income instruments may be constrained by the number of currencies that these tools can handle. A portfolio management firm observed that where there is no central trading place, monitoring is more difficult.

Data Available for Monitoring

74. Most respondents said that the data available to undertake monitoring was provided by execution venues. One firm reported that the London Stock Exchange produces data on all trades for a particular firm's broker code. This information includes whether the firm has obtained a price improvement relative to the touch price and provides analysis of performance against peers. Within the investment management context, there are a number of transaction cost analysis providers who offer this information. Information service providers such as Reuters and Bloomberg were also mentioned as sources of data.

75. Some respondents stated that they did not expect to use any additional sources of data after the Directives' transparency requirements become effective, while others said that execution venues are constantly increasing the volume and type of information on market activity but investment firms would have to assess whether the cost of obtaining access to this data is justified.

76. Two respondents cautioned against Level 2 advice that results in a compliance-driven bureaucratic process that loses touch with client and business needs.

77. Article 21(4) requires firms to monitor the effectiveness of their order execution arrangements and policy and in particular, to assess their execution venues on a regular basis. CESR understands that these provisions are linked to the overarching requirement in Article 21(1) that firms take all reasonable steps to obtain the best possible result for the execution of their client orders. Accordingly, CESR expects firms to design monitoring arrangements that meet the standard set in 21(1). Because of the great variety of firms and trading covered by Article 21, CESR does not believe that it would be advisable to impose more prescriptive requirements via Level 2 measures. Furthermore, Mandates 3.4.2 and 3.4.4 do not call for such advice.

Assessment of Execution Venues

78. Respondents listed a variety of events that had triggered a re-evaluation of execution venues in the past. These included:

~ deterioration in execution quality;

- changes in commission rates;
- LSE's Dutch Trading Service.
- new venues for equities in Europe, such as Virt-x, Euronext, NASDAQ Europe;
- the introduction of the electronic trading system Xetra in Germany;
- improvements in straight through processing via the FIX protocol;
- MTFs and dealers who provide a more tailored service;
- the shift in the Bund contract from LIFFE to Eurex;
- the shift away from SEAQ International when local markets moved to order books.

Frequency of Venue Assessments

79. Most respondents stated that investment firms review execution venues on a continuous basis. Two reported that they review venues on a continuous basis but not on a fixed schedule. One trade association said that investment managers formally review brokers quarterly or half yearly, while another group of trade associations stated that venues assessments vary depending on the nature of the market, client and instruments. These respondents noted that venues are more stable in the retail markets and more dynamic in the wholesale markets. They also stated that a change in the investment firm's business model could result in a reassessment of venues and that an annual assessment of venues may be appropriate as long as there was not an obligation to change for change's sake.

80. However, another trade association said that venues should be reviewed only when there is a material change. They further noted that one of the challenges resulting from a change of venue post review is that infrastructure needs to be built, in order to support trade and post trade processing.

81. While CESR believes that it is necessary to provide a minimum requirement for regular review of an investment firm's execution arrangements, such as, at least annually, the above list of events provides examples where market forces have led firms to re-evaluate their execution arrangements more frequently. CESR would expect to see such practices continue.

82. Question for Comment: How do you assure that your execution arrangements reflect current market developments? For example, if you do not use a particular execution intermediary or venue, how would you know whether they have started to offer "better execution" than the venues and intermediaries that you do use?

Data Availability for Venue Assessment

83. Most respondents agreed that there was data available and that new sources of data were emerging (the London Stock Exchange was noted as developing new services which would lead to greater data availability and transparency). Furthermore, the majority of respondents said that a market driven solution would be the best option for addressing the data availability issue.

84. However, one respondent stated that a market solution is less likely as the services offered by venues are not consistent nor is the pricing of these services. Therefore, comparison across different venues would be difficult. Another respondent cautioned that there is no market consensus on methodologies for transaction cost analysis and that it is expensive, particularly for smaller firms.

85. The major difficulty respondents noted was the lack of information (trading history information) needed to establish whether a new entrant venue could provide best execution on a consistent basis.

86. On the whole, respondents believe that execution venues do make investment firms aware of material changes to their business. One firm and one national trade association reported that execution venues made only those firms who were members aware of material changes. But

several other trade associations maintained that execution venues market themselves as a good place to do business and notifying investment firms of material changes was a part of this process.

87. *Question for Comment: Are intermediaries likely to inform investment firms that manage portfolios or receive and transmit orders about material changes to their business?*

Conclusions

88. *Frequency of Monitoring and Venue Reviews.* CESR is proposing that firms be required to review their execution arrangements, including the venues maintained or to be included in their execution policies

- as frequently as reasonably necessary to assure that the firm's execution arrangements permit it to comply with Article 21(1) and the firm's execution policy includes execution venues that enable the firm to obtain the best possible result on a consistent basis for the execution of its client orders,
- whenever a material change occurs that affects the firm's execution policy or other arrangements; and
- in any case, at least annually.

89. *Factors Regarding Selection of Execution Venues.* The variety of factors cited by respondents argues against taking a prescriptive approach to the Level 2 advice. Instead, CESR is proposing that, in determining which execution venues to maintain or include in its order execution policy, an investment firm must review the ability of each relevant venue to offer the best possible result for the execution of its client orders, taking into account the specific requirements of the investment firm's order execution policy and arrangements.

90. CESR's proposal thereby relates the factors that a firm must consider in selecting its execution venues to the factors in Article 21(1), as the investment firm has applied those factors in the context of its particular business. Therefore, just as Article 21(1) does not provide an exhaustive list of factors relevant to the execution of client orders, this Level 2 advice does not attempt to prescribe all of the factors relevant to selecting and reviewing execution venues.

91. As a general matter, CESR believes that it is for investment firms to develop these factors in the specific context of their businesses, provided always that each factor the firm considers contributes to obtaining the best possible result for the client and not just the highest profit for the firm.

92. Furthermore, in CESR's view, the factors cited by respondents are not different from those presented in the concept paper, but rather a further elaboration of them. For example, when looking at execution venues that investment firms access directly:

~ immediacy can be linked to speed;

~ order volume can be linked to size;

~ potential for price improvement can be linked to price; and

~ total cost is linked with cost.

93. In the case of investment firms that access execution venues indirectly:

~ execution quality can be linked to price;

~ ability to avoid adverse market impact is linked to costs;

~ counterparty risk / credit worthiness is linked with likelihood of execution and settlement; and

~ service quality or reputation is linked to the ability of the intermediary to manage the factors on behalf of the investment firm.

94. Indeed, this review has exposed the fact that the factors that CESR discussed in the concept paper also duplicate each other. The factors in 21(1) can be linked to price (price), liquidity (size, likelihood of execution, speed), fees, commissions and explicit costs (costs), average size of orders (size), types of market participants (size and likelihood of execution), settlement capabilities (likelihood of settlement), trading capabilities (the ability to manage the factors in 21(1)). Therefore, CESR has simplified its proposal in this regard.

95. CESR reiterates its view that while Article 21 leaves broad scope for firms to design different approaches to delivering execution services, all firms remain responsible for selecting venues that deliver the best possible execution result on a consistent basis. Commercial considerations may shape the types of clients a firm seeks to attract and the business strategy for doing it, but commercial considerations do not obviate the requirement to use venues that provide the best possible result on a consistent basis.

96. Given the wide variety of costs that firms may consider, depending on the nature of their businesses, CESR does not believe it would be appropriate to develop a list of approved costs for purposes of responding to this Mandate. However, CESR does wish to clarify that Article 21 requires investment firms to consider all costs that are relevant to determining which execution venue offers the best possible result for the execution of client orders. An investment firm that wishes to select a venue or intermediary because it imposes lower costs on the firm, would need to assure that the venue or intermediary also provided the best possible execution result for its clients orders.

97. On the issue of access costs, CESR also wishes to remind investment firms that they do not always need to be members of an execution venue in order to have trades executed there. An investment firm will often be able to execute orders indirectly through an intermediary. Therefore, for those investment firms for whom the cost of accessing a venue directly would be prohibitive, indirect access may provide a solution. Additionally, there may well be a commercial incentive for new execution venues to facilitate access to their services in order to attract new business.

Circumstances that Warrant Change

98. Mandate 3.4.4 asks CESR to provide technical advice on circumstances under which changes to a firm's execution arrangements may be appropriate. CESR believes that the Level 1 text covers this issue quite comprehensively. If a firm detects via its monitoring or otherwise, that its execution arrangements are not effective, that is that it is not obtaining the best possible results for the execution of its clients orders on a consistent basis, then it must review its execution arrangements, including its execution policy to determine whether it is taking all reasonable steps to obtain the best possible result for the execution of its client orders. If it finds any deficiency in the course of this review, then the firm must act to correct the deficiency. CESR does not have anything useful to add to these principles in the form of Level 2 advice.

Box 3

Article 21(6)(b)

(a) An investment firm must review its execution policy and arrangements:

i) as frequently as reasonably necessary to verify that the execution policy includes the venues that enable the investment firm on a consistent basis to obtain the best possible result for the execution of its client orders

ii) as frequently as reasonably necessary to verify that its execution arrangements include all reasonable steps to obtain the best possible result for the execution of its client orders;

iii) whenever a material change occurs that affects the ability of the investment firm to continue to obtain the best possible result for the execution of its client orders on a consistent basis using the venues in its execution policy; and

iv) at least annually

(b) In determining which execution venues to maintain or include in its order execution policy, an investment firm must review the ability of each relevant venue to offer the best possible result for the execution of its client orders, taking into account the requirements of the investment firm's order execution policy and arrangements. Factors that may be used by an investment firm for maintaining or including execution venues in its order execution policy include immediacy, order volume, quality of service, price, client reference. Factors that may be used by an investment firm when selecting execution intermediaries include: execution quality, reputation, ability to avoid market impact, credit worthiness, quality of service. The costs to be taken into account in seeking the best possible result for the client include: access costs, transaction fees, currency expenses, settlement costs and, where relevant, implicit costs.

Mandate 3.4.3 Information to the clients on the execution policy of the firm (21.3)

DG Internal Market requests CESR to provide technical advice on possible implementing measures by [30/04/2005] on the information to be provided to the client or potential client.

99. In the concept paper, CESR made a number of proposals for discussion about the information to be provided under Article 21(3) of the Directive.

Proposal 1 in the Concept Paper: Information on Execution Venues

100. We made the following statement in the concept paper:

"We are considering requiring that an investment firm disclose to its clients and potential clients the number and name of trading venues in its execution policy and whether the firm has direct or indirect access to those venues."

101. Most responses were negative in relation to this proposal. They argued that such a list would be excessive, both because it would overwhelm clients with not-very-useful information and because it would be expensive to send the information to each client. They objected, in particular, to the idea that they would have to send notices to clients every time they changed their execution venues.

102. Respondents explained that they accessed a very wide range of execution venues (especially if indirect access was included) that would lead to very long lists, which they argued would be unlikely to provide meaningful information to clients. Many noted that they may access any execution venue in the world, as client needs dictate. Respondents also queried why clients would be interested in how orders are executed, other than their own. One respondent suggested that market operators and systematic internalisers are better placed to disclose order execution flow.

103. CESR believes that clients and potential clients will benefit from information about the execution venues that investment firms access directly. This should help clients and potential clients to evaluate and compare the nature of the services offered by investment firms. However, CESR agrees that it should not be necessary for the disclosure to include every execution venue that the investment firm could access indirectly, as such a list is likely to be very long and of little practical use. Limiting this requirement to venues that firms access directly should mitigate the concerns about overly burdensome or unhelpful disclosure. It also will have the effect of requiring no disclosure from investment firms that access execution venues only indirectly. For all of these reasons, CESR is recommending that firms be required to disclose those venues that they access directly.

104. CESR also wishes to acknowledge that investment firms may institute different execution policies and arrangements for different types of clients. For example, an investment firm may have a different execution policy and arrangements for its retail clients than it has for its institutional clients. In this case, the investment firm need only disclose to its retail clients, information about its execution policy and arrangements for those retail clients, including the list of venues it accesses directly for those retail clients. If it accesses different venues for its institutional clients, this need not be disclosed to its retail clients.

105. In the concept paper, we also asked

"Should an investment firm be required to provide clients and potential clients with information on the percentage of a firm's orders that have been directed to each venue?"

106. In asking this question, CESR aimed at exploring the potential benefits of information about firms' actual historic use of execution venues and execution intermediaries, including the investment firm itself where it (or its affiliate) executes client orders by dealing on own account as the client's counterparty. CESR was interested in whether this sort of disclosure might allow clients and potential clients to better evaluate and compare the execution services of competing investment firms. CESR also took note of US SEC rule 11Ac1-6, "Disclosure of Order Routing Information" which requires broker-dealers that route orders in equity and option securities to make available quarterly reports that present a general overview of their routing practices.

107. Most respondents objected to the idea that they should disclose the percentage of their client orders directed to particular execution venues. They cited several reasons.

~ Clients would not want this information. All they care about is best net result.

~ This information will be overwhelming.

~ Clients only need to know about their own orders.

~ Compiling this list will be expensive.

~ The information is proprietary.

~ An investment firm's policies for selecting brokers would be far more relevant.

108. However, one respondent argued that this information (and quite a bit more) should be provided by market operators and systematic internalisers. This respondent also suggested that CESR should amend the advice to follow the example of the more detailed monthly requirements in SEC rule 11Ac1-6. Another respondent, who also endorsed the idea, argued that investment firms should also explain why the selected venues were chosen.

109. Upon reflection, after considering the comments, CESR has concluded that more work is needed in order to craft a proposal in this area. Accordingly, CESR is asking respondents to provide additional, more detailed information about the possibilities and difficulties presented by this type of disclosure requirement.

