THE COMMITTEE OF EUROPEAN SECURITIES REGULATORS

Ref.: CESR/05-290b

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

1st Set of Mandates where the deadline was extended and 2nd Set of Mandates

April 2005

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INTRODUCTION

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

2. In accordance with the Lamfalussy Process, the European Commission may adopt implementing measures, so-called "Level 2 measures", with respect to a large number of provisions of the MiFID. Before the European 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 20 January 2004 and on 25 June 2004, the Commission published respectively the provisional and formal "*Request 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 and by the end of April 2005. By the end of January 2005 CESR provided the Commission with its technical advice on many areas of this original mandate of the MiFID (Ref.: CESR/05-024c) together with the feedback statement (Ref. CESR/05-025).

4. CESR provides technical advice on the following areas:
   a) definition of investment advice (Art. 4.1);
   b) list of financial instruments – derivatives (Art. 4 – Annex I section C);
   c) investment research (Art. 13.3 and 18);
   d) general obligation to act fairly, honestly and professionally and in accordance with the best interest of the client (Art. 19.1) including portfolio management and best execution and order handling for portfolio management and order reception and transmission;
   e) suitability test (Art. 19.4);
   f) appropriateness test (Art. 19.5);
   g) execution only (Art. 19.6);
   h) best execution (Art. 21);
   i) client order handling (Art. 22.1);
   j) display of client limit orders (Art. 22.2);
   k) transactions executed with eligible counterparties (Art. 24);
   l) pre-trade transparency obligations (Art. 4 and 27);
   m) market transparency obligations (Art. 28-30, 43-45); and
   n) admission of financial instruments to trading (Art. 40).

5. In order to accomplish its tasks on the mandates covered by this advice CESR set up two Expert Groups: Expert Group on Markets, chaired by Mr Karl-Burkhard Caspari and Expert Group on Intermediaries, chaired by Mr Callum McCarthy. (The two Expert Groups on MiFID are coordinated through a steering group, which has been chaired by CESR's Chairman, Mr Arthur Docters van Leeuwen.) The Expert Groups are assisted by a Consultative Working Group formed of 21 market participants by CESR (the complete list of participants is given in Annex 2).

6. The detailed process of the consultation as well as work plan is part of Annex I.

7. A feedback statement (CESR/05-291b) accompanying the advice explains the decisions taken by CESR in response to the major points raised during the public consultations by market participants.

8. CESR responded to the mandates respecting the principles and criteria set by the Commission. In particular, CESR responded efficiently to the content of the mandates; when acting independently, created expert groups; took account of the different opinions expressed by the market participants; struck an appropriate balance between the objective of establishing a set of

harmonised conditions and the need to avoid excessive intervention; and very carefully calibrated the amount of detail included in this advice.

9. In order to offer its proposals, CESR organised several consultations, including three open hearings and a consumer day in order to have input on the proposals from market participants (both from the professionals and from investors' side of the market). It also conducted extensive discussion with the member of the Consultative Working Group.

TECHNICAL ADVICE

SECTION 1 – DEFINITIONS

Explanatory text of general application to the advice and relating to the definitions

For the purposes of consistency CESR has based the concept of investment research on the ancillary service together with the key elements of the definition of a recommendation under Directive 2003/125/EC implementing Directive 2003/6/EC as regards the fair presentation of investment recommendations and the disclosure of conflicts of interest. However, as Article 13(3) of the Directive relates to the organisation of investment firms, instead of the presentation of investment research and the disclosure of conflicts, CESR has proposed to restrict the definition to recommendations other than any recommendation that is clearly labelled as a marketing communication and contains a clear disclosure that is has not been prepared in accordance with certain requirements for the preparation of investment research and where the circumstances relating to the dissemination or presentation of the investment research would not lead a reasonable person to rely on it as investment research.

Communications classified as "investment research" for the purposes of this advice will still be capable of being marketing communications for the purposes of Article 19(2) of the Directive.

CESR's advice has been prepared on the basis that Member States may impose additional requirements in relation to its subject matter.

BOX 1

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

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

c) This advice uses the same definitions contained in the advice issued in January 2005 on the first set of mandates under the MiFID (Ref. CESR/05-024b). In addition, several further definitions are required to assist in the interpretation of the advice.

d) CESR has adopted the following definitions to facilitate comprehension the advice and simplify its structure:

1. "*investment research*" means a general recommendation within the meaning of section B(5) of Annex I to the Directive, to the extent that it recommends or suggests an investment strategy or expresses a particular investment recommendation, explicitly or implicitly, concerning one or more financial instruments or issuers of financial instruments, including any opinion as to the present or future value or price of such instruments, unless each of the following conditions is satisfied:

(i) the information is clearly and prominently labelled as a marketing communication;

(ii) the information contains a clear and prominent disclosure that it has not been prepared in accordance with the requirements designed to promote the independence of investment research and is not subject to the prohibition on dealing ahead of the dissemination of investment research; and

(ii) the circumstances relating to the dissemination or presentation of the information would not lead a reasonable person to rely on it as investment research.

2) "Units of collective investment undertaking" shall refer to open ended and closed ended funds whether they take the form of "units" or "shares"; and

3) "RM" or "MTF" means either the market operator or operator of an MTF or the Regulated Market of MTF itself.

SECTION II – INTERMEDIARIES

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

Extract from Level 1 text

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

Extract from the mandate from the Commission

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

- General recommendations,

- Marketing communications,

- Information given to the clients or from

- Simple offer

- The activities carried out by tied agents.

CESR advice

Explanatory text

In view of the consequences that flow from the characterisation of behaviour as the provision of investment advice (including authorisation and suitability requirements), investment advice should be defined in a proportionate manner, while ensuring an appropriate level of investor protection. In the light of the very wide range of activities that will need to be measured against this definition, it should contain an appropriate level of flexibility and involve the consideration of all relevant circumstances.

In order to ensure the proper application of conduct of business rules and to avoid uncertainty about the point at which investment advice is provided, the definition of investment advice should also include a recommendation that relates to financial instruments generally.

CESR recognizes the implications of this decision and in order to avoid imposing disproportionate requirements CESR considers that entities providing only generic advice should not be submitted to mandatory authorisation; this might happen, for example, through the provisions of Article 2(j) or Article 3 of the Directive, or by excluding from the definition of investment advice recommendations that are not likely to lead to the making of a recommendation relating to a specific financial instrument by the same person.

The term recommendation should be given its natural meaning.

Investment advice is only provided if a recommendation relates to the carrying out of transactions relating to one or more financial instruments. Recommendations on the size of transactions are also capable of being investment advice. Recommendations concerning the proper timing of a transaction may also be included in the definition of investment advice. However, a recommendation on, and the discretion as to, a delay of the execution of a transaction in financial instruments (for example, in order to avoid adverse market impact) will rather constitute an issue of best execution.

In order to prevent the avoidance of the requirements applying to the provision of investment advice, the definition of investment advice should catch communications in which there is no explicit recommendation but where, talking into consideration of all the relevant circumstances, an implicit recommendation is being made.

Recommendations of financial services such as the use of a certain broker, fund manager or custodian would not constitute investment advice unless, taking into consideration all of the relevant circumstances, it is clear that the recommendation of a certain investment service involves an implicit recommendation of a financial instrument. For example, a recommendation may involve an implicit recommendation of a financial instrument if it is a recommendation to invest in equity UCITS made by an investment firm that distributes only one equity UCITS or involves the recommendation of a fund manager who manages only one UCITS.

The provision of information on, or the making of an offer in relation to, financial instruments and financial services can generally be contrasted with investment advice because it does not involve a recommendation. Therefore, the following should generally not be regarded as investment advice when viewed in isolation:

- Explaining the implications of exercising certain rights or the happening of certain events (such as death).
- Providing a credit rating for the issuer of a bond.
- Advising on the likely meaning of uncertain provisions in an agreement relating to, or the terms of, a financial instrument or on the effect of contractual terms and their commercial consequences or on terms that are commonly accepted in the market.
- Explaining the structure, or the terms and conditions of a financial instrument.
- Advising on how to complete an application form.
- Valuing investments for which there is no ready market.
- Listing the prices of financial instruments.
- Circulating company news or announcements.
- Offering to buy or sell particular financial instruments.
- Comparing the benefits and risks of one financial instrument to another.
- Publishing league tables showing the performance of financial instruments of a particular kind against set published criteria.
- Publishing details of directors' dealings in the shares of their own companies.
- Alerting persons to the happening of certain events (for example that shares in company Y have reached a certain price).