110. Questions for Comment:

a) Please identify and estimate the specific costs that investment firms will incur to identify the execution venues and intermediaries that have executed or received and transmitted their client orders and to collect historical information about what portion of their client orders they directed to each such venue or intermediary. For example, what costs would be associated with determining what percentage of client orders an investment firm directed to each venue or intermediary it used in the last 12 months, based on both the number of trades and the value of trades?

b) Please explain what competitive disadvantage or other damage to their commercial interests firms would experience if they were to publish the percentage of their business that they direct to different execution venues and intermediaries.

c) If firms are required only to make this information available upon request, would that address respondents' concerns about overwhelming clients with too much information?

d) Please suggest approaches to focus this information. For example, should this information be disclosed for each execution venue, for different types of instrument, country-by-country, etc?. Should firms should break out this disclosure for different business lines (e.g. retail versus institutional). How?

e) Should there be information for execution venues that investment firms access indirectly? And, if so, should it be on the main intermediaries to whom the firms usually entrust the execution of their orders?

f) Please provide specific information about why, in less liquid markets, this sort of disclosure actually might be misleading. Is such disclosure about equity transactions more meaningful or useful than disclosure about transactions in other types of instruments?

Proposal 2 in the Concept Paper: Information on Procedures for the Selection of Trading Venues and their Periodic Review.

111. We made the following statement in the concept paper:

"We are considering requiring that an investment firm disclose to its clients and potential clients information about the policies it follows in selecting, monitoring and reviewing trading venues and any material changes made to those policies. This could include information about factors used to select venues."

112. With respect to the proposal that investment firms should disclose information about the policies they follow in their processes for venue selection and for monitoring and review of their execution arrangements, several respondents argued that firms should make this information available upon request but should not be required to send it to all clients. However, CESR regards this information as central to a client's understanding of the firm's execution policy and arrangements. Therefore, CESR is proposing that this information be provided in good time before the commencement of investment services.

113. In response to the question in the concept paper about what other information might be useful to clients, respondents offered:

~ general disclosure of the trading process;

~ detailed disclosure about the factors and how the investment firm considered them;

~ disclosure about any trade-offs that the investment firm is making among the criteria and factors in its execution policy; and

~ disclosure about the investment firm's error correction policy, error rates and client order handling policy.

114. With respect to the first three items, Article 21(3) requires the investment firm to provide information to clients and potential clients about its execution policy. We regard general disclosure about the investment firm's trading process and how it considers the factors in 21(1) and their relative importance to be central elements of this information requirement. In addition, this information is required expressly in paragraph 21(3)(1)(a) of the proposed level 2 advice. In CESR's view, a discussion of the relative importance that the firm places on the factors also naturally would include a discussion of any trade-offs that the firm may be making among these factors.

115. Question for Comment: With respect to the fourth disclosure suggested by respondents, CESR requests further comment on whether investment firms that execute client orders directly or indirectly should be required to disclose information about their error correction and order handling policies.

116. In the concept paper, CESR asked, "Should the information provided by portfolio managers and order receivers and transmitters be different from that provided by brokers? What are the key differences?" These questions elicited an interesting split among the respondents.

~ Some said that portfolio managers should be subject to the same requirements.

~ Some said that many of the proposed requirements are less relevant to portfolio managers (*e.g.*, detail on execution venues, express consent to execution outside an MTF).

~ Some said that because execution is only one dimension of portfolio management, a special focus on execution disclosure would be disproportionate and confusing.

~ One respondent argued that requirements for portfolio managers should focus on particular elements of the overall proposal (management of transaction costs); while others noted that particular proposals in the concept paper are especially relevant to portfolio managers (how execution venues and brokers are chosen, conflicts of interest).

117. Only one respondent addressed receivers and transmitters of orders, arguing that these firms should be required to provide information on criteria considered in selecting the intermediary to which they transmit orders.

118. While CESR appreciates that trading is only part of the service that a portfolio manager provides to its clients, CESR believes that it is a very important part of that service that justifies focused disclosure. However, as discussed above, CESR is not proposing to require firms to disclose a list of the intermediaries that they use to execute orders indirectly.

Proposal 3 in the Concept Paper: Information on Conflicts of Interest

119. We made the following statement in the concept paper:

"We are considering requiring that an investment firm disclose to clients and potential clients any arrangements with venues that involve incentives to select venues for reasons other than execution quality."

120. Several respondents stated that disclosure about incentives belongs under the general provisions relating to disclosure of inducements (an element of the requirement that investment firms disclose their conflicts of interest).[16] CESR agrees in general with these comments. However, it believes that where the disclosure relating to the investment firm's policy on inducements is contained in a separate document to the disclosure relating to its execution policy, an appropriate cross-reference should be included in the latter document. A similar cross-reference should be included if there are other conflicts of interest that affect a firm's trading process. For example, if a firm uses affiliated firms to execute or transmit client orders, deals as principal with respect to client orders, or arranges agency cross transactions between clients this should be disclosed or cross-referenced as part of the firm's disclosure about its execution policy.

Proposal 4 in the Concept Paper: Information on the Firm's Procedures for obtaining Client Consent and for Communicating Material Changes

121. We made the following statement in the concept paper:

"We are considering requiring that an investment firm discloses to clients and potential clients information about its procedures for:

~ Obtaining agreement to its execution policy;

~ Obtaining the express consent of clients in order to execute their orders outside a regulated market or MTF;

~ Notifying clients of any material change to the firm's execution arrangements or execution policy."

122. There was no response to this proposal. It has been retained.

Proposal 5 in the Concept Paper: Timing

123. We made the following statement in the concept paper:

"We are considering requiring that an investment firm provides the foregoing information to clients and potential clients according to the same requirements that have been proposed in the Level 2 measures under Article 19(3), that being, generally, in good time before commencement of services."

[16] Of course, firms must meet all the requirements regarding conflicts of interest in general and inducements in particular, not just the disclosure requirements mentioned in the Level 2 advice under Article 21.

124. There was general agreement that the timing for the information requirements under Article 21 of the Directive should follow the timing requirements in the Level 2 advice under Article 19(3). However, it remains to be considered whether the two derogations under Article 19(3) should also apply to disclosure made pursuant to Article 21 or Article 19(1). The main issue is whether these derogations would operate to prevent clients from acquiring enough information to provide a meaningful 'prior consent' to an investment firm's order execution policy or indeed the 'prior express consent' which firms must obtain before proceeding to arrange for the execution of client orders outside of a regulated market or MTF.

125. For voice telephone communications regarding execution policies requiring the prior express consent of the retail client or potential retail client, paragraph 19(3)(5) of the Level 2 advice (*Derogation for voice telephone communications*) allows an investment firm to provide only the information required by Article 19(3)(5)(a) – (c). Paragraph(5)(b) of the Level 2 advice under Article 19(3) requires "a description of the main characteristics of the relevant types of services and/or financial instruments". CESR believes an investment firm's order execution policy is one of the main characteristics of the relevant services that it provides. Therefore, CESR believes that Paragraph 19(3)(5) of the Advice, taking into account Article 21(3), would require an investment firm to describe its order execution policy. Nevertheless, there are a variety of views in CESR as to whether voice telephone communication about the order execution policy would be adequate to meet Article 21's requirements for client consent. Therefore, a parallel derogation has not been proposed as part of CESR's Level 2 advice under Article 21.

126. Questions for Comment:

a) How might an investment firm gain the necessary consents required under Article 21(3) of the Directive as part of a voice telephone communication?

b) What impact would there be on cross-border business and distance marketing if investment firms are not permitted to obtain the client consents required by Article 21 using voice telephone?

c) Can respondents suggest a different approach than the one used in paragraph 5 of the advice under Article 19(3) that would permit investment firms operating via voice telephone to satisfy the objectives of Article 21's consent requirements?

d) How might firms evidence that they had obtained client consent if they obtained that consent via voice telephone?

127. Paragraph 19(3)(6) of the Level 2 advice under Article 19(3) of the Directive (*Means of distance communication not enabling the provision of information in a durable medium*) allows a firm to provide the information required under Article 19(3) immediately *after* starting to provide a service to the retail client, provided that it meets the conditions in Article 19(3)(6)(a) – (c). However, Article 21(3) of the Directive clearly requires an investment firm that executes client orders to obtain the prior consent to its clients to its execution policy. In addition, before proceeding to execute client orders outside of a regulated market or MTF, investment firms must obtain the prior express consent of their clients. As a result, an investment firm will not be able to use the derogation under Paragraph 19(3)(6) of the Level 2 advice when offering order execution services to a retail client or a potential retail client.

New Proposal: Information about the Relative Importance of the Factors for Retail Clients

128. A number of respondents suggested that price and costs typically are the most important considerations in executing retail client orders. While CESR has no wish to preclude firms from determining that other factors may be more important for some types of retail trading, we are concerned that such determinations might run counter to the expectations of most retail clients. Therefore, we have proposed that where firms determine that other factors are more important than price and costs when executing retail orders, that this is highlighted.

> *129. Question for Comment: Should investment firms that do not consider speed to be an important factor in the execution of retail orders be required to highlight this judgement?*

New Proposal: Risk Warning on Client Instructions

130. Several respondents to the concept paper reported that clients commonly provide specific instructions to investment firms that override firms' execution policies and arrangements. CESR is concerned that clients understand the implications of this practice. Specifically, CESR wants clients to understand that specific instructions prevent an investment firm from arranging for their orders to be executed in accordance with the firm's execution policy, which represents the firm's considered opinion about the best way to execute client orders. Therefore, CESR is proposing that firms provide risk warnings to clients who present them with specific instructions that conflict with the firm's own execution policy or arrangements. CESR also wishes to caution firms against soliciting including "client instructions" either as part of their general terms of business or otherwise, in order to evade their obligations under Article 21.

131. CESR also wishes to remind firms that client instructions are unlikely to address every aspect of a firm's order execution policy and arrangements. Therefore, even if a firm receives a specific client instruction regarding venue selection, that firm still has a duty to follow its execution policy and arrangements with respect to those aspects of the transaction that are not governed by the instruction.

Box 4

21(3) Appropriate information that investment firms must provide to clients and potential clients regarding their order execution policy

1. The information to be provided under the second paragraph of Article 21(3) of the Directive and any rules or regulations there under must be provided in a durable medium and in good time in accordance with Article 19(3) of the Directive (except that the derogations in paragraph 5 and (6) of the Level 2 advice under Article 19(3) of the Directive shall not apply); this information must include:

(a) description of how the investment firm seeks to obtain the best possible result when it executes orders on behalf of clients, including:

- i) the relative importance the investment firm assigns to the factors cited in Article 21(1) or the process by which the firm determines the relative importance of these factors;
- ii) in the case of a service provided to a retail client, if the investment firm gives or might give a factor other than price or cost more importance than any of price or cost for the purposes of Article 21(1) of the Directive, an explanation of why this is in the best interests of its retail clients;
- iii) if the investment firm accepts specific instructions from its clients, a clear and prominent warning that such instructions may affect the investment firm's ability to achieve the best possible result for that client's orders;
- iv) whether the investment firm may use execution venues not included in its execution policy and if so, how the investment firm makes the determination to use such venues; and
- v) each execution venue that the investment firm accesses directly.

(b) a description of the investment firm's process for:

- i) obtaining client consent to its execution policy;
- ii) obtaining express consent to execute orders outside a regulated market or an MTF; and
- iii) communicating material changes to its order execution policy.

(c) if an investment firm offers or receives permitted inducements in relation to the carrying out of client orders and the information about the investment firm's policy on inducements required under Article 19(3) of the Directive is not contained in the same document as the information required under Article 21(3), an explanation of how the information about the policy on inducements is provided;

(d) if an investment firm may execute or receive and transmit client orders itself, arrange transactions between its clients or between its clients and clients of its affiliates, or direct client orders to its affiliates for execution or reception and transmission, a description of those practices; and a discussion of how the firm manages the related conflicts; and

(e) a description of the investment firm's process for selecting, monitoring and reviewing its execution arrangements and the execution venues in its order execution policy, including a description of how deficiencies in the investment firm's execution arrangements are identified and addressed.

CESR

CHAPTER 4

Market Transparency

1. Definition of Systematic Internaliser (Article 4)

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."

Draft CESR advice

Introduction

Scope of the definition

1. In the first consultation paper, CESR proposed that the criteria that should be used to determine when an investment firm was undertaking systematic internalisation – and in particular was undertaking the internalisation of client orders on an organised, systematic and frequent basis – should be based on the following qualitative criteria:

   - 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. The following main topics were raised in the consultation process:

   - Some respondents argued that the definition proposed at level 2 was too wide and could be fulfilled as a matter of course by any properly managed firm or could inappropriately encompass activities which should not trigger the quoting obligation.

     CESR proposes to solve these problems by redrafting the advice and providing some guidance by including a list of factors in order to exclude Investment Firms from the systematic internalisation regime.

     Regarding the need to fulfil the qualitative criteria either collectively or separately, there were mixed responses. A particular concern was that delineation of a systematic internaliser by use of any individual criteria could capture a much wider range of firms than intended.

- Considerations about MIFID Recital 53. Several respondents were concerned that it was not clear enough that the proposed definition did not specifically exclude the OTC transactions covered in Recital 53.

  CESR has recognised the issue and has proposed some changes to the definition in order to accommodate those concerns.

- The need to define "frequent" and to set up quantitative criteria. There were mixed responses on this. Some proposed establishing quantitative criteria for frequent while others considered that CESR should avoid trying to set quantitative/numeric criteria for this term.

  CESR is now proposing some quantitative criteria that could be used as indicators as to when a firm probably should be considered to be a systematic internaliser in a share. This should help to tighten the scope of the article and make it easier for investment firms to implement the internalisation regime

- List of "positive" and "negative" criteria.

  Another proposal by some respondents was to set up two non-exhaustive indicative lists containing "positive" and "negative" indicators of whether an investment firm was likely (or not) to be conducting systematic internalisation

  CESR considers that the proposed qualitative factors could be taken as "positive" indicative factors. Regarding the "negative" factors, CESR's proposal is to consider the quantitative thresholds as such criteria, although formulated as "positive criteria".

Commencement and termination of systematic internalisation

3. In the former advice, CESR proposed that 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.

4. Some responses argued that such announcement is not necessary. Others pointed out that the communication through the publishing channel might not be possible in some cases. CESR proposes to keep the requirement, but it is modified in order to meet the concerns raised during the consultation.

Explanatory text

5. 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 words open to interpretation in this definition – "frequent", "organised" and "systematic" – have to be fulfilled collectively. They imply that the only internalisers that are intended to fall within the scope of Article 27 are those which engage in internalisation outside a regulated market or MTF, on an ongoing commercial basis or on a scale of such significance that it requires a business enterprise of commercial proportions. CESR has taken the view that the criteria for determining Systematic Internalisation in the context of Level 2 provisions in respect of Article 27 should be applicable only to systematic internalisation in shares. Where an investment firm is a systematic internaliser both in shares and in other financial instruments, all references in the level 2 text should be understood as referring only to shares.

6. "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).

7. In the former Consultation Paper, CESR had doubts on the interpretations of the term "frequent" and some reservations about recommending a quantitative route. Nevertheless and on the basis of the consultation process, CESR would like to keep open the possibility of introducing a quantitative criteria for the term "frequent" in order to tighten the qualitative criteria mentioned above and to avoid encompassing other activities that, although carried out on firms´ own account, should not be included within the scope of the systematic internalisation regime. The proposed quantitative criteria represent a mixed solution of both a threshold based on the ratio of internalised order volume to overall trading volume of the firm in a given share and a minimum value threshold. Such approach would allow the different sizes of firms internalising orders to be taken into account. For instance, a small firm may internalise a significant part of its activity in a given share but it might still represent a very small amount of the total turnover in that share such that it could reasonably be excluded from the scope of article 27. On the other hand, a big firm may internalise a significant amount of the total volume in a share and even though this may represent only a small percentage of the firm´s activity, it should be covered by the obligations set out in article 27.

8. In order to clarify the proposed regime and to facilitate the practical implementation by investment firms, CESR has decided to introduce an indicative list of factors tending to show where internalisation activity is carried out on an organised, frequent and systematic basis and so could be considered within the scope of article 27, because of the specific nature of the transactions or the counterparties involved. Such a solution would accommodate what is already required by Recital 53 of MiFiD. In particular, 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 standard market size and are carried out outside the systems usually used by the firm concerned for its business as a systematic internaliser.

9. CESR has also given consideration to how a systematic internaliser should start and 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 start or to stop conducting this activity in a given stock. On the other, it should not be able to commence or 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. CESR proposes to add a "safe harbour" proposal in its advice, which clarifies that if a firm has decided to cease its systematic internalisation activity, it is no longer to be considered to be covered by article 27 obligations, provided that it has informed the market in advance. This has been seen important especially in cases where a firm will cease its activity in a certain share but continue with other shares.

10. CESR has also analysed the channels through which a systematic internaliser should inform the public when wishing to start or to stop internalising in one or more several shares and to start or to stop its entire internalisation business. When an investment firm is wishing to start or to stop internalising in one or several shares but continue with its internalisation business, the investment firm should make public that it is ceasing internalisation in the share or shares in advance using the same publication channel as for the publication of its quotes where this is possible.

<u>Draft Level 2 advice</u>

BOX 1

11. For the purposes of MiFID Article 27, where an investment firm deals on own account by executing client orders outside a regulated market or MTF, it should be considered as [likely to be] conducting the activity on an organised, systematic and frequent basis, when it undertakes it on the following basis:

a. The use of a separate business model in which internalisation has a commercial role

   OR

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

   AND

b. 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;

   AND

c. The internalisation activity is marketed and made available to clients on a regular and continuous basis.

12. The following criteria, where met, may be taken as indicators that a firm is undertaking systematic internalisation on a frequent basis and is covered by the scope of the systematic internaliser definition:

(a) the ratio of the value of client orders executed on own account outside the RM or MTF to the total value of executed client orders for each share on an yearly basis is more than 20%;

   OR

(b) the ratio of the value of client orders executed on own account outside the RM or MTF to the total value of trading in a share on the most liquid market (in the meaning of Article 25) on a yearly basis is more than 0,5 %.

13. Regardless of the above a firm will no longer be considered as systematic internaliser in one or more shares when it has ceased the activity having made an announcement of its intention to do so in advance. The announcement should be made by using the same publication channel that it uses to publish its quotes or where this is not possible, via an alternative but equally effective channel.

Questions for comments:

Q 1.1: Do the revised criteria for assessing 'organised, systematic and frequent' better delineate the activity of systematic internalisation? If not, what further modifications would they propose?

Q 1.2: Is the proposed use of a quantitative measure as an additional indicator useful?

Q. 1.3: Has the quantitative test been appropriately structured? If not, how should it be improved?

2. Pre-trade Transparency requirements for Regulated Markets (Article 44) , MTFs (Article 29) and Systematic Internalisers (Article 27)

2.1 Defining the scope of the quoting obligation for Systematic internalisers

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".

Draft CESR advice

Introduction

14. CESR would like to stress that there are several ways to define those shares which are deemed to be liquid for the purposes of Article 27, each with different implications. The first consultation document divided into two categories, one based on certain pre-determined criteria and the other based on the use of proxies. CESR notes that 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. After careful consideration and taking into account the responses to the first Consultation Paper, CESR is of the opinion that the method based on certain pre-determined criteria is preferable.

15. The current proposal is based on the responses to the consultation and an analysis of market data provided by several exchanges, some of which was published in December 2004 on CESR's website. Several respondents supported the average number of trades and the average daily turnover as key criteria. In addition to these criteria, CESR considers that a supplementary requirement should be that a share is traded daily, although it recognises that these criteria may not be very selective in many instances.

16. As most indices are based on some kind of market capitalisation or free float measure, CESR considers it useful to include free float as one of the criteria. Free float is closer to measuring (potential) liquidity than market capitalisation as such. For the determination of the free float, CESR proposes to exclude those holdings which represent more than 5 % of the voting rights. The same threshold is used in the Transparency Obligations directive in order to define those holdings which need to be made public. For the interim period before that directive in is force, CESR proposes to use a free float of well recognised and wide EU wide index.

Explanatory text

17. 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.

18. 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.

19. 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.

20. 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).

21. CESR proposes to have a two step evaluation of shares. First all shares have to meet the general criteria of being traded daily and having a free float of more that 1 billion euro. In addition to that each Member State shall choose an additional criterion which is either the number of trades per day or the average daily turnover. The decision, when taken, should apply to all shares within that Member State. CESR notes that proposing such an option is not favourable from the harmonisation point of view. On the other hand it proved to be extremely difficult to find common thresholds that could be used cumulatively. Market structures seem to be so different, that allowing some flexibility would meet the goal of Article 27.

Draft Level 2 advice

BOX 2

22. A share should be deemed to have a liquid market for the purpose of Article 27, when it meets the following criteria:

(a) Trading activity: The share is traded daily; and

(b) The free float of the share is at least 1 billion euro.

The free float should be calculated by excluding those holdings exceeding 5 % of the voting rights, as defined in the Transparency Obligations directive. CESR notes that during the period when the Transparency obligations directive is not in force, the free float may be calculated by using a widely accepted/used EU-wide index calculations as a proxy;

And additionally one of the following alternative criteria as chosen by a Member State

(c) Average number of trades per day: The daily average number of transactions in a share is more than 500; or

(d) Average daily turnover in a share: The average daily turnover in a share is more than 2 million euro.

23. Before the MiFID transparency regime [or article 25] is working, the thresholds in points c) and d) should be based on the order book data on Regulated Markets.

Question for comments:

Q 2.1: Does the proposed approach to identifying liquid shares establish a sound methodological approach in the context of Article 27? If not, please specify (in sufficient detail) a modified or alternative approach and explain why it would be superior.

2.2. Content of pre-trade transparency

Extract from Level 1 text

Article 29 [for MTFs]:
1. Member States shall, at least, require that investment firms and market operators operating an MTF make public current bid and offer prices and the depth of trading interests at these prices which are advertised through their systems in respect of shares admitted to trading on a regulated market. Member States shall provide for this information to be made available to the public on reasonable commercial terms and on a continuous basis during normal trading hours.

2. Member States shall provide for the competent authorities to be able to waive the obligation for investment firms or market operators operating an MTF to make public the information referred to in paragraph 1 based on the market model or the type and size of orders in the cases defined in accordance with paragraph 3. In particular, the competent authorities shall be able to waive the obligation in respect of transactions that are large in scale compared with normal market size for the share or type of share in question.

Article 44 [for regulated markets]:

1. Member States shall, at least, require regulated markets to make public current bid and offer prices and the depth of trading interests at those prices which are advertised through their systems for shares admitted to trading. Member States shall require this information to be made available to the public on reasonable commercial terms and on continuous basis during normal trading hours.

Regulated markets may give access, on reasonable commercial terms and on a non-discriminatory basis, to the arrangements they employ for making public the information under the first subparagraph to investment forms which are obliged to publish their quotes in shares pursuant to Article 27.

2. Member States shall provide that the competent authorities are to be able to waive the obligation for regulated markets to make public the information referred to in paragraph 1 based on the market model or the type and size of orders. In particular, the competent authorities shall be able to waive the obligation in respect of transactions that are large in scale compared with normal market size for the share or type of share in question.

Article 27 (for Systematic Internalisers)

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.

"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."

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.

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

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.

"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

- Specify the range of bid and offers or designated market-maker quotes, and the depth of trading interest at those prices that are to be made public.

- Establish the criteria for determining the type and size of orders for which pre-trade transparency obligations may be waived and define orders that are "large in scale compared with normal market size"

In respect of size, and in particular when defining orders that are "large in scale compared with normal market size" (block orders), CESR advice should take account of the fact that the objective of the waiver is to exempt from the pre-trade transparency obligation those transactions which size could have a market impact that could affect investors and/or that could affect the provision of liquidity by market makers and/or could affect the quality of price formation process on the market. In this respect, CESR should also take particular account of the differences between order and quote driven markets. The definition of block orders should be analysed with a view to establish harmonized criteria for each type of shares in the EU, to promote legal certainty and to develop as simple a model as possible. At this respect, CESR, in delivering its advice, might wish to analyse the possibility to establish a single measure in terms of number of shares and/or of quantity that could be applicable to most of the trading in shares in the EU.

- Establish the criteria for determining the market models for which pre-trade transparency obligations may be waived.

- 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."
- 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.
- specifying the general criteria for the handling of client orders in case that systematic internalisers publish multiple quotes.
- The criteria for determining what constitutes considerably exceeding the norm in order to limit the total number of transactions from different clients.
- 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.
- Specifying the criteria for determining what is a size customarily undertaken by a retail investor

<u>Draft CESR advice</u>

<u>Introduction</u>

24. CESR's first consultation paper on implementing measures for articles 29 and 44 of MiFID approached the requirement to make public pre-trade information advertised through the systems of the regulated market (RM) or the multilateral trading facility (MTF) as referring only to the information RMs or MTFs advertised through their systems under their rules. Following consultation with the Commission and within CESR, the advice has been modified to take into account what type and amount of pre-trade information in general RMs and MTFs should advertise through their systems and make public. In practice this means that trading on an RM or MTF should be subject to sufficient pre-trade transparency (as described in paragraphs [73-78] of CESR's draft advice). However trading on an RM or MTF could still be possible without such a level of pre-trade transparency where it is covered by a specific exemption provided for in paragraphs [81-86] of CESR's advice.

25. A number of respondents to the first consultation paper suggested that CESR should take a more principles-based approach in its advice. The proposed draft advice in CESR's first consultation paper was criticised by consultees as restricting the scope of market models complying with pre-trade transparency obligations under MiFID to electronic open auctions, continuous order book trading, continuous quote-driven trading and floor trading with the use of market personnel. Such a defined list of trading mechanisms was said to hamper innovation in and reduce competitiveness and flexibility of European markets. The approach was considered as being too prescriptive limiting the ability of RMs and MTFs to adapt their services to the needs of their users. Costs were supposed to increase without any obvious benefit in return causing a decrease in utilisation of RMs and MTFs, hence diminishing liquidity and, thus, also pre-trade transparency. Moreover, the approach of the first consultation paper was said not to take into account that complete pre-trade transparency for less liquid shares may be harmful for retail investors and promote questionable market practices. More differentiated market models, however, were deemed to be able to take into account and better accommodate the situations in certain market segments, such as the market for SMEs.

26. CESR recognises the need both to leave different markets sufficient flexibility for their particular market models and to provide for future evolution in trading methods and trading practices. However, it also considers that principles alone cannot provide sufficiently precise guidance and harmonisation in an important area. CESR has therefore provided advice in respect of the most common trading methodologies currently used by organised markets in the EU. The advice then indicates the conditions for considering other methodologies as complying with the pre-trade transparency requirement of MiFID. CESR believes that this approach is providing a sufficient degree of detail as required by MiFID and the mandate from the Commission while at the same time granting the desired flexibility and room for innovation.

27. CESR's original proposal of requiring all bids, offers and quotes in all different market models to be made public was widely criticised by the consultees. This requirement was seen especially unfit for periodic auctions where the structuring of the auction and extent of the information made public was best seen to be left to the RMs and MTFs themselves. Additionally, the requirement to make public the full depth of the order book was seen as unnecessary because there is no demand for this information below a limited amount of levels in the order book. CESR has modified its advice to reflect these comments.