However, the provision of information or the making of an offer will constitute the provision of a recommendation and therefore potentially constitute investment advice where, taking into consideration all of the relevant circumstances, it is clear that an implicit recommendation is being made. For example:

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

As well as communications that include an express statement that they are suited to, or based on a consideration of, the client's personal situation, the definition of investment advice should include a communication where the circumstances surrounding it imply that it is suited to, or based on a consideration of, the recipient's personal situation. Therefore, a recommendation will be personal even though it does not expressly involve a consideration of the client's situation if this is implied by a consideration of all of the relevant circumstances.

It is necessary to take all of the relevant circumstances into consideration in evaluating whether a communication falls within the definition of investment advice, including the relationship between the parties and their communication in its entirety. For example, factors indicating that investment advice has been provided could include the fact that the investment firm has requested the information required under the Directive to determine the suitability of a transaction (even if the client has refused to provide this information) or the existence of an agreement to provide investment advice. However, the absence of such an agreement would not prevent a communication constituting investment advice.

The use of a disclaimer by the investment firm may be relevant in determining that no investment advice has been provided, although a disclaimer will not prevent a communication that clearly falls within the definition of investment advice being considered as such.

The nature of the recipient may also be relevant in performing this evaluation. For example, an inexperienced retail investor may be more likely than an institutional investor to interpret a recommendation made to it by an investment firm as suited to, or based on a consideration of, his personal circumstances.

The main criterion for differentiating a "*general recommendation*" from a personal recommendation is the fact that a general recommendation will generally not be understood to be suited to, or based on a consideration of, the recipient's personal circumstances. However, where the substance of a recommendation is common to a number of documents that are each expressed to be suited to or based on a consideration of the circumstances of the recipients, those documents are capable of constituting both personal recommendations and general recommendations.

The main criterion for differentiating a personal recommendation from a "marketing communication" is that the latter is generally not understood to be suited to, or based on a consideration of, the client's personal circumstances and it is intended for public distribution. Moreover, a "*marketing communication*" is, as a rule, not issued on a client's request but at the initiative of the investment firm. However, a general recommendation could also be part of a marketing communication.

A communication by an investment firm may involve an overlap between two or more of the categories of "*personal recommendation*", "*general recommendation*", "*marketing communication*", "*information given to a client*" and "*offer*". In these cases, each relevant regime will apply to the communication by the investment firm.

For example, where an investment firm prepares a brochure, a leaflet or a prospectus that constitutes a general recommendation, a marketing communication and/or involves the provision of information, it is conceivable that this document is also used as a basis for a personal recommendation. Also, if an investment firm prepares a research report and then sends this report with a personalised recommendation to a specific client, the communication may involve both the provision of investment advice and the dissemination of investment research. Therefore, in addition to the regime for the preparation of research, the regime for investment advice may apply if the relevant factors are sufficient to establish that a "*personal recommendation*" has also been given. Likewise, the regime for the making of an offer to the public and the regime for investment advice will apply if a prospectus which meets the other conditions under the Prospectus Directive is used for the provision of investment advice.

Also, overlaps between "*marketing communication*" and "*personal recommendations*" might occur, (for example, where letters are addressed to a wide range of clients for marketing purposes, though

the mail is personalised and appears to be tailored to each recipient's specific situation). Depending on a consideration of all of the relevant circumstances of the particular case, both regimes may apply to such communications.

Tied agents

Concerning the differentiation between "*personal recommendation*" and "*tied agents*", CESR does not see any criteria for a meaningful distinction. Since CESR could only state that tied agents may also provide investment advice within the limits of Article 23(1) MiFID, we decided not to provide advice on tied agents.

Level 2 advice

BOX 2

Definition of personal recommendation

1. "*Personal recommendation*" means any communication that, taking into consideration all of the relevant circumstances, it is reasonable to understand as being:

    a. a recommendation to:

        i. buy, sell, subscribe for, exchange, redeem, hold or underwrite one or more financial instruments; or

        ii. exercise, or not to exercise, any right conferred by one or more financial instruments to buy, sell, exchange, redeem or subscribe for one or more financial instruments; or

        iii. carry out any other transaction relating to one or more financial instruments; and

    b. suited to, or based on a consideration of the personal circumstances of the recipient.

2. Communications in which there is no explicit recommendation will still be recommendations for this purpose where, talking into consideration of all the relevant circumstances, an implicit recommendation is being made.

3. The relevant circumstances that may be taken into consideration when determining whether investment advice is being provided include, among others:

    a. the communication in its entirety and any other communications between the parties; and

    b. the relationship between the parties including the nature of the recipient.

Differentiation with other terms

4. In comparison with a personal recommendation, in most cases, a "*general recommendation*" would not be understood to be suited to, or based on a consideration of, the recipient's personal circumstances.

5. In comparison with a personal recommendation, in most cases, a "*marketing communication*" would not be understood to be a recommendation that is suited to, or based on a consideration of, the recipient's personal circumstances and would be issued to the public. A "*Marketing communication*" is generally not prepared on a client's request but at the initiative of the investment firm.

6. In comparison with a personal recommendation in most cases, "*information given to the client*" is factual information that would not be understood to be suited to, or based on a consideration

of, the recipient's personal circumstances, nor would it include a recommendation in respect of one or more financial instruments or specific transactions or be intended to influence the client in this respect.

7. In comparison with a personal recommendation, in most cases, an "*offer*" would generally lack a recommendation in respect of one or more transactions in financial instruments and would not be understood as being suited to the recipient's personal circumstances.

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

CESR

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

Extracts from Level 1 text

Article 4: Definitions

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

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

- *the derivative contracts mentioned in Section C 7 of Annex I that have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are cleared and settled through recognised clearing houses or are subject to regular margin calls*
- *the derivative contracts mentioned in Section C 10 of Annex I that have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are traded on a regulated market or an MTF, are cleared and settled through recognised clearing houses or are subject to regular margin calls;*

Annex I – list of services and activities and financial instruments

Section C – Financial instruments

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

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

Extract from the mandate from the Commission

3.1(1) Definition of commodity

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

(1) A definition of commodity.

CESR advice

Explanatory text

CESR's advice on this mandate is limited to the meaning of "commodity" for the purposes of the definition of a financial instrument (sections C(5), (6) and (7) of Annex I to the Directive). It is not intended to affect the various definitions of "commodity" in national and other legislation for other purposes.

It is neither feasible nor helpful to provide an exhaustive list of commodities for the purposes of the Directive. The advice therefore adopts a more generalised definition.

The ability to deliver goods that are to be treated as commodities should not, for the purpose of the definition of "*commodity*", require the physical movement of goods from one place to another if the commercial environment applicable to those goods does not necessitate this.

A number of the paragraphs in Annex I to the Directive that cover derivative instruments use the phrase "relating to". CESR considers that this phrase refers to a direct link between the derivative contract and the relevant underlying commodity or factor. Thus, for example, a contract for differences based on the price of crude oil would be a derivative contract relating to oil. Conversely, a contract for differences based on the transportation costs for oil would not be a derivative instrument relating to oil, but rather one relating to oil transportation costs.

A derivative that relates to a commodity derivative (such as an option on a commodity future) is a derivative relating to a derivative, rather than a derivative relating to a commodity and therefore falls within section C(4) of Annex I to the Directive rather than sections C(5) to (7). However, it still constitutes an indirect investment in commodities and should therefore still be regarded as a commodity derivative for the purposes of Articles 2(1)(i) and (k) of the Directive.

Level 2 advice

BOX 3

1. The concept of a "*commodity*" covers any goods of a fungible nature that are capable of being delivered.

2. This includes (but is not limited to) metals and their ores and alloys, agricultural products, energy supplies (including electricity), and raw materials and may also include the products and by-products of, and the things that are derived from, such things.

3. For these purposes, "*delivery*" should be one of:

   a) physical delivery of the relevant goods themselves;

   b) delivery of a document giving rights of an ownership nature to the relevant goods or the relevant quantity of the goods concerned (such as a bill of lading or a warehouse warrant); or

   c) another method of bringing about the transfer of rights of an ownership nature in relation to the relevant quantity of goods without physically delivering them (including notification, scheduling or nomination to the operator of an energy supply network) that entitles the recipient to the relevant quantity of the goods.