28. In the first consultation paper, CESR also proposed that all bids, offers and quotes should be made available by an RM or MTF to all members, participants, investors or other interested parties alike, thus ruling out the incentivisation of liquidity provision based on access to privileged information. CESR has revised its proposals in this regard such that a minimum level of pre-trade information is required to be made available to the general public but no further guidance is proposed at Level 2 on the information that should be made available to members and participants. This has been seen by CESR to go beyond the scope of CESR's mandate.

29. There was wide agreement among the consultees for providing a waiver for iceberg-type orders. However, at the same time respondents were concerned about similar order types which should also qualify for a waiver. Therefore CESR has decided to change the approach by noting that certain order types as well as facilities provided by the RMs and MTFs for the management of orders do not have to be specifically exempted from the pre-trade transparency obligations.

30. The opinions of the consultees were divided in relation to granting a waiver from the pre-trade transparency obligations for crossing systems. CESR has considered the matter and proposes to maintain the waiver primarily because the requirement to publish the orders, especially in less liquid shares, might increase the incentive to manipulate the continuous market before the reference price is fixed.

<u>Withdrawal of quotes (by systematic internaliser)</u>

31. Respondents to the consultation had several comments relating to the withdrawal. While some considered the CESR proposal appropriate, others pointed out that the proposal is too narrow. The correct reference point should be market makers on RM. Additionally it was pointed out that technical difficulties may prevent the firm from quoting. CESR recognises that for example technical failures may prevent firms to display their quotes as well as other "force majeure" type of issues. CESR is however of the view that the proposal should concentrate only on active withdrawal of quotes (as a reaction to market conditions). Therefore the formulation of the proposal has not been changed.

<u>Handling of client orders</u>

32. Respondents widely supported CESR analysis that in case systematic internalisers publish multiple quotes, there is no need for additional proposals on top of the general provisions for order handling and best excution. That proposal has been kept unchanged.

33. In regard to the proposals on limiting the total number of transactions exceeding the norm, the CESR proposal was generally seen appropriate. Some respondents however commented the requirement to communicate that policy to clients and the requirement too keep an audit trail.

34. CESR proposal on execution of several securities as one transaction (basket trades), were also widely accepted. Some comments were raised relating to the proposed number of securities. On the one hand it was not felt necessary to specify the number while it was proposed to raise the number up to 20 on the other hand. CESR proposes to amend the proposal by keeping the requirement of 10 shares but adding a requirement of minimum value of the transaction of 3 million euro.

35. Comments to CESR proposal on treatment of "orders subject to conditions other than current market price" were more critical. Some respondents considered the proposal too open, making it possible that most orders in the whole sale market would fulfil the criteria and not being subject to the provisions of Article 27. Others, on the contrary, considered that CESR proposal unnecessarily limits the exemption provided by level 1. According to their view all other orders than market orders should fulfil the criteria and be left outside the relevant provision of Article 27. CESR has asked the view of the Commission of the goal of that provision. According to the Commission the exemption provided by Art 27 (3) 5th subparagraph is intended to cover for example trades where the price is determined to be an average of the prices during a day (volume weighted average proce (VWAP) orders) and should not cover any other orders than pure market and limit orders. CESR has therefore not changed the propose advice in substance.

Explanatory text

36. The market models presented in paragraphs 73-78 are intended to serve as examples rather than as an exhaustive list. That way the content of information to be made public is specified for certain market models while leaving room for any other models which, in paragraph 6, are required to provide an appropriate degree of pre-trade transparency comparable to that required under the market models given as examples. The basis for this solution is that MiFID accepts different market models with varying degrees of pre-trade transparency as being sufficiently pre-trade transparent and thus complying with articles 29 and 44 of MiFID. Exemptions will then be needed only in case of trading mechanisms where there is not sufficient level of pre-trade transparency.

37. The requirement for the publication of the depth of trading interest has been defined on the basis of the realities of the different market models and intends to provide sufficient leeway for diverging market structures. For example, CESR considers that the display of a minimum of five different price levels in order-matching trading systems serves adequately the interests of the public. In periodic auctions the publication of the indicative equilibrium price and the indicative volume has been considered to be sufficient.

38. In some market models, especially auctions, the individual bids/offers/quotes are firm but they are not published and are used instead to form an indicative price or price range. The ability of RMs and MTFs to continue to operate such a market model is recognised in CESR's draft advice.

39. The pre-trade transparency obligation can be waived for the information held in the facilities provided by RMs or MTFs for the management of orders such as 'iceberg'-type orders, whereby only part of the order is visible, stop orders or close orders. The reason for this is that these are facilities provided by RMs or MTFs that help intermediaries and their clients in executing their orders in the most efficient way. CESR is of the opinion that the provision of these facilities should be left to the discretion of RMs and MTFs.

40. MiFID provides the competent authorities with the possibility to waive the obligation for RMs and MTFs to make public pre-trade information based on the market model or the type and size of orders. The advice specifies the conditions for granting these waivers.

41. The pre-transparency obligation can be waived for transactions that are not accessible to to other members/participants of the RM or MTF than the one(s) that have prenegotiated the transaction. These "negotiated trades" are defined in paragraph [83] of CESR's draft advice.

42. There is a need for an exemption for negotiated trades made within or at the current spread or within a set percentage of a suitable periodic reference price because they are commonly used in cases where it would not be in the interest of the client to enter the order into the order book because a better quality of execution might sometimes be achieved outside the order book (e.g. when the order book cannot fill the whole order). Thus, negotiated trades are sometimes necessary for intermediaries to achieve best execution for their clients. Negotiated trades may also be needed where it is not possible to trade certain orders through a central trading mechanism, for instance where an order book has a significant minimum order size, permits the trading of only round lots or imposes other standard conditions (e.g. settlement) that some types of orders cannot meet.

43. A suitable price condition is needed to ensure fair treatment of clients expressing their trading interests either in the order book or bilaterally. An execution within a certain percentage of a suitable periodic reference price as mentioned in the second alternative of paragraph 84 is sufficient only if there is no spread due to the nature of the price discovery mechanism or the present trading conditions.

44. There is also a need for a waiver for negotiated trades that can be made without being subject to the price condition referred to in paragraph [84]. This waiver relates to transactions which are subject to other conditions than the current market price of the share. Examples of this type of transactions are transactions where the price is based on the volume weighted average price of a certain period (VWAP) or transactions related to the individual shares in a principal portfolio trade.

45. A core function of most organised markets is price discovery. However, a number of RMs and MTFs also provide crossing systems that enable market participants to match supply and demand without price discovery but at a fixed reference price (e.g. at the opening or closing price or at a reference price recorded at some other point of the day). In some cases market participants may be able to view the orders entered for crossing. However, in other cases, the RM/MTF publishes no information relating to orders entered for crossing. This is primarily because the publication of orders, especially in the less liquid shares for which crossing systems are most frequently used, may increase the incentive to manipulate the continuous market before the reference price is fixed. In CESR's view, these types of systems should be eligible for a waiver from the pre-trade transparency obligations. This requires that the price being referenced is widely recognised as a reliable reference price and also widely publicised.

Calculation of the average order value

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

47. 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 and disclose this classification.

Calculation period

48. The period used for calculation should be long enough to guarantee the statistical representativeness of the result and discount temporary changes in trading patterns. On the other hand, it should adequately reflect more permanent changes in the average order values for each share. Additionally the adjustment process should not create an undue burden for market participants. In order to balance the different needs, a calculation period of 12 months could be considered appropriate.

Basis for calculations

49. In order to calculate the average order size, such orders executed which are large in scale compared to normal market size should be excluded. Since Art.27 MiFID is different in scope from Art.29 and 44 MiFID 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 Art.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 provisions in the Directive.

50. Another issue relating to classification is whether the basis for calculations ("orders executed") should be interpreted to refer as completed transaction rather than to separately executed buy and sell orders. Regarding the content of information, it should be noted that article 27 of the Directive refers to "orders executed" not to "transactions" and that depending on market structure, there can be significant difference between both terms[17]. However, following discussions in the expert group and the view of the Commission, it is proposed that the term "orders executed" should be understood as "transactions" for the purpose of article 27. A practical issue relating to this matter is the availability of the necessary information for calculations. If executed transactions are used as a basis for the calculation, the information is available either 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 but additional reporting obligations (or requests by competent authorities) would be needed. This view is however not shared by all CESR members. Some CESR members underline that the text of the directive is without any ambiguity in its reference to orders executed and consider that the use of "orders executed" will generate a Standard Market Size that more accurately reflects the role of large orders in trading mix .

51. Furthermore, the first calculation of the average value of executed transactions must be completed at the latest when 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 calculate the average value of transactions on the basis of EU-wide data and for this reason, CESR believes that a transitional period will be necessary where the calculations will be carried out on the basis on regulated market data only.

Definition of SMS classes and the SMS for each class of shares

52. Rather than allocate an individual standard market size to each share, the directive has chosen to create groups of shares that will share the same SMS. It is therefore important that the groups are structured in a way that will ensure that the group SMS is not unduly low for shares with an average trade size at the top of the group and not too high for shares with an average trade size at the bottom.

53. CESR has considered several possible solutions to this issue. The most precise would probably be to band the shares on a logarithmic scale. However, CESR also recognises the importance of simplicity and an approach that is readily understood. It is therefore recommending a simple tiering in bands of €10,000 up to €100,000 and in €20,000 bands above that figure. (The bands should be at the eurozone equivalent for non-euorozone currencies.)

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[17] 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).

54. CESR is also recommending that the determination of the SMS for each class of shares should be simple. It is therefore suggesting that the SMS should be set at the mid-point of each band. For example, the mid-point of the €20,000 - €29,999 band would be €25,000. Adoption of this approach implies a minimum SMS size of €5,000 in the bottom band, followed by a relatively sharp jump to €15,000 for the next band.

55. CESR has also considered whether there might be significant advantages in converting the monetary SMS for an issue into a number of shares. This would involve dividing the SMS value for each share by the current share price so that SMS was then expressed as a number of shares. Shares might then be regrouped into classes with 'round lot' numbers of shares. The main benefits of this approach would be that dealers generally prefer to work with number of shares and would have no ongoing need to calculate whether any dealing quantity exceeded the monetary SMS. It would also mean that SMS could more readily fluctuate with the market price of an issue (and therefore need less frequent revision). However, this is a more complex exercise to set up and may possibly stray too far from the provisions of Level 1.

Revision of a share's group allocation and revision of SMS groups

56. The average value of trade in any share can change considerably over time, in both relative and absolute terms. CESR considers that an annual review should normally be sufficient. An annual review would also bring the recalculation into line with the recommended frequency of other calculations (especially the calculation of larger trade sizes) that will need to be carried out under the MiFID.

57. Although 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 can safely be fixed in level 2 rules, CESR has recommended that they should at least be reviewed at no more than three-yearly intervals. In the early years at least, it will be important to confirm that the new groupings and SMSs are working satisfactorily and do not lend themselves to a better arrangements.

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

58. It is important that the arrangements for determining the SMS for each share provide both for adjustment or review processes in light of changed circumstances and for 'new entrants' to the Article27 list between annual reviews.

59. The need for such reviews, and possible reallocations, will normally be caused by events that mechanistically alter a transaction's average value. These will usually flow from a change of capital (e.g. following a new issue, merger etc), but competent authorities should not be required to review a share's SMs for every de minimis capital adjustment. There may also be exceptional circumstances in which a company's financial position and share price alter radically during the course of a year. While reviews and reallocations should for the most part be held to a minimum, competent authorities should retain the discretion to review a share's SMS in exceptional circumstances, e.g. when a company has run into serious financial difficulties and the share price appear set to remain at a much lower level for soemmonths to come.

60. CESR has also considered how to deal with shares admitted to a regulated market for the first time (e.g IPOs) and which are deemed liquid as the data needed to group the share into a class (and thus determine its SMS) is initially missing. CESR is not convinced that the fact that such shares have no trading track-record for calculating SMS should mean that they should have no SMS until they have been trading for a number of months. On the contrary, these shares often experience substantial trading in their first few weeks after admission to a regulated market and

it is desirable that there should be a high level of transparency during this period. CESR has therefore recommended that the competent authority should provisionally allocate a newly admitted share to an SMS group on the basis of known information about the size of the issue, likely trading interest and the SMSs of any 'peer group' shares. Several RMs already take this approach in allocating a provisional block sizes to a share before it starts trading.

Coming into force

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

62. In order to give enough time for market participants to prepare themselves CESR is proposing that the new average size and the new classification of a share into the relevant class will come into force two weeks after the competent authorities made it public to market participants.

Publication of the class of shares to which each share belongs

63. Competent authorities are responsible for publication of the class of shares to which each share which is deemed to be liquid for the purposes of Article 27 belongs. Consequently, there should be a system that guarantees full access to this information across EU countries.

64. 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.

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

Updating of quotes

66. 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

67. 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

68. 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.

69. 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.

70. 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.

71. CESR´s proposals on handling client orders in case of multiple quotes and exceeding the norm have been kept the same as in the first proposal.

72. In relation to the size customarily undertaken by a retail customer, a fixed amount is proposed. The proposed threshold 7.500 euro is based on information collected by CESR. The typical retail sizes differ from market to another and additionally depending on the nature of the intermediary (internet broker vrs. universal bank).

Draft Level 2 advice

BOX 3

Regulated markets and MTFs

73. For regulated markets (RMs) and multilateral trading facilities (MTFs) to comply with their obligations to make public pre-trade information, they should publish for each share admitted to trading on an RM, at least the information set out in the paragraphs below.

74. Where an RM or MTF operates an order-matching trading system providing continuous trading, it should make public the aggregate number of shares and orders represented at each price level, up to the five best bid and offer levels.[18]

75. Where an RM or MTF operates a price discovery mechanism through a periodic auction trading system it should make public sufficient information relating to trading interests entered into the auction to enable market participants to be reasonably informed as to the likely outcome of the auction. This information should include an indicative theoretical equilibrium price (i.e. the price at which the largest volume of shares could be executed at that moment) and an indicative auction volume.

76. Where an RM or MTF operates a quote driven trading system, it should make public, in a montage for each share, information on the best bid and offer currently available, together with the best bid and offer (price and volume) of each market maker in that share.

77. Where an RM or MTF operates a trading system with market members acting as market personnel in one or more shares, the bids and offers (quotes) of the market personnel should be made public.

78. Where an RM or MTF operates a trading system which does not align with any of the market models described in paragraphs [73-77] above either because it is a hybrid system or because the price determination process is of an entirely different nature, this system shall also be

18 Market by Level.

considered as complying with pre-trade transparency obligations if the following conditions are met:

a. a standard of pre-trade transparency is provided that is comparable to the pre-trade transparency described in paragraphs [73-77] and the trading mechanism shall be in the interest of fair and orderly trading and investor protection; and
b. The five best bid and offer levels are made public, if the price discovery mechanism so permits. Otherwise it shall provide a level of pre-trade transparency that is comparable to that described in papragraphs [73-77] taking into account the characteristics of the trading system and the principles of fair and orderly trading and investor protection; and
c. RMs and MTFs are able to demonstrate upon request of the competent authority that any price discovery mechanism they operate is in compliance with the principles mentioned under a.

Updating and withdrawal of quotes

79. Members and participants are entitled to update and withdraw their bids/offers/quotes, subject to orderly market and market abuse provisions.

80. RMs and MTFs should have rules governing the conditions and circumstances in which designated market makers may withdraw their quotes.

Exemptions from pre-trade transparency

Based on the type or size of order/ transaction

81. The pre-trade transparency obligation can be waived for the information held by an RM or MTF in an order-management facility pending it being made public (e.g. an iceberg order).

82. The pre-trade transparency obligation can be waived for orders large in scale compared with normal market size, as defined in Section 4.

83. Transactions which are not accessible to other members/participants of the RM or MTF can be made on the RM/MTF if the conditions defined below are fulfilled. These transactions refer to transactions concluded outside the order book of the RM/MTF but subject to the rules applicable to these types of trades ("negotiated trades"). A negotiated trade is a trade where:

- one member/participant acts for the account of both the buyer and seller; or
- one member/participant acts for the account of the buyer and another member/participant for the account of the seller; or
- one member/participant trades for own account against a client order.

84. Regardless of the size of orders (as referred to in para [82]), the pre-trade transparency obligation can be waived for negotiated trades made on an RM or MTF, if:
a. the transaction is made within or at the current spread on the RM/MTF, if applicable, or within a set percentage of a suitable periodic reference price if a continuous reference price is not available; and
b. the other conditions specified in the rules of the RM or MTF for this type of transactions have been fulfilled; and
c. the post-trade information published on the transaction fulfils the requirements of paragraph [139].

The waiver is not available where the transaction is made by a member/participant in a share in which it is a systematic internaliser in a size equal to or smaller than the SMS for that share, except where the transaction involves the crossing of two client orders.

85. In addition to the transactions referred to in paragraph 84 above, the pre-trade transparency obligation can be waived for negotiated trades made on the RM or MTF if:

a. the transaction is subject to other conditions than the current market price of the share (e.g. a VWAP transaction or a transaction related to an individual share in a principal portfolio trade); and
b. the conditions specified in the rules of the RM or MTF for this type of transactions have been fulfilled; and
c. the post-trade information published on the transaction fulfils the requirements of paragraph [139].

Based on market model

86. The pre-trade transparency obligation can be waived if trading on an RM or MTF is based on a trading methodology where the price is referenced to a price generated by a different trading mechanism, whether or not part of the same RM or MTF, and provided that the price being referenced would be widely recognised as a reliable reference price and widely published.

Systematic internalisation

Quoting obligations of Systematic internalisers

Calculation of the average *size*

87. 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

Orders large in scale compared to normal market size

88. An order executed that is large in scale compared to normal market size for the purposes of Art.27 MiFID shall refer to any transaction larger than the size of transaction specified as large in scale compared with normal market size for the purposes of Art.44 and 29, MiFID.

Definition of classes

89. The classes into which shares should be grouped for the purposes of applying Standard Market Size should be set in bands of □10,000 up to □100,000 and in bands of □20,000 above that figure (or the Euro equivalent).

Definition of SMS for each class of shares

90. The SMS for each class of shares shall be the mid-point in each band (e.g. □25,000 for the band from □20,000 - □29,999).

91. Standard Market Size groups and Standard Market Sizes should be reviewed and, as appropriate amended, by the Commission no less frequently than every [3]years

Revision cycles for the allocation of shares to an SMS group

92. Member States should require competent authorities to recalculate at least annually the average arithmetic value of the orders executed in shares in which there is a liquid market, on the basis of the methodology set out in Article 27, paragraph one.

93. In addition to the revision in the previous paragraph, Member States should require competent authorities to review and, as necessary, to adjust the SMS for a share following any adjustments to an issuer's capital structure that will mechanistically affect the average value of trades in its shares by more than a de minimis amount.

94. Additionally Member States should provide for competent authorities to review and, as necessary, adjust the SMS for a share in circumstances in which there is an exceptional change in an issuer's financial position, share price and trading in the share.

Grouping of shares following first admission to trading on a regulated market

95. The competent authority for the regulated market where a share (which is deemed to be liquid as referred to in section 2 of this document) is admitted to trading for the first time - for instance, following an initial public offering - shall determine an initial SMS by grouping the shares 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.). The competent authority should review the suitability of the initial SMS no more than 6 months after trading commences.

Coming into force

96. The Standard Market Size should become effective two weeks after the competent authority has published the class into which the share has been grouped and the resulting Standard Market Size.

Publication of the information

97. 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.

Quotes reflecting market conditions

98. 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.

Withdrawal and updating of quotes

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

Obligations for Systematic internalisers when handling and executing client orders

Limiting the total number of transactions

100. 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.

101. 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.

102. Where a systematic internaliser decides to limit the number and/or volume 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.

Transactions in several securities as a part of one transaction

103. 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 representing a market value ot at least 3 million euro and traded as a single lot against a specific reference price

Orders subject to other conditions that the current market price

104. Orders from professional clients subject to execution 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 limit orders (as defined in Article 4 (1) 16 of the MiFID)

Size customarily undertaken by a retail investor

105. For the purposes of article 27.3 (fourth subparagraph) size customarily undertaken by a retail investor is 7.500 euros.

Handling orders in case that systematic internaliser publish multiple quotes

106. CESR proposes that no implementing measures are needed to clarify the manner in which firms should execute orders when they publish quotes in sizes that are not contiguous

Questions for comments:

Q 3.1. Do consultees agree with the specific proposals as presented or would they prefer to see more general proposals?

Q 3.2. Is the content of the pre-trade transparency information appropriate?

Q 3.3: Do consultees agree on the proposed exemptions to pre-trade transparency? Are there other types or order/transaction or market models which should be exempted?

Q 3.4: Do consultees agree on the proposal in the second subparagraph of paragraph 84? Would it cause difficulties for firms trading in several capacity (systematic internalisation, crossing clinet orders etc.)? Are there alternative ways to adress the potential loophole between Article 27 and Article 44?

Q 3.5: 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, 44 MiFID on the other hand would be advisable?

Q 3.6: Would you consider a large number of SMSs in order to reflect a large number of classes each comprising a relatively small bandwidth of arithmetic average value of orders executed as problematic for systematic internalisers?

Q 3.7: In your opinion, would it be more appropriate to fix the SMS as monetary value or convert it into number of shares?

Q 3.8: 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, especially, should the time of revision be fixed at level 2?

Q 3.9: 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 to determine which class the share should belong to?

Q 3.10: Do you consider a two week period from publication as sufficient for systematic internalisers to adapt to new SMSs?

Q 3.11: Do you agree on the proposal on publication of the classification of shares, would you prefer establishing a single contact point (at level2)?

Q 3.12: Do you have further comments on the proposals for the obligations of systematic internalisers?

2.3 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.

Introduction

107. Respondents were generally supportive of CESR's approach to limit order display arrangements, including of the "visibility" and "accessibility" tests. However, several respondents expressed diverging comments on some more detailed aspects of CESR's proposal.

108. A first set of comments suggested the Draft Advice to state more clearly that Regulated Markets (RMs) and/or MTFs were the most, if not the only, adequate arrangements to meet Article 22.2 requirements, possibly with some additional criteria for the selection of the RM or MTF, such as liquidity or non-discriminatory access. CESR considered that the obligation for the investment firm under Article 22.2 to look for the largest possible audience for the limit order as well as for its earliest possible execution, combined with best execution obligation will most likely lead to the transmission of the order to the most liquid RM or MTF providing for non-discriminatory access and did not feel necessary to revise the proposed advice accordingly.

109. Other respondents pointed out that under the draft advice which refers to the transmission of the limit order to a RM or an MTF running a "public" order book, the transmission of the order to a RM or an MTF running a trading system such as a partially "closed" order book or a call auction system where the limit order itself is not displayed but reflected in the indicative price and volume displayed by the trading venue during the accumulation or pre-negociation phase would not be considered as meeting Article 22.2 requirements. They considered this as too narrow an interpretation of possible arrangements under Article 22.2 .

110. Although such trading mechanisms (call auction systems, partially open order books) may be used by RMs or MTFs to provide an alternative trading mechanism for liquid shares, they are sometimes the only trading mechanism for less liquid shares for which there is no sufficient supply and demand to provide for an efficient trading based on continuous order book trading. Where there is no other trading mechanisms provided by a RM or MTF for such stocks and where the trading mechanisms allows for the characteristics of the limit order (price and volume) to be at least reflected in the indicative price and volume displayed by the RM or MTF, and thus made "visible", CESR's revised draft advice considers that the transmission of limit order to such RM or MTF could possibly provide for the largest possible audience and for the earliest possible execution and should therefore not be ruled out as a possible arrangement under Article 22. 2.

111. On the opposite, some respondents suggested that par 3 of the draft advice should be redrafted to clearly spell out that proprietary websites were to be considered as adequate arrangements for limit order display. CESR considers that the general reference to "an appropriate venue that achieves similar results" is more appropriate and adequate to cater for possible technical evolutions in venues and systems potentially eligible under Article 22.2

112. It was suggested in the comments that the order routing to a RM or an MTF or another trading venue via another investment firm should be included as an option, provided the end result is the same. The draft advice has been amended to include this possibility.

113. A limited number of comments disagreed with the requirement that the arrangements for limit order display should be included in the investment firm's execution policy document. After consultation of the Commission on the scope of Article 22.2, CESR considered appropriate to keep the requirement set out in Par 5 as limit order display arrangements are considered to be a key element of the client order handling procedures and execution policy.

<u>Draft CESR advice</u>

<u>Explanatory text</u>

114. 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

115. 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".

116. 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 large 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

117. 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.

118. The publication of standard client limit orders where an existing RM and/or MTF offers a public 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 would not be among the five best bid and offer levels displayed by the RM or the MTF in accordance with paragraph [80], its immediate transmission to the RM or MTF would nonetheless allow it to benefit from time/price priority, to be made visible to the public when the limit gets closer to the market price and to be immediately executed once market conditions permit.

119. Where the non-immediately executed limit order is transmitted to a RM or MTF running a trading system (e.g. call auction) where the order is not immediately displayed as such but is reflected in the indicative price and volume disseminated by the RM or MTF in the pre-negociation phase ("visibility test"), and where the transmission of the limit order to such trading system would provide the order with a large audience and make it potentially easily and rapidly executable, once it becomes executable in terms of market price, the transmission of limit order to such trading venue would be considered as meeting Article 22.2 requirements, without prejudice to Best execution obligations.

120. 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 normally not be visible and accessible to market participants as required by Article 22.2. unless the operator provides such a facility. 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 would more easily be able to meet the requirement of article 22.2.

121. 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.

122. The investment firm may either transmit the limit order to the most appropriate venue directly or route the order via another investment firm, provided that a similar end result is achieved.

123. 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 be one that displays the limit order in a way that is visible to other market participants and is widely publicised. 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. The venue should publish the information in a way that does not impede consolidation, in accordance with paragraph 201e.

124. Furthermore, it should be noted that 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.

125. The arrangements used by a firm for limit order display should be described in the order execution policy required under Article 21 as limit order display arrangements are considered as a key element in the client order handling procedures and execution policy.

Draft Level 2 advice

BOX 4

126. 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.

127. The obligation would be met where the limit order is sent to an order driven Regulated Market (RM) or a Multilateral Trading Facility (MTF). 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.

128. 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 makes the order visible to other market participants and provides it with the greatest opportunities to be rapidly and easily executed once market conditions allow. The venue should publish the information in a way that does not impede consolidation, in accordance with paragraph 201e.

129. The investment firm may either transmit the limit order to the most appropriate venue directly or route the order via another investment firm provided that a similar end result is achieved.

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

3. Post-Trade Transparency requirements for Regulated Markets (Article 45) and MTFs (Article 30) and for Investment Firms (Article 28)

Extract from Level 1 text

Article 28:
1. Member States shall, at least, require investment firms which, either on own account or on behalf of clients, conclude transactions in shares admitted to trading on a regulated market outside a regulated market or MTF, to make public the volume and price of those transactions and the time at which they were concluded. This information shall be made public as close to real-time as possible, on a reasonable commercial basis, and in a manner which is easily accessible to other market participants.