   This concept of "delivery" should also be used to determine whether a contract can be physically settled and therefore falls within section C(6) or (7) of Annex I to the Directive.

4. The concept of a "*commodity*" should not include services or other items that are not goods (such as currencies or rights in real estate) or that are entirely intangible.

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

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

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

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

CESR advice

Explanatory text

It is appropriate to address together the questions of whether a contract has been made for commercial purposes and whether it has the characteristics of another derivative contract.

CESR's advice on this mandate is only intended to be used for the purposes of determining which contracts fall within section C(7) of Annex I to the Directive and is not intended to be used for other purposes, such as interpreting sections C(5) and (6) of Annex I to the Directive or for determining the scope of close out netting mechanisms.

The level 1 text of section C(7) refers to contracts "not being for commercial purposes" in addition to whether they have "the characteristics of other derivative financial instruments". Therefore a consideration of both the characteristics of the contract and of the purposes for which it is used is required by the level 1 text. This is appropriate because the question of when a physically settled contract for the delivery of commodities ceases to be a simple commercial contract and becomes a financial instrument raises different policy questions from the treatment of cash settled contracts (or contracts with an option for cash settlement) and contracts that are traded on a regulated market or MTF. There is much greater potential for overlap between general commercial activities and investment services and activities in relation to such contracts.

The advice is intended to strike an appropriate balance between achieving certainty where possible, without unduly extending or restricting the scope of the Directive. It first sets out factors that are intended to be determinative and are intended to provide certainty in many cases. It then sets out indicia that should be considered where none of the determinative factors is present. If a number of indicia are relevant, it is important to avoid giving any single one undue weight. Instead, all of the indicia should be considered together to determine the overall nature of the transaction.

This approach is intended to provide certainty in more straightforward cases. However, it is not possible to devise a test that will allow the question to be answered in an appropriate manner with certainty in every case. While additional determinative factors would increase the level of certainty, they would also result in the inclusion of contracts within the definition of a financial instrument that should properly be excluded or the exclusion of contracts that should properly be included.

A derivatives market may require its members to trade on the market as principal, even where executing an order on behalf of a client. Reasons for such requirements may include the effective operation of netting arrangements. In such a case, the member of the market may enter into a matching back-to-back derivative contract with its client. Even though such a back-to-back contract is not traded on a regulated market, MTF or equivalent third party market, it should be classified as a financial instrument.

One of the determinative factors depends on whether the settlement period for the underlying exceeds the lesser of two business days and the generally accepted settlement period in the relevant market. This factor is only intended to be relevant for the purposes of determining whether a contract falls outside of the scope of section C(7) and should not be used for other purposes. It is not intended to constitute a definition of a "spot" contract. At the time an option contract is entered into, it is not known whether the underlying will be delivered, as this will depend upon whether or not the option is exercised. This factor is therefore not relevant to options.

Certain commodities, such as electricity, are, because of their nature, traded in relation to specified periods of time. The first stage of the settlement of transactions in such commodities may take place through notification, scheduling or nomination (for example, to the operator of an energy supply network) before the time period to which the contract relates. However, delivery of the underlying should not be seen as having been completed until the start of the time period to which the contract relates.

The fact that both of the parties to the contract have the same intention in relation to the delivery of the underlying also provides a determinative factor. As the intention of the parties may change during the life of the contract, this test should apply by reference to the intention of the parties at the time of the formation of the contract. The pattern of behaviour of the parties may, in conjunction with any other relevant evidence, be relevant in determining their intention. In some contexts, the position will be very clear from the circumstances. In particular contracts for the future delivery of goods intended for domestic consumption will usually, under the intention to deliver test, not be within the scope of commodity derivatives under the Directive. The fact that the preferred outcome of a person who writes an option is likely to be that the option is not exercised should not be taken into account for the purposes of this evaluation.

Level 2 advice

BOX 4

1. The following paragraphs set out factors for determining whether a derivative contract in relation to commodities (which can be physically settled and is not otherwise covered by Section C(6)) ("relevant contract") is or is not made for commercial purposes and has the characteristics of other derivative financial instruments. Certain of these factors are determinative, while others are merely indicators. The determinative factors in paragraph 2 should be considered first. Where neither of these is present, the determinative factors in paragraph 3 should be considered next. Where none of these are present, the determinative factors in paragraph 4 should be considered next. Where none of these are present, the indicative factors in paragraphs 5 and 6 should be considered. When the indicative factors are considered, all of those factors must be considered and the overall picture based on those indicators taken as the result. Such indicative factors should be considered to have equal weight.

Determinative factors

2. If either of the following factors is present, a relevant contract is to be regarded as not made for commercial purposes and as having the characteristics of another derivative financial instrument.

   a) The contract is traded on a third country marketplace or trading facility that is equivalent to a regulated market or an MTF.

   b) The contract is expressed to be traded on a regulated market, an MTF or an equivalent third country marketplace or trading facility or is expressed to be equivalent to such a contract (even though not traded on such a market or facility).

3. If any one or more of the following factors is present, a relevant contract is to be regarded as made for commercial purposes and as not having the characteristics of another derivative financial instrument.

   a) Under the terms of the contract (other than an option contract), delivery of the underlying is to be made within the lesser of:

      i) two business days; and

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

unless it can be shown that there existed an understanding that delivery would not be made within that period.

If, because of its nature, the underlying is sold in relation to a specified period of time, delivery of the underlying for this purpose takes place at the start of the time period to which the contract relates.

b) The contract is entered into with or by the operator of an energy transmission grid or pipeline network, and is either for the purpose of ensuring security of energy supplies or is necessary to keep in balance the supplies and uses of energy at a given time.

c) The seller intends to deliver the underlying and the purchaser intends to take delivery of it, where any such intention should be determined in accordance with paragraphs 7 and 8.

4. If any one or more of the following factors is present, a relevant contract is to be regarded as not made for commercial purposes and as having the characteristics of another derivative financial instrument.

a) Each party lacks the legal capacity or any necessary permit or licence to make or take delivery of the underlying.

b) The seller does not intend to deliver the underlying and the purchaser does not intend to take delivery of it, where any such intention should be determined in accordance with paragraphs 7 and 8.

Indicative factors

5. The following are indications that a relevant contract is made for commercial purposes, and does not have the characteristics of another derivative financial instrument.

a) One or more of the parties is a producer of, or commercial merchant in relation to, the commodity or uses it in his business.

b) The seller intends to deliver the underlying or the purchaser intends to take delivery of it, where any such intention should be determined in accordance with paragraphs 7 and 8.

c) The price, the lot, the delivery date or other terms are determined by the parties for the purposes of the particular contract and not by reference (or not solely by reference) to regularly published prices, to standard lots or standard delivery dates.

6. The following are indications that a relevant contract is not made for commercial purposes, and that it has the characteristics of another derivative contract:

a) Performance of the contract is enforced by a regulated market, an MTF or an equivalent third country marketplace or trading facility or a clearing house.

b) There are arrangements for the payment or provision of margin in relation to the contract.

c) Neither party is a producer, of, or commercial merchant in relation to, the commodity nor uses it in his business.

d) Neither party intends to have an obligation for immediate physical delivery of the commodity at any time determined in accordance with paragraphs 7 and 8.

e) The price, the lot, the delivery date or other terms are determined solely by reference to regularly published prices, to standard lots or standard delivery dates.

Intention of the parties

7. The intention of the parties in relation to delivery of the underlying should be determined as at

the moment of formation of the contract.

8. Amongst other things, the following may be used for the purpose of determining the intention of the parties in relation to delivery of the underlying:

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

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

   c) any course of dealings between the parties;

   d) any history of behaviour in relation to equivalent transactions with other parties; and

   e) the parties' direct ownership positions in the underlying.

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

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

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

BOX 5

The terms used in Annex I, section C(10) are sufficiently certain and understandable. Implementing measures for their definition are therefore unnecessary.

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

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

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

CESR advice

Explanatory text

It is necessary to take account of the continuing development of the financial derivatives markets. The advice therefore sets out general criteria for determining the types of underlying that are intended to fall within the scope of section C(10) of Annex I.

In order to provide certainty and to include certain underlyings within the scope of section C(10) that may not fall within the general criteria, the advice also identifies certain specific underlyings that are intended to fall within the scope of section C(10) in their own right, regardless of whether they satisfy the general criteria.

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

the applicable register of emissions allowances should also be capable of falling within section C(10).

Derivative contracts relating to geological, environmental or other physical variables, such as levels of streamflow, should be capable of being financial instruments.

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

Level 2 advice

BOX 6

1. A derivative contract relating to emissions allowances that is settled by amendment of the parties' positions on the applicable register of emissions allowances should fall within section C(10) of Annex I to the Directive if the other criteria set out in that section are satisfied in relation to it.

2. A derivative contract relating to any of the following underlyings should fall within section C(10) of Annex I to the Directive if the other criteria set out in that section are satisfied in relation to it:

   b) telecommunications bandwidth;

   c) commodity storage capacity;

   d) transmission or transportation capacity relating to commodities, whether cable, pipeline or other means;

   e) an allowance, credit, permit, right or similar asset which is directly linked to the supply, distribution or consumption of energy derived from renewable resources;

   f) a geological, environmental or other physical variable;

   g) any other asset, right or obligation of a fungible nature (other than a right to receive, or an obligation to provide, a service) that is capable of being transferred; or

   h) an index or measure related to the price or volume of transactions in any asset, right, service or obligation.

3.1(6) Characteristics of other derivative financial instruments

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

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

CESR advice

Explanatory text

Recital (4) to the Directive states that it is intended to apply to derivatives that are constituted and traded in such a manner as to give rise to regulatory issues comparable to traditional financial instruments. Therefore, a derivative relating to another asset, right, obligation or index will have the characteristics of other derivative financial instruments if:

- (by analogy with section C(5)) it is settled in cash or may be settled in cash at the option of one or more of the parties (otherwise than by reason of a default or other termination event);

- (by analogy with section C(6)) it does not fall into the above category, but is traded on a regulated market and/or an MTF; or

- (by analogy with section C(7)) it does not fall into either of the above categories but is not a contract for a commercial purpose and has the characteristics of other financial instruments, where both such concepts are interpreted in the same way as for section C(7), with the necessary modifications where the underlying is intangible. For example, in the case of a derivative contract relating to emissions allowances, delivery would involve the amendment on the parties' positions on the applicable register of emissions allowances and the process of delivery would commence with the submission by each of the parties of the relevant application for amendment of their position on the register.

Level 2 advice

BOX 7

A derivative relating to climatic variables, freight rates, emission allowances, inflation rates and other official economic statistics or any of the underlyings identified in the advice under mandate 3.1(5) will have the characteristics of other derivative financial instruments if:

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

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

3. it does not fall into either of the above categories but is not a contract for a commercial purpose and has the characteristics of other financial instruments, where both such concepts are interpreted in the same way as for section C(7), with the necessary modifications where the underlying is intangible.

Conflicts of interest (Articles 13(3) and 18))
Investment research

Extract from Level 1 text

Article 13(3) - An investment firm shall maintain and operate effective organisational and administrative arrangements with a view to taking all reasonable steps designed to prevent conflicts of interest as defined in Article 18 from adversely affecting the interests of its clients.

Article 18(1) - Member States shall require investment firms to take all reasonable steps to identify conflicts of interest between themselves, including their managers, employees and tied agents, or any person directly or indirectly linked to them by control and their clients or between one client and another that arise in the course of providing any investment and ancillary services, or combinations thereof.

Article 18(2) - Where organisational or administrative arrangements made by the investment firm according to Article 13(3) to manage conflicts of interest are not sufficient to ensure, with reasonable confidence, that risks of damage to client interests will be prevented, the investment firm shall clearly disclose the general nature and/or sources of conflicts of interest to the client before undertaking business on its behalf.

Extract from the mandate from the Commission

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

(1) the appropriate criteria for determining the types of conflict of interest whose existence may damage the interests of the clients or potential clients of the investment firm;

(2) the steps that investment firms might reasonably be expected to take to identify, prevent, manage and/or disclose conflicts of interest when providing various investment and ancillary services and combinations thereof.

CESR advice

Explanatory text

This advice addresses the management of conflicts of interest arising from the provision of investment research, providing a number of minimum organisational measures to be considered by investment firms when setting out their conflicts policy. These particular provisions, which are based on IOSCO standards, are complementary to the provisions of Directive 2003/6/EC on insider dealing and market manipulation ("Market Abuse Directive"), the implementing measures contained in the Directive 2003/125/EC as regards the fair presentation of investment recommendations and the disclosure of conflicts of interest, and to the proposals for the management of conflicts included in the CESR's Technical Advice on Possible Implementing Measures of the Directive 2004/39/EC on Markets in Financial Instruments.

Article 13(3) of the Directive by reference to Article 18(1) refers to the management of conflicts of interest arising from both the provision of investment and ancillary services and from combinations thereof. In the light of this, specific provisions are necessary for the proper prevention or management of conflicts of interest arising both from the provision of investment research, and from the interactions of this ancillary service with other services and activities.

The proposed measures for the management of conflicts are applicable to investment research that is produced and intended for dissemination outside investment firms and their groups whether orally or in a written format. This excludes investment research that is only produced for internal use by

these investment firms and the members of their group. It is also necessary to address cases in which investment firms disseminate investment research produced by another person, unless that research is produced by a third party and is not substantially altered by the investment firm. It is also necessary to prevent investment firms from circumventing these requirements by appointing a member of their group to provide investment research to their clients.

It is necessary that restrictions on trading in financial instrument to which investment research relates should also apply to other related financial instruments. For example, this would be the case where the person trades in a financial instrument whose value is likely to be materially affected by the investment research.

The restrictions on personal dealing by the relevant persons involved in the preparation of investment research should be implemented according to the advice on personal transactions under Article 13(2) of the Directive.

BOX 8

1. Where an investment firm produces investment research that is intended, or is likely, to be disseminated to one or more persons outside of its group, its conflicts policy shall include the following minimum requirements in relation to the preparation of that investment research:

   a) a relevant person involved in the production of the investment research must not trade in financial instruments to which the investment research relates or any related financial instruments ahead of disseminating that investment research;

   b) a relevant person who produces the substance of the investment research must not trade in financial instruments to which the investment research relates or any related financial instruments in a manner contrary to their existing recommendations, except in special circumstances subject to pre-approval by compliance or legal personnel;

   c) a relevant person who produces the substance of the investment research must not accept any payment or inducement from issuers, or others with a material interest in the subject matter of the investment research, other than minor gifts or hospitality below a value specified in the conflicts policy;

   d) the investment firm must not promise issuers favourable research coverage including specific ratings, or specific target prices, in return for a future or continued business relationship, service or investment;

   e) issuers, the investment firm's relevant persons or any other person with a material interest in the subject matter of investment research, may only be permitted to review draft investment research for the purpose of verifying the accuracy of factual statements made in that research. This draft investment research must not include a recommendation or a target price;

   f) effective information barriers must be established between relevant persons who produce the substance of investment research and:
      (i) the firm's corporate finance business; and
      (ii) the firm's other business activities involving a material conflict of interest that may affect the objectivity of the relevant person who produces the substance of the investment research;

   g) a relevant person who produces the substance of the investment research must not be directly supervised by a natural person who has responsibilities or interests that might reasonably be considered to conflict with the interests of the clients to whom the investment research is disseminated;

h) the remuneration of a relevant person who produces the substance of the investment research must not
   (i) be directly determined by a person who is prohibited from supervising them under sub-paragraph (g); or
   (ii) create any incentive which is inconsistent with their objectivity, or could reasonably be considered to be so; and

i) a relevant person who produces the substance of the investment research must not become involved in activities other than the preparation of investment research (such as participating in investment banking activities such as corporate finance business and underwriting, or attending and/or participating in pitches or "road shows" or being involved in the preparation of issuer marketing), where such involvement is inconsistent with that person's objectivity, or could reasonably be considered to be so.

2. Where an investment firm alters the substance of investment research that it did not produce and disseminates it to a person outside of its group, the same requirements should apply to the alteration of that investment research as would apply to the production of investment research by that investment firm.