2. Member States shall require that the information which is made public in accordance with paragraph 1 and the time limits within which it is published comply with the requirements adopted pursuant to Article 45. Where the measures adopted pursuant to Article 45 provide for deferred *reporting for certain categories of transaction in shares, this possibility shall apply mutatis mutandis to those transactions when undertaken outside regulated markets or MTFs.*

Article 30:
1. Member States shall, at least, require that investment firms and market operators operating an MTF make public the price, volume and time of the transactions executed under its systems in respect of shares which are admitted to trading on a regulated market. Member States shall require that details of all such transactions be made public, on a reasonable commercial basis, as close to real time as possible. This requirement shall not apply to details of trades executed on an MTF that are made public under the systems of a regulated market.

2. Member States shall provide that the competent authority may authorise investment firms or market operators operating an MTF to provide for deferred publication of the details of transactions based on their type or size. In particular, the competent authorities may authorise the deferred publication in respect of transactions that are large in scale compared with the normal market size for that share or that class of shares. Member States shall require MTFs to obtain the competent authority's prior approval to proposed arrangements for deferred trade-publication, and shall require that these arrangements be clearly disclosed to market participants and the investing public.

Article 45:
1. Member States shall, at least, require regulated markets to make public the price, volume and time of the transactions executed in respect of shares admitted to trading. Member States shall require details of all such transactions to be made public, on a reasonable commercial basis and as close to real time as possible.

Regulated markets may give access, on reasonable commercial terms and on a non-discriminatory basis, to the arrangements they employ for making public the information under the first subparagraph to investment firms which are obliged to publish the details of their transactions in shares pursuant to Article 28.

2. Member States shall provide that the competent authority may authorise regulated markets to provide for deferred publication of the details of transactions based on their type or size. In particular, the competent authorities may authorise the deferred publication in respect of transactions that are large in scale compared with the normal market size for that share or that class of shares. Member States shall require regulated markets to obtain the competent authority's prior approval of proposed arrangements for deferred trade-publication, and shall require that these arrangements be clearly disclosed to market participants and the investing public.

Extract from the mandate from the Commission

- Specify the scope and content of the information to be made public.

- Establish the conditions under which deferred publication of trades may be allowed as well as the criteria to be applied when deciding the transactions for which, due to their size or the type of share involved, deferred publication is allowed,

In respect of large orders, CESR should, where relevant, combine this request with the requests formulated in the context of Article 44.

2) Specify the scope (which types of transactions) and the conditions of application of the post-trade transparency obligation to transactions involving the use of shares for collateral, lending or other purposes where the exchange of shares is determined by factors other than the current market valuation of the share.

<u>Draft CESR advice</u>

Introduction

131. The requirement on the content of the post-trade information to be made public has been slightly modified to include a possibility requested by some consultees to publish also cumulative trade volumes for a single share for trades made at the same price at the same time. CESR is of the opinion that this possibility does not affect the in formativeness of the post-trade information published and could thus be accommodated in the advice.

132. The requirement for publishing data in an aggregated manner at the end of trading session included in the first consultation paper has been abolished. This reflects the opinion of the consultees that the provision of this kind of information should be left to the discretion of the RMs, MTFs and systematic internalisers.

133. The consultees had difficulties in understanding the meaning of the wording of the directive which refers to transactions where the exchange of shares is determined by other factors than the current market valuation of the share. The intention of the new wording proposed by CESR (transactions that are subject to other conditions than the current market price of the share) is to clarify the scope of the cases in which the provisions related to these types of transactions apply. The publication of information on these transactions has also been made dependent on the fact if they entail information that would be significant for the efficient price formation of the share in question.

Explanatory text

134. Paragraph 13 includes the requirement for post-trade information to be published on each trade made on an RM, MTF or outside them. This information is considered to be necessary in order to provide sufficient data for checking the quality of completed trades and assisting intermediaries is assessing which trading venues consistently offer the most competive prices and indentifying trends on the market.

135. If the publication is made by means of one price determination the published information still fully reflects traded volume with respective price at one point in time and helps avoiding significant investment in IT for RMs/MTFs and the addressees of the data who would need larger bandwidth to publish or receive the data. Publishing cumulated trade volume reduces the bandwidth necessary without any significant loss in information.

136. In order to give reliable information on trading which took place, the post-trade information should cover each transaction only once. If trading takes place on an RM or MTF trades will be published usually automatically by the systems of the market operator (and the system itself makes sure that there is no multiple publication). If in some cases it is not determined by the RM or MTF and in cases where the trade takes place off-RM and off-MTF, CESR proposes that the investment firm acting as seller should be responsible for publication.

137. For certain types of transactions post-trade transparency to the public may be more or less useful. In certain circumstances such information could even send misleading signals as to trading conditions in the real market. It is therefore proposed that the publication of certain transactions where the transaction was subject to other conditions than the current market price of the share will be required only if the transaction entails information that is important for the efficient price formation of the share in question. If a transaction is published it should always be marked (flagged) in order to avoid misleading signals.

138. CESR has taken the view that intermediaries should be able to benefit from delayed publication only where they enter into a transaction in order to facilitate third party business as otherwise the firm is not deemed to be providing a service (in the form of liquidity provision) that justifies deferred publication. Furthermore, CESR has assumed that any principal transaction through which a firm executes a client order (i.e. facilitates third party business) above a certain size

would potentially create a risk position for the firm, and as a consequence should be eligible for delayed publication.

Draft Level 2 advice

BOX 5

Content of post-trade information

139. Regardless of whether a trade was executed on an RM, MTF or outside them, the following information shall be made public either trade by trade or by one price determination, meaning traded volume for a single share at the same price at one particular point in time:

a. identification of the RM or MTF where the trade was executed or, in case of trades executed outside RMs and MTFs, the name of the investment firm which executed the trade;
b. security identifier;
c. date and time of trade;
d. volume (number of shares);
e. price per share;
f. (if applicable) indicator that the trade was a negotiated trade defined in paragraph 83;
g. (if applicable) indicator that the transaction was subject to other conditions than the current market price of the share as defined in paragraph 85;
h. (if applicable) indicator that the trade was subject to delayed publication as defined in paragraph 142; and
i. any amendments to previously disclosed information.

140. The procedures for disclosing the information in paragraph 21 shall ensure that every trade is published only once. If the trade is made on an RM or an MTF the publishing should happen according to their rules. If not specified by their rules, or for trades which are executed outside an RM or an MTF, the investment firm acting as the seller shall be responsible for disclosing the information. Where the seller is not an EU investment firm (but the buyer is), the publication obligation is on the buyer.

141. In case of transactions made outside the RM or MTF that were subject to other conditions than the current market price of the share, post-trade information should be published only if the transaction entails information that is significant for the efficient price formation of the share in question.

Any information published should include an indicator explaining the reason for the deviation from the current market price.

142. The publication of post-trade information may be deferred when the following requirements are met:

a. The transaction includes the participation of an investment firm acting as a principal in the transaction as a direct result of the facilitation of third party business; and

b. The size of the trade is above the relevant threshold to qualify for deferral, as specified in Box 7.

Questions for comments:

Q5.1: Do consultees support the method of publishing post-trade information (either trade by trade *information or on the basis of one price determination)?*

Q5.2: Do consultees agree that the responsibility for publishing the post-trade information lies on the seller in case of trades made outside RMs and MTFs?

CESR

4. Transactions large in scale compared to normal market size

Extracts from Level 1 text

Article 44 (2) : Member States shall provide that the competent authorities are to be able to waive the obligation for regulated markets to make public the [pre-trade] information referred to in paragraph 1. ……In particular, the competent authorities shall be able to waive the obligation in respect of transactions that are large in scale compared with normal market size

Article 45 (2): Member States shall provide that the competent authority may authorise regulated markets to provide for deferred publication of the details of transactions based on their type or size. In particular, the competent authorities may authorise the deferred publication in respect of transactions that are large in scale compared with the normal market size for that share or class of shares. Member States shall require regulated markets to obtain the competent authority's prior approval of proposed arrangements for deferred trade publication, and shall require that these arrangements be clearly disclosed to market participants and the investing public.

Article 27 (1): [In respect of standard market size] 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 value compared to normal market size for that share.

Extract from the mandate from the Commission

DG Internal Markt requests CESR to provide technical advice on possible implementing measures by 30/04/2005 on the following issues: **Article 44** (Waivers from pre-trade transparency for regulated markets): Establish the criteria for determining the type and size of orders for which pre-trade transparency obligations may be waived and define orders that are 'large in scale compared with normal market size'. In respect of size, and in particular when determining orders that are 'large in scale compared with normal market size (block orders), CESR should take account of the fact that the objective of the waiver is to exempt from the pre-trade transparency obligations those transactions the size [of which] could have a market impact that could itself affect investors and/or that could affect the provision of liquidity by market makers and/or could affect the quality of price formation process on the market. In this respect, CESR should also take particular account of the differences between order and quote driven markets. The definition of block orders should be analysed with a view to establish harmonised criteria for each type of shares in the EU, to promote legal certainty and to develop as simple a model as possible. At this respect, CESR, in delivering its advice, may wish to analyse the possibility to establish a single measure in terms of the number of shares and/or of quantity that could be applicable to most of the trading in shares in the EU. **Article 45** (Deferred publication of trades for Regulated Markets): Establish the conditions under which deferred publication of trades may be allowed as well as the criteria to be applied when deciding the transactions for which, due to their or the type of share involved, deferred publication is allowed. In respect of large orders, CESR should, where relevant, combine this request with the requests formulated in the context of Article 44. **Article 27** (Systematic internalisation): Defining what is to be considered an order large in scale compared to normal market size.

Introduction

143. The MifFID recognises that transactions larger than normal market size are often conducted in a different way to normal-sized trades. Implicitly, the Directive accepts that these trades may be

executed more efficiently in a less transparent environment, without causing disproportionate harm to the market as a whole.

144. The Directive therefore provides for the possibility of waivers from pre-trade transparency and for the possibility of deferred publication of completed transactions in respect of 'transactions that are large in scale compared to normal market size'.

145. Transactions that are large in scale compared with normal market size are also relevant in the context of Article 27 (Pre-trade transparency for Systematic Internalisers). This article requires, for the purposes set out in the article, the establishment of a Standard Market Size based on an average trade size that excludes executed orders that are large in scale compared to normal market size.

146. The Directive does not specify whether larger than normal market size has a common meaning in each of the three main contexts in which it is used. Nor does it given any further indication of what is normal size or what magnitude of trade should be considered large in scale compared with normal.

In developing its approach to defining transactions large in scale compared to normal market size, CESR has taken account of the following main considerations:

- the desirability of achieving optimal transparency, taking account of different market structures and practices, the commercial demand for liquidity and the need to provide for market evolution;
- the desirability of developing proposals that properly address (i.e within the considerations of bullet point one) the potential for regulatory arbitrage in the Single Market;
- the case for considering that 'large' should be approached differently in the context of the Directive's pre- and post- trade provisions;
- the balance that needs to be struck between theoretical purity and the practicability and costs of the proposals.

147. In its first consultation paper on transparency issues, CESR invited views on two proposals relating to larger transactions. The first proposal was that the thresholds for deferred publication arrangements (DPAs) should be set at a different, and higher, level than the thresholds for waivers from pre-trade transparency. This was on the grounds that mandatory public exposure of an order before it is traded is potentially far more damaging to the initiator than publication of a similar-sizes risk position already entered into by an intermediary. Most respondents to the CP supported this argument and CESR has retained this proposal

148. The second proposal suggested three methodologies that might be used as a basis for calculating the thresholds in each case. These were :

- the percentage of average daily volume (i.e. value) method in which transactions larger than normal market size would be those transactions larger than a selected percentage of the share's average daily volume;
- the average trade size method, which would permit large transactions to be defined and expressed as some multiple of average trade size;
- the market impact method, under which a large transaction would be defined as the size of order, on average, that could be immediately executed at the best bid and offer or for a given percentage movement in price.

149. This proposal attracted mixed responses. There were divergent views on the market impact approach, some support for the percentage of average daily volume approach and little support for the use of average trade size. Since publication of the two 'first round' CPS on transparency

issues, CESR has also examined statistical data supplied by EU exchanges, set up a small statistical sub-group and consulted informally with industry participants. It is extremely grateful for the all the assistance it has received.

150. CESR's assessment of the different methodologies, taking account of their theoretical soundness and practicability, is as follows:

- The percentage of average daily volume approach does not in itself indicate what percentage of ADV would be appropriate for either a pre-trade or DPA threshold. Any thresholds therefore need to be tested, at least generally, against one or more other criteria.

  Nonetheless, the approach is easy to understand and straightforward to calculate. It also provides some context for considering the dual parameters of DPAs - how large a trade should be to qualify for deferred publication and how long the deferral should last. Thus, for example, a trade equal to 12% of ADV would equate to one hour's trading on a market operating for 8.5 hours per day – the common trading hours for many EU regulated markets. That does not mean that 12% is the 'correct' threshold, but it does provide an indication of the relationship between size and the time, on average, consumed in trading such a volume.

- The average trade size approach provides an indicator of sorts of mid-size trades in a share, though it may not necessarily provide either an accurate or consistent indicator of normal market size. This is because average trade size may have a very different relationship with normal (i.e. a commonly traded) size depending on the retail/institutional mix of trading in the share. For example, a small number of large institutional transactions may raise the ATS in a predominantly retail-traded share well-above what might be perceived to be its commonly traded size. This may produce considerable inconsistency across shares in general, while applying the same multiple to a predominantly retail-traded share and a predominantly institutionally-traded share will produce significantly different thresholds for otherwise similar shares. The size of these differences would be particularly apparent in some DPA thresholds.

  One possible way of reducing this shortcoming would be to base average trade sizes on order-book transactions only. In terms of application, a pre-trade block size might be set as a low multiple of average trade size (or taken as average trade size to, say, 1 standard deviation). Deferred publication thresholds could then be set as higher multiples, of either average trade size or the pre-trade threshold size. Like ADV, average trade size has the merit of being simple to understand and straightforward to calculate

- The market impact method offers a more scientific approach. However, the methodology is highly data intensive and its alignment to the specific regulatory objectives is questionable. This is because there is no precise or constant connection between the potential impact of exposing trading interest and the cost of attempting to execute it immediately. Similarly, in the post-trade context, knowledge of the cost of laying off an order immediately may be relevant information to an intermediary which has entered into a large risk position but is not a good guide to the overall risk assessment that firm will make before taking on the risk.