3. Where an investment firm:

a) disseminates investment research that it did not produce to a person outside of its group; or
b) arranges for a member of its group to produce and disseminate investment research to the investment firm's clients in connection with the provision of investment services by the investment firm to these clients where such clients are not part of the investment firm's group,

it must:

x) take all reasonable steps to ensure that the producer of that investment research establishes, maintains and effectively implements an effective written conflicts policy that includes the minimum requirements set out in paragraph 1 in relation to the production of that research; and

y) include all of the minimum requirements set out in paragraph 1 in its conflict policy on the basis that the producer of that investment research must be treated as if it were a relevant person of the investment firm producing the substance of investment research.

4. An investment firm that disseminates investment research produced by another person to a person outside of its group does not need to comply with the requirements in paragraph 3 if each of the following conditions is met:

a) the person that produces the investment research is not a member of the investment firm's group;
b) the investment firm does not alter the substance of the investment research;
c) the investment firm does not present the investment research as having been produced by it;
d) the investment research indicates clearly and prominently the identity of the person that produced it,
e) the investment firm either:

   i) verifies that the person that produced the investment research is an investment firm or is subject to national regulation by the competent authority of a Member State that requires it to establish, maintain and effectively implement an effective written conflicts policy that includes the minimum requirements set out in paragraph 1 in relation to the production of that research; or
   ii) obtains written confirmation from the person that produced the investment research that it has established and that it maintains and effectively implements an effective written conflicts policy that includes the minimum requirements set out in paragraph 1 in relation to the production of that research, unless it knows that such written confirmation is not correct.


CESR

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

Extracts from Level 1 text

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

Extract from the mandate from the Commission

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

CESR advice

Explanatory text

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

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

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

Level 2 advice

BOX 9

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

Suitability test (Article 19(4))

Extract from Level 1 text

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

Extract from the mandate from the Commission

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

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

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

CESR advice

Explanatory text

Criteria for assessing the minimum level of information

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

The advice takes the status of professional clients into account. Since a professional client is deemed to have sufficient knowledge and experience, an investment firm does not need to obtain information on the professional client's knowledge and experience other than the information obtained to determine the client's professional status according to the procedure under Annex II of the Directive. Where the client or potential client is classified as a professional client for some transactions, products or services, but not for others, this should only apply to the extent that the client is classified as a professional client.

Article 19(4) also makes it clear that only information regarding the client's or potential client's knowledge and experience "in the investment field relevant to the specific type of product or service" must be obtained. Generally, investment firms must obtain from the client or potential client at least information on his knowledge and experience concerning the investment services and types of financial instruments he is interested in or which the investment firm intends to recommend. For example, if the client or potential client is only interested in shares, the investment firm does not need to obtain other information on the client's knowledge and experience in derivatives such as options or futures. However, in certain cases, the wider knowledge and experience of the client or

potential client may be relevant. For example, this may be the case where the client or potential client does not have any knowledge and experience in the envisaged services or transactions.

If the client or potential client does not provide all information requested by the investment firm, generally, the investment firm has to assess whether the information received is sufficient to provide the specific investment advice or portfolio management services envisaged, i.e. to comply with the suitability-test under Article 19(4) of the Directive. If the information obtained from the client or potential client is not sufficient to conduct the suitability-test in relation to the specific investment advice or portfolio management service envisaged (for instance, advice on extremely complex derivative instruments or high risk portfolio management services), the investment firm may provide the investment advice or portfolio management service which it considers suitable depending on the extent of information provided by the client or potential client. If the client or potential client fails to provide information that is required to be obtained by the investment firm under Article 19(4) of the Directive and the necessary information is not otherwise available to the investment firm, the only basis on which it may proceed is a cautious basis in respect of that missing information while providing the services of investment advice or portfolio management (for example, if no information is provided by a retail client in respect of his knowledge and experience, it may proceed on the basis that this client does not possess any knowledge or experience). However, alternatively, the investment firm may provide other investment services such as services under Article 19(5) and Article 19(6).

However, the investment firm shall not invite the client or potential client not to provide any information. The possibility for an investment firm to proceed on a cautious basis where a client refuses to provide information does not affect the requirement set out in CESR's advice under Article 19(7) of the Directive that the retail client agreement for the provision of portfolio management services must set out the management objectives, including the level of risk agreed upon and any specific constraints on the investment firm's discretion.

In line with the mandate, the advice sets out criteria for assessing the minimum level of information that should be obtained instead of the minimum information that should be obtained in any particular case.

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

Criteria for assessing the suitability

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

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

The factors that have to be taken into account in the suitability-test may vary according to the nature and extent of the service provided. For example, the knowledge and experience of the client or potential client may be more relevant to the provision of investment advice than to the provision of a portfolio management service. In the case of investment advice, the client must evaluate the advice provided by the investment firm and decide whether to enter into a transaction (although different advisory services may involve the investment firm providing different levels of support to the client in evaluating the advice). In the case of a portfolio management service, the investment firm retains discretion over individual transactions. As a result, the knowledge and experience of the client or potential client is relevant in respect of the determination whether the client is able to understand the implications of the service he is to be provided with and to evaluate that service once it has been provided.

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

If the suitability-test is limited to recommendations or decisions to trade, it would not apply to inaction by the firm. However, a portfolio manager will generally be appointed to keep the client's portfolio under review. It should therefore take reasonable steps to review the suitability of the client's portfolio in addition to conducting the suitability-test in relation to each decision to trade. This sort of arrangement is not confined to portfolio managers. In some instances, an investment advisor will have accepted a similar responsibility for keeping the client's portfolio under review. Where this is the case, the suitability obligation shall apply in respect of the evaluation of the portfolio as well as any recommendation.

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

Level 2 advice

BOX 10

Criteria for assessing the minimum level of information from the client

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

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

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

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

and/or tax efficiency.

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

   a) Whether the information is necessary and sufficient to enable the investment firm to provide the service to the client or potential client, which will be determined by:

      i) the type and characteristics of the transaction and financial instrument that will be subject to the investment advice or the portfolio management service; and

      ii) the nature and extent of the service to be provided to the client or potential client and the risks involved in, and the complexity of, the envisaged transactions.

      For example, limited information may be sufficient if the client or potential client has restricted the investment advice or the portfolio management service to a certain amount of his liquid assets and confirmed that the risk of partial or total loss does not exceed his financial capacity.

      The investment firm should also take into account other relevant circumstances, such as whether the intended transactions will be paid from the client's own funds or will be financed with loans, to which extent these transactions are exposed to the risk of loss, margin requirements, leverage or other risks that can affect the ability of the client to bear the risks of the envisaged transactions.

   b) An investment firm does not need to obtain information on a professional client's knowledge and experience other than the information obtained to determine the client's professional status according to the procedure under Annex II of the Directive. Where the client or potential client is classified as a professional client for some transactions, products or services, but not for others, this should only apply to the extent that the client or potential client is classified as professional client.

3. An investment firm must not invite a client or potential client not to provide information.

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

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

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

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

Criteria for assessing the suitability

6. An investment firm providing investment advice or portfolio management services must take

all reasonable steps to ensure the suitability of each envisaged transaction taking into account the following factors in light of the information disclosed to it by the client or potential client:

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

b) Giving due consideration to the nature and extent of the service provided, the investment firm must take the knowledge and experience of the client or potential client and his financial situation into account regarding the envisaged transactions, especially their complexity and the risks involved.

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

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

9. If a client or potential client fails to provide any information that is required to be obtained by an investment firm under Article 19(4) of the Directive and the necessary information is not otherwise available to the investment firm, the only basis on which it may proceed with the service of investment advice or portfolio management is a cautious basis in respect of that missing information (for example, if no information is provided by the retail client in respect of his knowledge and experience, it may proceed on the basis that the client or potential client does not possess any knowledge or experience).

10. Where an investment firm provides investment advice to a client on the basis that it will keep that client's portfolio under review or where an investment firm acts as a portfolio manager, it must take reasonable steps to ensure that the portfolio in relation to which it has been appointed remains suitable, having regard to the factors in paragraph 6.

CESR

Appropriateness test (Article 19(5))

Extract from Level 1 text

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

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

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

Extract from the mandate from the Commission

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

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

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

CESR advice

Explanatory text

Annex II to the Directive stipulates that a professional client "per se" is a client who possesses the experience, knowledge and expertise to make his own investment decisions and to properly assess the risk that he incurs, CESR is therefore of the opinion that information regarding the knowledge and experience of professional clients "per se" does not need to be requested. These professional clients are deemed to have sufficient knowledge and experience in all investment services and activities and financial instruments, unless a non-professional treatment (i.e. a higher protection) is agreed upon. Regarding a client who may be treated as a professional client according to the criteria and procedure under Annex II paragraph II, the investment firm does not need to obtain more information on the client's knowledge and experience than needed for the assessment whether to classify him as professional for the relevant transactions. CESR therefore believes that an investment firm should be deemed to have satisfied its obligations under Article 19(5) in relation to a professional client by determining the professional status of that client, unless it is agreed that a higher degree of protection should be provided. Where a client is classified as a professional client for some transactions, products or services, but not for others, this should only apply to the extent that the client is classified as professional client

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

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

Criteria for assessing the appropriateness

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

Content of the related warnings

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

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

<u>Level 2 advice</u>

BOX 11

Minimum Level of information to be obtained from the client

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

2. The information to be requested from a client or potential client on his knowledge and experience depends on the type of product or transaction envisaged, including the risks involved in and the complexity of the transactions, and the nature and extent of the service to

be provided by the investment firm.

3. An investment firm does not need to obtain information on a professional client's knowledge and experience other than the information obtained to determine the client's professional status according to the procedure under Annex II of the Directive. Where the client or potential client is classified as a professional client for some transactions, products or services, but not for others, this should only apply to the extent that the client is classified as a professional client.

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

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

Criteria for assessing the appropriateness

6. For assessing the appropriateness of the transaction, service or product envisaged, an investment firm shall define, on the basis of the information obtained from the client or potential client, appropriate investment parameters (for example, the types of instruments, types of transactions or types of orders, of which the client has sufficient knowledge or experience).

7. An envisaged transaction, product or service should be deemed to be appropriate to the extent that the client is classified as professional client in relation to the envisaged transaction, product or service.

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

Execution only (Article 19(6))

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

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

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

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

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

Extract from the mandate from the Commission

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

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

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

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

- The content of the related warnings.

CESR advice

Explanatory text

The mandate under Article 19(6) of the Directive is restricted to a recommendation of criteria for the determination of the terms "non-complex instruments" and "at the initiative of the client", as well as advice on possible implementing measures on the content of the related warnings.

Non-complex instruments

When determining criteria for what is to be considered a non-complex instrument, it is important to note that markets are open and constantly changing and firms should be able to develop new products and instruments to meet market and consumer demand. The criteria for non-complex

instruments should therefore be considered as high level principles that are flexible and should leave enough space to allow for the emergence of new types of instruments.

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

The criteria provided in the advice are intended to provide the necessary flexibility for a wide range of existing and innovative financial instruments. However, CESR recognises that level 1 intends to exclude derivatives as financial instruments which are available for the service under Article 19(6).

The financial instruments that are expressly identified in the first indent of Article 19(6) of the Directive (shares admitted to trading on a regulated market, or in an equivalent third country market, money market instruments, bonds or other forms of securitised debt (excluding those bonds or securitised debt that embed a derivative) and UCITS), are automatically non-complex financial instruments. The tests set out in this advice to determine whether financial instruments are non-complex therefore only apply to those financial instruments that are not expressly identified in the first indent of Article 19(6).

Moreover, CESR is aware that the practical implications of the Level 2 advice may require further work under level 3.

At the initiative of the client

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

CESR is of the opinion that Recital 30 already addresses very specific circumstances and provides concrete orientation for the question when a service is considered to be provided at the initiative of the client. The concept of Recital 30 is clearly outlined so that any additional criteria are likely to interfere with this concept agreed on Level 1. Thus, CESR advises the European Commission not to implement any level 2 measures beyond Recital 30.

Content of the related warnings

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

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

According to this reading of level 1, it seems to be evident that additional level 2 measures are not necessary in this respect. Moreover, the mandate of the EU Commission asked CESR to strike the

right balance between a comprehensive set of rules and excessive intervention in order to avoid overregulation (*see 2.3. of the mandate*). Thus, CESR advises the EU Commission not to implement any level 2 measures regarding the content of the related warnings.

Level 2 advice

BOX 12

Definition of "non-complex instrument"

A financial instrument that is not expressly identified in the first indent of Article 19 (6) of the Directive shall be a non-complex instrument if it meets each of the following conditions:

a) It is not a derivative financial instrument; and

b) There are frequent opportunities to dispose of, redeem, or otherwise realise it at prices that are frequently available to investors in it; and

c) It does not involve any actual or potential liability for an investor that exceeds the amount of his acquisition costs (any commitment that represents a genuine contribution to its acquisition costs should be regarded as part of the acquisition costs for this purpose); and

d) Adequate information on its characteristics, including

(i) its structure; and

(ii) the costs and expenses for acquiring, holding and realising an investment in it; and

(iii) other factors that may have material effect on its performance

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

"At the initiative of the client"

Regarding the determination of the criteria when a service is considered to be provided at the initiative of the client, no Level 2 measures should be implemented, since this is sufficiently addressed in Recital 30.

Content of related warnings

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

CESR

Best Execution and Order Handling for Portfolio Management and Order Reception and Transmission (Article 19(1))

Extract from MiFID (Markets in Financial Instruments Directive)

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.

Extract from mandates from the Commission

DG Internal Market requests CESR to provide technical advice on possible implementing measures 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.

CESR Advice

Explanatory Text

Investment firms that provide the service of portfolio management or order reception and transmission often, as part of that service, select one or more investment firms to provide the service of executing orders on behalf of their clients and also may instruct them on how or where to execute. As a result, investment firms that provide the service of portfolio management or order reception and transmission often play an important role in determining the quality of execution that their clients receive.

Moreover, in many business models, an investment firm that provides the service of portfolio management or order reception and transmission may select an entity to execute its client orders that is not subject to the requirements of Article 21 of the Directive. For example, the investment firm's client may not have a separate contractual or agency relationship with the investment firm that provides the service of execution. Where this is the case, the firm that provides the service of execution is not subject to the best execution requirements with respect to those clients. (See MiFID Recital 33 of the Directive). A similar problem arises when an investment firm that provides the service of portfolio management or order reception and transmission selects an entity to execute its client orders that is not subject to the requirements of the Directive at all (for example, an entity in a third country). In both of these cases, if the best execution requirements are not applied to investment firms that provide the services of portfolio management or order reception and transmission, then many of their clients will not enjoy any of the protections afforded by the best execution requirements.

An investment firm should not be permitted to select another entity to execute its client orders unless it takes all reasonable steps to ensure that the entity achieves the best possible result for its client orders on a consistent basis. Furthermore, clients should benefit from the full protections of the best execution requirements, regardless of whether their orders are executed by the investment firm with which they have a contractual relationship or by another entity selected by their investment firm.

However, the best execution requirements should be applied in a flexible manner to provide investment firms with broad discretion in how they organise their business models in general and their execution arrangements in particular.

Likewise, an investment firm that is providing the service of order reception and transmission or portfolio management should implement procedures and arrangements which provide for the prompt, fair and expeditious carrying out of orders on behalf of its clients, relative to other client orders or trading interests of the firm.

BOX 13

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 executing orders shall be treated as references to carrying out decisions to deal in financial instruments by the investment firm on behalf of its client;

(b) 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 executing shall be treated as references to the investment firm instructing another to execute or transmit orders for execution; and

(b) cross references shall be read accordingly.

CESR

Best Execution (Article 19(1) and 21)

Extract from MiFID (Markets in Financial Instruments Directive)

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.

Extract from mandates from the Commission

DG Internal Market requests CESR to provide technical advice on possible implementing measures 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.

CESR Advice

Explanatory Text

It is not appropriate for regulatory requirements to pre-determine the relative importance of the factors under Article 21(1) of the Directive because each investment firm is best placed and should retain the flexibility to tailor its execution policy to its particular strategies and goals. However, the best execution requirements do not leave complete discretion to the investment firm to define whatever execution policy and arrangements it likes. The investment firm must devise arrangements (including an execution policy) that fulfil the best execution requirements, including the requirement to take all reasonable steps to achieve the best possible result when carrying out orders on behalf of their clients.

Level 2 advice

BOX 14

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 to which an investment firm directs a client order for execution and may include regulated markets, MTFs, systematic internalisers, investment firms, 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.

Extract from mandates from the Commission

DG Internal Market requests CESR to provide technical advice on possible implementing measures 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.