Block size methodologies

	% of Average Daily Volume	Average Trade Size	Market Impact
Sets threshold(s) as…..	A selected percentage of average daily volume	A selected multiple of average trade size	The size at which the cost of immediate execution exceeds a selected number of basis points
Judgement factors	Requires estimate of appropriate	Requires estimate of appropriate multiple	Requires judgement on size of acceptable price

	thresholds. Easily understandable.	of ATS. Easily understandable.	movement (i.e. execution cost). .
Suitability	Dual parameter of trading volume and time has some relevance to DPAs. Too insensitive to liquidity differences to be ideal for pre-trade block sizes.	As representing a mid-point has at least some relation to normal trade size May be more suited to pre-trade than DPA threshold.	A scientific approach that may produce most consistent outcomes. However, MI measures cost of immediate trading, not market reaction to size of exposed order, and has no time dimension
Long-term / ideal data base	Total EU volume data	Total EU volume and trades data	Extensive order-book (or quote data) from all significant venues.
Short term/ acceptable data base	Order-book volume of lead market (+ any other significant market--place)	Average order-book size of lead market.	Order-book data of lead market
Computation	Relatively simple	Relatively simple	Relatively intensive

151. CESR considers that in the absence of any wholly satisfactory methodology, it is desirable to focus on methodologies that are simple to understand, straightforward (and not too costly) to calculate and which deliver thresholds broadly in line with the objectives set out above.

152. In relation to pre-trade transparency, this could be achieved by setting a threshold at a selected decile of order-book trade sizes or order-book trading value. More simply, but less precisely, one could take a multiple of average order-book size, with a view to capturing trades rather above the norm but excluding the less frequent larger trades.

153. In relation to DPA thresholds, the percentage of average daily volume appears to provide a relatively straightforward approach and one that has been used, with different variations, in several member states. However, this approach is likely to produce very large absolute sizes for the most actively traded securities. Even though these are highly liquid, the size of risk involved is likely to be beyond the risk appetite of even the largest intermediaries, especially in difficult market conditions. There is therefore a case for providing an absolute size threshold for permitting deferred publication.

154. Deferred publication involves two elements – size of trade and the time available to lay off the risk before publication. Here, CESR notes two important issues. First, it is likely that the relative size/time parameters for larger trades in less liquid shares may need to be more accommodating, largely because the daily flow of trading is likely to be considerably more volatile than for more liquid shares. This is one reason why it may be preferable to leave member states more scope to customise their own regimes for less liquid shares. Secondly, it is desirable to ensure that the length of deferred publication is no longer than reasonably necessary. In this respect, CESR considers that any transaction that qualifies for deferred publication should, ideally, be published as soon as the major part of the risk has been laid off if that is achieved in lerss than the maximum time permitted.

Draft Level 2 advice

Explanatory text

155. CESR's advice in respect of what should be regarded as transactions large in scale compared with normal market size addresses each of the three main contexts in which the Commission has

requested advice. These are waivers from pre-trade transparency in respect to transactions conducted on regulated markets and MTFs (articles 44, 29), the calculation of Standard Market Size for Systematic Internalisers (Arrticle 27), and the approval of deferred publication arrangements for Regulated Markets, MTFs and investment firms (Articles 45, 30, 28).

156. CESR has developed its advice having considered the basic principles that should be taken into taken into account in each of the three contexts set out above. It has also attempted to develop an approach which can be easily understood, easily implemented by both market authorities and market participants and administered effectively but as simply and cheaply as possible. In addition, CESR has, where necessary, put forward transitional recommendations that take account of the limitations of available data with which to calculate thresholds during the first 12-18 months following implementation of the directive.

Pre-trade transparency waivers

157. CESR's proposal in respect of waivers from pre-trade transparency for RMs and MTFs are based on the view that a waiver should be available for all trades once they surpass a size at which mandatory public exposure of the interest in trading might, taking account of market conditions, make the costs of execution higher than would be the case if the transaction could be negotiated privately. In developing its advice, CESR has taken account of the price restrictions placed on negotiated trades that fall below the threshold and the different trading patterns in different markets.

158. CESR has considered three main options for determining the threshold:

- A multiple of average order-book trade size;
- A percentage of order book trading by [value/number of trades];
- A single threshold figure for each of [4] groups of shares, based on the grouping of the shares into different liquidity categories.

Standard Market Size

159. In respect of the calculation of the average trade size of Article 27 shares, the directive requires the average value of those shares to be calculated by taking the total of orders executed in the EU, less those large in scale compared with normal market size for that share. CESR is recommending that orders executed that are large in scale compared with normal market size should be taken as those transactions in sizes above the threshold established for pre-trade transparency for order-book trading methodologies. Mecanistically, this inevitably results in sizes smaller than those for the pre-trade threshold itself. However, this reflects the risk placed on internaliers by requiring them to maintain a continuous quote (albeit that a systematic internaliser could theoretically quote in only 1 share) and by limiting their scope to price defensively.

Deferred publication

160. CESR's proposal in repect of size thresholds for transactions that may qualify for deferred publication sets out to ensure that deferred publication (which should be available only for the facilitation of large trades for clients) is confined to the largest trades and that the time provided for delay is no longer than is reasonably required for a firm that is actively working off its risk.

161. CESR is recommending the iuse of a percentage of average daily turnover as the basis for setting thresholds for deferred publication. It considers this Because the thresholds cover a wide range of stocks in each size band, CESR has also proposd a monetary cap in each band. This allows for a higher percentage threshold overall in each band than might otherwise be desirable for the shares at the top of each band. A particular risk in setting thresholds is that they are set at a level that leaves the block market dominated by too few firms, leading to non-competitive pricing.

162. As in the pre-trade proposals,CESR has recommended that shares be split into three liquidity bandings. While the calculation methodology as a percentage of average daily value is inherently a relative measure, it is important to allow for the fact that the tradability of individual shares declines as the frequency of trading declines.

Application and implementation considerations

163. CESR's advice on the application of the above thresholds is that they should represent EU-wide minimum thresholds for each share. This accords with the Commission suggestion in its manadate that CESR should focus on a harmonised approach for the Single Market, and consider the possibility of a single figure, by value or number of shares, for shares traded in the EU (while recognising that RMs and MTFs can have more stringent requirements).

164. CESR has recognised that implementation on an EU-wide basis is not straightforward. The directive provides for Member States to grant competent authorities discretion in granting waivers and approving deferred publication arrangements This means that a competent authority could requirte a higher level of transparency by either refusing to grant a pre-trade waiver or refusing to approve deferred publication arrangements, or permit them only on the basis of thresholds higher than those envisaged as the EU minimum. In turn, this raises the question of whether it would be more desirable from a regulatory viewpoint for the arrangements adopred in the lead market Member state to set the requirement for the whole of the EU, or for each competent authority to be permitted to approve any waiver or deferred publication arrangements that meet the EU minimum standard. CESR has assumed that the latter most closely accords with the intent of the directive but recognises that this creates potential difficulties for some Member States. They may come under significant commercial pressure to drop any requiremnents over and above the minmum standards; and they may be faced with a domestic issue of whether to grant waivers/approvals to other trading venues when they are not siought be the regulated market.

165. The setting of EU-wide minimum pre-trade and deferred publication thresholds for EU shares raises a further issue in respect of calculation and administrative responsibilities. In particular, it requires a decision on who would calculate the EU block size, under what vires and on what basis. Clearly, it shifts the onus to make the calculation from individual regulated markets to some public authority, whether that is the competent authority in the Member State of the relevant market or a central CESR/EU body. While competent authorities will be required to obtain and compute extensive data in order to calculate Standard Market Size for the purposes of Article 27, this would normally apply to only a relatively small sub-set of shares in most markets.(and in some markets there may be no article 27 shares).

166. In proposing an EU-wide approach, as favoured by the Commission, CESR therefore notes that the Commission will need to consider how to address the issues raised in the paragraph above. In particular, it needs to consider how to structure the precise responsibilities of competent authorities and what arrangements would be needed to provide them with access to relevant data. In these two respects, the Commission should be aware that several Member States oppose the idea of competent authorities undertaking these tasks and that a larger number have no formal powers to obtain market data for the purposes envisaged.

Data sets

167. CESR is aware that there is currently only a limited amount of readily accessible data available for calculating some of the thresholds set out in this advice. In some cases, this position will not improve until the MIFID has come into force and requires the reporting of a much wider data-set. In the meantime, CESR has focussed on developing threshold calculations on the basis of data that is regularlry collected, even if not always by the competent authority.

168. In the first consultation paper CESR proposed three methodologies in order to determine the thresholds for pre-trade waivers (and delayed publication arrangements). After analysing the trading data from various RMs CESR has come to the conclusion that it is very difficult to use a multiple of average trade size as a basis for determining the thresholds for pre-trade waivers.

Average trade size is largely dependent on the retail/institutional mix of trading in a particular share and could thus provide very different results for shares with similar turnover and liquidity depending on the trading pattern of each share. .

169. The method based on the percentage of average daily turnover seems to work relatively well in the case of post-trade thresholds. To be workable in the pre-trade context the thresholds should be set at very low levels (less than 1 %). An exact calculation formula would also lead to relatively small differences in the thresholds. That is why CESR has decided to propose a methodology that divides shares into different liquidity categories on the basis of their daily average order-book turnover and then defines a fixed threshold for each of these categories. The highest threshold for the most liquid shares is proposed to be EUR 500.000.

170. CESR proposes a simplified approach in order to determine the minimum thresholds on the basis of which a competent authority may grant a waiver from the pre-transparency obligation on an RM or MTF. The minimum thresholds are fixed amounts defined for four categories to which shares are assigned based on the value of the daily average order book turnover in that share.

Draft Level 2 advice

BOX 6

Waiver from pre-trade transparency obligations for transactions that are large in scale compared with normal market size

171. Member States shall provide for the competent authority to grant an RM and MTF which operates an order-matching trading system a waiver from the obligation to make public pre-trade information relating to transactions that are large in scale compared with normal market size. The size of the transaction applicable for a waiver should exceed the relevant minimum threshold set out in Table 1.

A waiver should not be required in respect of regulated markets operating systems with designated market makers, provided the regulated market requires the market maker(s) to maintain quotations in a size that balances the needs of participants to deal in a commercial size and the risk to which the market maker exposes itself.

172. In order to determine the minimum threshold for a share, the competent authority of the most relevant market defined under article 25 of MiFID should determine (or have appropriate arrangements for the determination of) the minimum threshold for that share. The minimum threshold for each share should be determined on the basis of the value of the daily average order-book turnover on the lead RM. The average daily turnover should be calculated on the basis of the most recent 12 month period and should be recalculated every 12 months.

Orders executed large in scale compared with normal market size for the purposes of calculating average trade size for Article 27 shares.

173. When calculating the arithmetic average value of orders excuted in the market for an Article 27 share, competent authorities should exclude from the calculation orders above the threshold size of transaction established for the purposes of a pre-trade waiver in that share established in para 171 above.

Approval of deferred publication arrangements for transactions that are large in scale compared with normal market size.

174. Member States shall provide for the competent authority to authorise deferred publication of transactions that are large in scale compared with normal market size when the transaction size exceeds the relevant minimum threshold set out in Table 2.

175. In order to calculate the minimum threshold for a share, Member States which are the relevant market for the share under Article 25 should require the competent authority to calculate and make public the minimum thresholds for that share. Competent authorities should calculate (or have appropriate arrangements for the calculation of) the minimum thresholds for a share on the basis of the specified percentages of the average daily value of order-book trading on the lead market for the share. Where the resultant amount for a share in relation is greater than the specified cash amount for that threshold, then the specified cash figures should be the threshold. The data for calculating the average order-book trade size should be drawn from the order-book data over the most recent 12 months and should be recalculated no less than every 12 months.

176. In respect of shares admitted to trading on a regulated market, Member States should require competent authorities to utlilise the thresholds set out in the tables as the minimum basis for granting any pre-trade waivers to MTFs and for authorising any deferred publication arrangements for MTFs or investment firms.

177. Where competent authorities approve deferred publication of principal portfolio trades, they should do so only when the portfolio includes at least one security in the "top liquidity band" in excess of the threshold for that share.

Table 1: Pre-trade waiver thresholds[19]

Minimum size of transaction qualifying for a waiver			
High liquidity shares (> EUR 50 million)	Upper mid-liquidity shares (EUR 25-50 million)	Lower mid-liquidity shares (EUR 1-25 million)	Low liquidity shares (< EUR 1 million)
EUR 500.000	EUR 400.000	EUR 250.000	EUR 100.000

Table 2: Deferred publication arrangements

Maximum permitted delay for trade publication	Minimum qualifying size of trade (and cash ceilings)		
	High liquidity shares e.g. € 50 m+	Mid-liquidity shares e.g. € 1-50 m	Less liquid shares e.g. less that € 1 m
60 minutes	More than 10 % of ADV or more than € 10m.	More than 10 % of ADV or more than € 3,5 m.	More than 5 % of ADV but at least € 10.000
120 minutes	More than 20 % of ADV or more than € 20 m.	More than 15 % of ADV or more than € 5 m.	More than 15 % of ADV but at least € 30.000
End of day (+roll-over	More than 30 % of	More than 25 % of	More than 25 % of ADV,

19 An alternative way to define the thresholds would be to examine the transaction size up to which all (order-book) trading accounts for an agreed percentage [95 %] of total order book trading in the share or an agreed percentage [95 %] of the number of trades in the share (see annex I; option 2).

to close of next trading day if undertaken in final 2 hours of trading	ADV or more than € 50 m.	ADV or more than € 10 m.	but at least € 50.000
End of next trading day	More than 100 % of ADV	More than 100 % of ADV	
End of second trading day following trade			More than 100 % of ADV but at least € 1 m.