The criteria an investment firm should consider in selecting and reviewing venues for its execution policy derive from the factors articulated in the level 1 text of the Directive, as applied in the context of each firm's particular business model. The level 2 advice adds some certainty to this analysis by articulating several criteria (factors and costs) that investment firms may take into account in performing these analyses. However, the Level 2 advice is not intended to provide an exhaustive list of criteria. It remains with investment firms to develop the factors in the Level 1 text and the Level 2 advice, as appropriate, in the specific context of their business, subject always to the Level 1 requirement that they take all reasonable steps to achieve the best possible result, when executing orders on behalf of clients.

Level 2 advice

BOX 15

1. An investment firm must not leave a gap of more than 12 months between each review of its execution policy and arrangements.

2. An investment firm must review its execution policy and arrangements more frequently whenever this is reasonably necessary to verify that:

(a) its execution policy includes venues that enable it on a consistent basis to obtain the best possible result for the execution of its client orders; and

(b) its execution arrangements include all reasonable steps to obtain the best possible result for the execution of its client orders.

3. An investment firm must also review its execution policy and arrangements whenever it becomes aware, or reasonably should have become aware, that a material change has occurred that affects its ability 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.

4. 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 an investment firm may take into account in considering whether to maintain or include execution venues in its order execution policy, where relevant, include, but are not limited to: execution quality, creditworthiness and ability to avoid market impact. Costs that an investment firm may take into account in considering whether to maintain or include execution venues in its order execution policy where relevant, include, but are not limited to: transaction fees and settlement costs.

Extract from mandates from the Commission

DG Internal Market requests CESR to provide technical advice on possible implementing measures on the information to be provided to the client or potential client.

Explanatory Text

General disclosure about the investment firm's trading process and how it considers the factors in Article 21(1) and their relative importance are central elements of the information requirement relating to the firm's execution policy. 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 those factors.

Disclosure of information about the execution venues that an investment firm accesses will help clients and potential clients to evaluate and compare the nature of the services offered by different investment firms. However, it should not be necessary for firms to disclose to all clients and potential clients every execution venue that it could access, as such a list is likely to be very long. Instead, a firm should disclose only those venues on which it places significant reliance in meeting its obligation to obtain on a consistent basis the best possible result for the execution of its client orders and make more detailed information available upon request.

Information about the investment firm's process for selecting, monitoring and reviewing trading venues is central to a client's understanding of the firm's execution policy and arrangements. This information should, therefore, be provided in good time before the commencement of the relevant investment services.

It is important for clients to understand that if they give specific instructions that prevent an investment firm from carrying out their orders in accordance with its execution policy and arrangements, they may impair the results that the investment firm will be able to achieve for those orders. Investment firms should not attempt to evade their obligations under Article 21 or under the Level 2 advice under Article 19(1) by encouraging clients to provide them within instructions that would direct firms to violate their execution policies or arrangements, whether this is accomplished as part of the firm's general terms of business or otherwise.

Client instructions may not address every aspect of a firm's order execution policy and arrangements. 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.

The timing for the best execution information requirements should be aligned with the timing requirements in the Level 2 advice under Article 19(3). However, the derogations for voice telephone communications in the advice under Article 19(3) should be modified in relation to services falling within the scope of the best execution requirements because of the requirement to obtain the consent of the client to the execution policy.

Investment firms may choose to institute different execution policies and arrangements for different types of clients and provide the required disclosures accordingly.

BOX 16

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

(a) a description of how the investment firm seeks to obtain the best possible result when it executes 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) if the investment firm accepts specific instructions from its clients that conflict with the firm's execution policy or arrangements, a clear and prominent warning that such instructions may prevent the firm from taking the steps that it has designed to obtain the best possible result for the execution of those orders; and

iii) each execution venue on which the investment firm places significant reliance in meeting its obligation to take all reasonable steps to obtain the best possible result for the execution of its client orders on a consistent basis, together with a statement that the client may request:

(1) a complete list of venues in the execution policy and

(2) the investment firm's policy on whether it may use execution venues not included in its execution policy and if so, how the investment firm makes the determination to use such venues

(b) a description of the investment firm's process for communicating material changes to its order execution policy.

(c) if an investment firm may execute transactions between its clients or between its clients and clients of its interested persons, execute client orders by dealing on own account or direct client orders to its interested persons for execution or reception and transmission or if an investment firm that provides the service of portfolio management or order reception and transmission also may execute orders on behalf of its clients, a description of those practices, and a discussion of how the firm manages the related conflicts; and

(d) 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.

Voice telephone communications

2. In the case of voice telephone communication with a client or potential client, the information to be provided under paragraph 1 may be communicated orally, provided that:

i) the information must be communicated on a taped line and maintained as a record of the firm;

ii) if express consent is required under Article 21(3) of the Directive, this must be recorded on a taped line and maintained as a record of the firm; and

iii) the investment firm must provide the information referred to in paragraph 1 on paper or in a durable medium immediately after starting to provide service to the client

Client order handling (Articles 19(1) and 22(1))

Extract 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 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 22(1) - Member States shall require that investment firms authorised to execute orders on behalf of clients implement procedures and arrangements which provide for the prompt, fair and expeditious execution of client orders, relative to other client orders or the trading interests of the investment firm.

These procedures or arrangements shall allow for the execution of otherwise comparable client orders in accordance with the time of their reception by the investment firm.

Extract from mandates 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.

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

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

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

To respond to these requests CESR should take into account the retail or professional nature of the client.

CESR Advice

Explanatory text

Under Article 22(1) of the Directive, Member States are to require that investment firms authorised to execute orders on behalf of clients implement procedures and arrangements which provide for the prompt, fair and expeditious execution of client orders, relative to other client orders or the trading interests of the investment firm.

In determining whether the requirements for prompt and sequential execution are met, any relevant condition to the execution of the order may be taken into account by the investment firm.

An investment firm should not improperly deal ahead of investment research that it intends to publish. However, this should not prevent dealing by the investment firm where an information barrier is maintained between the persons involved in the decision to effect the transaction and the persons involved in the preparation of the investment research.

An example of the case in which it would not be improper for an investment firm to affect a transaction for its own account before carrying out a client order if when it maintains an information barrier between its relevant persons involved in the effecting of the transaction for own account and its relevant persons involved in carrying out the client order.

In order to ensure that clients are treated fairly it is also important that conflicts of interest are properly managed. The order execution rules are of relevance in managing conflicts of interest that arise in relation to the investment firm's orders or other activities such as the practices of front running or dealing ahead.

In accordance with Article 13(6) of the Directive, investment firms should be required to make adequate records of client orders and other transactions undertaken in the course of adhering to the order execution requirements.

Level 2 advice

BOX 17

Details of orders

1) Before carrying out an order, an investment firm must ensure that it has obtained the information that is necessary to carry out the order. This includes:

   a) the name or other designation of the client and of any relevant person acting on his behalf;

   b) the financial instrument to be traded;

   c) the number or total value of the financial instrument to be traded;

   d) the nature of the order (such as subscription, buy, sell or exercise);

   e) any other relevant details and particular instructions from the client for the order to be properly carried out (such as price limits, validity period and venue of execution); and

   f) the account for which the order is to be carried out.

2) An investment firm must immediately record the essential elements of each order that is received or arises. This includes at least:

   a) the details of the order set out in paragraph 1(a) to (f); and

   b) the date and exact time of the decision to deal or the receipt of the order.

Information

3) An investment firm must inform the client in advance:

   a) that it may act as principal in relation to an order (if this may be the case); and

   b) of any relevant risks or impediments for the proper carrying out of orders.

Front running

4) An investment firm must take all reasonable steps not to improperly effect a transaction for its own account or the account of any of its relevant persons before those of clients in identical or better conditions than the latter.

Dealing ahead

5) Where an investment firm intends to disseminate investment research that is or is likely to be disseminated to one or more persons outside of its group, it must take all reasonable steps to refrain from improperly effecting transactions on its own account until those clients have had a reasonable opportunity to act upon it.

Prompt and sequential execution and transmission of orders

6) An investment firm must carry out orders for clients sequentially.

7) The requirements to carry out orders promptly and sequentially do not apply where the characteristics of the order or prevailing market conditions make this impossible or require otherwise in the interests of the client.