ADV = Average Daily Volume

Questions for comments:

It would be particularly useful if consultees to this section who wish to propose modifications or different approaches to CESR's proposal could supply statistical or other relevant information to demonstrate the need for modification or how their alternative proposals would work.

Q6.1: Do consultees agree with the approach to establishing a threshold for a waiver from pre-trade transparency? Would the cathegoric approach cause difficulties or market distortion for shares with different trading patterns? Would the alternative proposal described in annex I option 2 (footnote 19), as more stock sensitive, provide better outcome? If that approach would be taken, would the proposed threshold (95 %) be appropropriate and should it be calculated on the basis of trading volume or number of trades? Are there other alternative proposalthat you would put forward, bearing in mind the objective of finding an easily understood and easily implemented solution?

Q6.2: For purposes of calculating ther average trade size for Article 27 shares, do consultees agree that trades larger than the pre-trade threshold should be those that are excluded when calculating the average size? If not, which trades large in scale comparted with normal market size should be excluded? It would be helpful if any suggestions could be illustrated with resultant figures.

Q6.3: Do consultees agree with the proposals for determining thresholds for deferred publication arrangements? Is the balance of proposed threshold sizes and time delays appropriate? If you consider that they should be modified, please suggest how and why.

Q6.4: Do consultees consider that intermediairies should benefit from the maximum delay proposed, regardless of whether they have unwound their position? If not, on what basis should CESR recommend a rule aimed at requiring immediate disclosure once all, or the major part, of the position have been unwound?

Q6.5: Do consultees agree with the proposal that Competent authorities should be able to grant pre-trade waivers and/or approve deferred publication arrangements that comply with the minimum thresholds regardless of whether or not the competent authority of the lead market adopts higher standards? Would it be better to require all member states to follow the transparency arrangements adopted by the competent authority of the lead market, whether by the competent authority or the lead market operator? CESR would like to receive comments that throw more light on the pros and cons of each option?

Q6.6: Do consultees have any comments on the proposed short-term arrangements?

Q6.7: Do the propsoals adequately address issues relating to less liquid shares? If not , what arrangements would be preferable?

Q6.8: Is the suggestion in respect of portfolio trades suitable?

Q6.9: Do consultees have any other comments on the proposals in this section

5. Publication of transparency information (and consolidation)

Extract from Level 1 Text

1. Member States shall, at least, require investment firms which, either on own account or on behalf of clients, conclude transactions in shares admitted to trading on a regulated market outside a regulated market or MTF, to make public the volume and price of those transactions and the time at which they were concluded. This information shall be made public as close to real-time as possible, on a reasonable commercial basis, and in a manner which is easily accessible to other market participants.

2. Member States shall require that the information which is made public in accordance with paragraph 1 and the time limits within which it is published comply with the requirements adopted pursuant to Article 45. Where the measures adopted pursuant to Article 45 provide for deferred reporting for certain categories of transaction in shares, this possibility shall apply mutatis mutandis to those transactions when undertaken outside regulated markets or MTFs.

Mandate from the Commission

1) Specify the means by which investment firms may comply with their post-trade transparency obligations including the following possibilities:
i) through the facilities of any regulated market which has admitted the instrument in question to trading or through the facilities of an MTF in which the share in question is traded;
ii) through the offices of a third party;
iii) through proprietary arrangements.

Draft CESR advice

Introductory text

178. CESR's original proposal that post-trade information be made public no later than one minute after the transaction took place was felt by the majority of consultees to be appropriate for electronic trading but unrealistic for off-market transactions which tend to be more complex. CESR has therefore decided to extend the maximum time limit for the complexity of certain trades or the characteristics of the trading venue to three minutes from the time of completetion of the transaction. This requirement is notwithstanding the general principle that transactions must be published as close to real time as possible and where a RM, MTF or investment firm can make a trade public sooner than three minutes, it is obliged to do so. Furthermore, CESR considered the need for possible transitional period during which the general requirement would apply without the express three minute limit. That was however not felt necessary, since there are plans to address the issue of transitional period (and postponement of the implementing deadline).

179. The requirement for investment firms to make available post-trade information for 14 days following publication was felt by many consultees to be a cost-driver for the firms and likely to result in information overload for investors. CESR has therefore removed this requirement and replaced it with an obligation for firms to make available such information on request on a reasonable commercial basis. This is not felt by CESR to be overly burdensome for firms given that they are required under the MiFID to retain relevant data releting to all transactions that they carry out for at least five years.

180. Consultees also expressed concerns on cost-benefit grounds about the requirement that the publication mechanism for post-trade transparency should operate the entire time that trading takes place (whether on a RM, MTF or within an investment firm). Respondents suggested instead that trades outside market hours should be published at the beginning of the next trading day (either before the open of the relevant RM or MTF or immediately after).

181. CESR has noted these concerns but, following discussions with the Commission, has concluded that there is no provision in the Level 1 text for an exemption for such trades from the general requirement to publish as close to real time as possible. CESR's advice therefore makes it clear that, where the normal trading hours of an investment firm operating as an internaliser or carrying out OTC trades in shares admitted to trading on a RM extend beyond the trading hours of the relevant RM or MTF, it has to meet the general post-trade transparency rule. However if trades that take place both outside market hours and outside the normal business hours of the firm, CESR thinks that it is unlikely that the benefits of making these trades transparent within 3 minutes will outweigh the cost to firms of maintaining 24 hour publication arrangements. CESR therefore proposes that such incidental trades should be reported before the open of the relevant market the following day.

182. A number of responses to the first and second consultations asked for CESR to make it clear that RMs, MTFs and investment firms should be able to make pre and post-trade information available on a reasonable commercial basis. As a result, CESR has introduced this wording from the Level 1 text into the draft advice.

183. In the first consultation papers on the first and second set of mandates, CESR expressed concerns about whether publication of pre and/or post-trade information solely on a firm's website, or on a third-party website where only one or a few firms' data is published, would be sufficient to meet the "easily accessible" test and therefore to facilitate consolidation.

184. Investment firms in particular criticised CESR's comments on websites as being in contradiction of the Level 1 text. Regulated markets on the other hand stressed the need for CESR to ensure the quality of information and argued that publication via proprietary means could fail to achieve the purpose of creating a truly uniform and complete picture of the market.

185. As pointed out by consultees, the Level 1 text explicitly allows for publication via proprietary arrangements such as web-sites. However, CESR believes that significant risks arise if efficient consolidation does not occur as the markets may not be able to operate efficiently, quality control standards (e.g. data correction and cleansing processes) may deteriorate and the ability of investors to compare prices may be impaired. CESR has therefore made it clear in its advice that investment firms making pre and post-trade information public under Articles 27 and 28 may do so through any of the means explicitly mentioned in the directive. However, CESR is proposing the introduction of general conditions that must be met by any publication mechanism chosen by a RM, MTF or investment firm to make pre and/or post-trade information available to the public and these include conditions designed to prevent data being deliberately hidden or made difficult to consolidate.

186. In respect of CESR's general comments on the desirability of achieving consolidation, the views of respondents were also mixed. Some said it was not CESR´s task to intervene in the consolidation area and that it should be left to market forces. However, other respondents supported the need for CESR to encourage consolidation and agreed that trade data published by regulated markets, MTFs, and investment firms needs to fulfil certain criteria with regard to both quality and consolidatability. Given CESR's concerns about data fragmentation, CESR has therefore decided to undertake work in conjunction with the market (involving investment firms, data publishers, exchanges, etc), to consider how barriers to consolidation could be reduced, in particular, those created by the current lack of data standardisation. That work will be started when the level 2 advice has been finalised.

<u>Explanatory text</u>

187. The publication of quotes by systematic internalisers on a regular and continuous basis should be taken to mean that a quote must be published 100 % of the time during the normal trading hours of the firm's systematic internalisation activity, rather than the business hours of the firm as a whole. The normal trading hours during which a firm carries on its systematic internaliser activity must be predetermined and made public by the firm.

188. Taking into account the importance of post-trade information and the purpose of the Directive it is extremely important for that information to be disclosed as soon as it is technically possible (except where delayed publication is justified in accordance with paragraph[139] and the thresholds set out in Box 5). Therefore CESR has taken a strict view on the timing in order to promote an efficient and competitive market. As such, the three minute deadline should be seen as the maximum permissible time limit and a trading system or investment firm must publish details of a completed transaction sooner if it is able to do so.

189. There are several ways for market participants to organise the publication of post-trade information. Since the information is considered vital for investors, the methods shall ensure that such information is available all the time the trading method in question is functioning. For example, for RMs and MTFs the publication arrangements should operate all the time trading takes place i.e. normal trading hours but also different forms of "after market hours".

190. For investments firms the information should be available throughout the normal trading hours of the firm. When choosing the publication channel the party responsible for publication should take this into account. If for example an investment firm's normal trading hours extend beyond the opening hours of the RM or MTF that it uses to publish its data, it should make sure that the service provided by that RM is functioning all the time the firm is trading. Where it does not, the investment firm must have in place third-party or proprietarty arrangements which comply with the general conditions for publication mechanisms as set out in Box5.

191. The directive sets out that fair competition requires that market participants and investors be able to compare the prices that trading venues (i.e. RMs, MTFs and investment firms) are required to make public. While MiFID also provides for a genuine choice of reporting arrangements for investment firms, CESR believes that only if data published through these different mechanisms can be brought together in a way which facilitates consolidation and comparison between the prices prevailing in different trading venues, can the true benefits of broad-based post-trade transparency requirements be reaped by investors and the market as a whole.

192. When making pre and post-trade information public, a RM, MTF or investment firm must therefore ensure that the publication mechanism chosen is capable of publishing the pre and post-trade information in a form which does not impede consolidation and in a manner which can be accessed by all interested parties on a reasonable commercial basis. In CESR's view, this does not preclude RMs, MTFs and investment firms from making different levels of pre and post-trade information available on different (reasonable) commercial terms, however, the information should be made available to all interested parties that wish to receive it and are prepared to pay for it.

Draft Level 2 advice

BOX 7

Timeliness and availability of pre and post-trade infomation

193. Pre-trade information made public by RMs and MTFs shall be disclosed in real time during the trading hours of the RM or MTF.

194. A systematic internaliser will be deemed to have met its obligation to publish a quote on a regular and continuous basis when it publishes a quote throughout 100 % of the time during its

normal trading hours as a systematic internaliser, details of which must be predetermined and made transparent to investors.

195. Post trade information shall be made public as close to real time as possible taking into account the characteristics of the trading venue where the transaction was executed. This should in any case not happen later than three minutes after the transaction was completed. The post-trade information published shall be available on request on a reasonable commercial basis.

196. The publication arrangements for post-trade information shall operate all the time trading takes place. For RMs and MTFs that covers the period when trading is possible according to their systems and rules. For investment firms the mechanism shall be available throughout the firm's normal trading hours. Where an investment firm uses the facilities of a RM or MTF to publish trades and the normal trading hours of the firm extend beyond the opening hours of that market, the firm must have a third party or proprietary arrangement in place for trading that takes place within the firm's normal trading hours but outside the market's opening hours.

Arrangements to disclose pre and post-trade information

197. Pre-trade information can be made available to the public by RMs or MTFs either directly, through contractual arrangements, or indirectly, through data vendors on a reasonable commercial basis.

198. A systematic internaliser can comply with its obligation to make public its quotes by publishing its quotes through the facilities of a RM or MTF, through third party arrangements or via proprietary means. The systematic internaliser shall remain responsible for the publication of its quotes, irrespective of the publication mechanism chosen.

199. Post-trade information can be made available to the public by RMs and MTFs either directly, through contractual arrangements, or indirectly through data vendors on a reasonable commercial basis.

200. Post-trade information can be made available to the public by investment firms either through the facilities of a RM or MTF, through third-party arrangements or via proprietary means on a reasonable commercial basis.

201. When making pre and post-trade information public, RMs, MTFs and investment firms must ensure that the publication arrangements chosen:

a. ensure that the information published is reliable by monitoring the correctness of the information, alerting of obvious mistakes and correcting wrong data when necessary; ;
b. are capable of publishing the information within the time frames set out in paragraphs 195-196 above;
c. function all the time that the RMs, MTFs or investment firms' publication obligations apply;
d. are accessible to all interested parties on a reasonable commercial basis;
e. publish the data in a manner that does not impede its consolidation.

ANNEX I to the draft advice on Market Transparency

Options for calculating pre-trade transparency thresholds

CESR examined several different methodologies for determining thresholds above which trades should be considered large in scale compared with normal market size for the purposes of granting a waiver from pre-trade transparency. The waiver in question is designed for regulated markets and MTFs operating order-matching trading systems.

Option 1 – A fixed monetary value for each of a number of bands of shares.

This is the approach proposed in the consultation paper. It sets a fixed monetary value for each of four groups of shares, tiered by magnitude of turnover. The approach is simple, easy to understand and involves no regular recalculation work. The threshold figures proposed in the consultation paper approximate to those that have been used by a number of Member States for some years. However, the fact that each threshold figure covers a wide range of shares inevitably means that this approach can have only limited sensitivity to the trading characteristics of each share within a band.

Option 2. - The transaction size level up to which the value of all order-book trading in a share accounts for more than a selected percentage of total order-book trading vaue in the share.

This method examines the transaction size up to which all (order-book) trading accounts for an agreed percentage (95%) of total order-book trading value in the share to ensure that an optimal percentage of business is publicly exposed. A variation on this approach would be to set the target percentage (95%) on the basis of the number of trades rather than the value of business.