Aggregation and allocation of orders

8) An investment firm may only aggregate an order for carrying out with another order or a transaction for own account if each of the following conditions is met:

   a) it is likely that the aggregation will not work to the disadvantage of any client whose order is to be aggregated;

   b) the investment firm has disclosed to each such client that the effect of aggregation may, on occasion, work to its disadvantage; and

   c) the investment firm has established and effectively implements an order allocation policy that provides for the fair allocation of such orders and transactions.

9) If an investment firm aggregates an order for carrying out with another order or a transaction for own account, it must make a record of the intended basis of allocation of such orders and, where applicable, such transaction, prior to carrying them out.

10) An investment firm must ensure the proper and prompt recording and allocation of executed orders.

11) Where an investment firm is responsible for overseeing or arranging the settlement of an executed order it must take all reasonable steps to ensure any client assets received in settlement of that executed order are promptly and correctly delivered to the account of each relevant client.

12) Where a transaction for own account and an order are aggregated, the investment firm must not allocate the related trades in any way that is detrimental to any client.

13) An investment firm must have procedures in place to prevent the reallocation of transactions for own account executed with orders on an aggregated basis giving unfair preference to the investment firm or to any of its clients.

14) If an investment firm that carries out an order aggregates that order with one or more other orders and the aggregated order is partially executed, it must allocate the related trades on a proportional basis, unless it has a different order allocation policy and each client has been notified accordingly before the order was carried out.

15) If an investment firm that carries out an order aggregates that order with a transaction for own account and the aggregated order is partially executed, allocation to the client must take priority over allocation to the firm, unless the firm is able to demonstrate on reasonable grounds that without its own participation it would not have been able to carry out the order on such advantageous terms, or at all, in which case the transaction for own account may be treated in the same way as an order when carrying out an allocation under paragraph 14.

Record keeping of orders carried out

16) An investment firm must record the essential elements of all:

a) orders carried out, together with transactions executed for own account, other than orders falling within sub-paragraph (b), immediately after their execution; and

b) orders that were transmitted to another for execution, immediately after they are transmitted.

An investment firm must record in an analogous manner the orders it issues and the transactions it carries out for the purpose of remedying errors made in recording, or carrying out orders.

17) To comply with paragraph 16(a), an investment firm that carries out an order (other than an order falling within paragraph 16(b)) should at least record the following details of the execution of the transaction:

a) name or other designation of the client;

b) name of the counterparty if known;

c) venue of execution if known;

d) date and exact time of execution provided that where an order is executed on an open outcry market the time period of execution may be recorded where it is not practicable to record the exact time of execution and this is in accordance with the rules of the market;

e) the relevant person who executed the transaction;

f) the financial instrument;

g) the number of or total value of the financial instrument;

h) price and other significant terms; and

i) nature of the transaction.

18) To comply with paragraph 16(b), an investment firm that transmits an order to another for execution should at least record the following details of the transmission:

a) name or other designation of the client;

b) the person to whom the order was transmitted;

c) the terms of the order transmitted; and

d) the date and exact time of transmission.

Transactions executed with eligible counterparties (Article 24)

Extract from Level 1 text

Article 24(2):

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

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

Article 24(3)

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

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

Article 24(4)

Member States may recognise as eligible counterparties third country entities equivalent to those categories of entities mentioned in paragraph 2.
Member States may also recognise as eligible counterparties third country undertakings such as those mentioned in paragraph 3 on the same conditions and subject to the same requirements as those laid down at paragraph 3.

Extract from the mandate from the Commission:

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

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

- The criteria, including quantitative thresholds, that would allow considering an undertaking as an eligible counterparty and

- The procedures for obtaining their express confirmation to be treated as eligible counterparties.

CESR Advice

Explanatory Text

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

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

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

Recital 40 to the Directive makes it clear that eligible counterparties should be considered as acting as clients. Article 24 only provides for the disapplication of Articles 19, 21 and 22(1) and does not prevent an eligible counterparty falling within the definition of a client for other purposes.

Therefore, other relevant provisions of the Directive that apply in relation to the provision of services to clients will continue to apply. For example, if an investment firm holds financial instruments belonging to an eligible counterparty while providing services falling within Article 24(1) of the Directive, the requirements relating to the holding of client financial instruments under Article 13(7) of the Directive will continue to apply.

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

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

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

Where an investment firm ("F1") executes an order on behalf of a client ("C") with a counterparty that is also an investment firm ("F2"), F1 will be an eligible counterparty "per se" because it is an investment firm. If the services provided by F2 fall within the scope of Article 24(1) and F1 and F2 do not agree that a higher degree of protection is appropriate, F2 will not owe F1 any obligations under Articles 19, 21 and 22(1) in respect of those services. However, the fact that F2 is not subject to the obligations under Articles 19, 21 and 22(1) in relation to its dealings with F1 does not relieve F1 of its obligations to C under those Articles (unless C is also an eligible counterparty and the services F1 provides to C fall within the scope of Article 24(1)).

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

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

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

CESR advice addresses the issue of the procedural rules for opting-in and opting-out of a more protective treatment, and in addition, addresses the criteria that undertakings must satisfy in order to be capable of being treated as eligible counterparties.

The Directive foresees the possibility of Member States recognising as eligible counterparties other undertakings, provided they meet certain pre-determined requirements. These requirements, including quantitative thresholds, have to be proportionate, i.e. they have to allow for the existence of counterparties in the relevant markets and adapt to the real needs in terms of investor protection.
In selecting the criteria for defining the quantitative requirements, CESR has decided to advise, for the sake of coherence, the use of the quantitative criteria already present in the Directive, for the definition of the professional regime: balance sheet total, net turnover and own funds (on a company basis).

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

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

CESR considered the adoption of other criteria, further to the proportionate quantitative thresholds. Since the scope of the regime proposed is quite broad, the definition of qualitative criteria does not seem necessary.

Level 2 advice

BOX 18

Policies and procedures

1. If an investment firm intends to classify any of its clients as eligible counterparties, it must implement appropriate written internal policies and procedures for the categorisation of eligible counterparties in accordance with the applicable requirements. The latter are responsible for keeping the firm informed about any change that could affect their current categorisation.

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

2. An investment firm may, either upon request or at its own initiative, treat a client that falls within one of the categories in the first paragraph of Article 24(2) as a professional client or a retail client. If it does so:

   a) the client shall be classified as a professional client or a retail client, as the case may be, and benefit from the protections under Articles 19, 21 and 22(1); and

   b) the investment firm must promptly notify the client in writing of the classification so established, specifying any limitations that apply to the classification (for example, whether this applies to one or more particular products and/or transactions).

Opt-out regime (certain undertakings classified as eligible counterparties)

3. Where an undertaking that falls outside of Article 24(2) informs an investment firm that it wishes to be treated as an eligible counterparty (either generally or in respect of a particular investment service, transaction or type of product), the investment firm may treat the undertaking as an eligible counterparty, provided that:

   a) it ensures that the undertaking meets at least two of the following criteria:

      i) balance sheet total: EUR 20,000,000;
      ii) net turnover: EUR 40,000,000;
      iii) own funds: EUR 2,000,000,

   b) it promptly notifies the undertaking in writing of the new classification, specifying any limitations that apply to the classification (for example, whether it applies to one or more particular products and/or transactions);

   c) it promptly gives the undertaking clear written information about the protections it will lose and investor compensation rights it may lose to the extent that the new classification applies; and

   d) it obtains a statement from the undertaking in writing and in a separate document from the contract, that the undertaking is aware of the consequences of losing such protections.

Services provided to an eligible counterparty "per se" before the transposition of the Directive

4. If an investment firm provided investment services to a client falling within one of the categories listed in the first paragraph of Article 24(2) before the transposition of the Directive it may either classify that client as:

   a) an eligible counterparty; or

   b) a professional client or a retail client.

5. If an investment firm classifies the client referred to in paragraph 4 as an eligible counterparty, it must inform the client, before providing any services to the client after the transposition of the Directive, that:

a) on the basis of the information available to it, the client is deemed to be an eligible counterparty "per se" and will be treated as such unless both parties agree otherwise; and

b) the client can request to be treated as a retail or professional client in order to secure a higher degree of protection and that it is the responsibility of the client to make such a request.

6. The information requirement stated in paragraph 5 shall not apply to the extent that the eligible counterparty has been classified by the investment firm as having a similar status to that of an eligible counterparty under the domestic regime of a Member State before the transposition of the Directive by that Member State.

SECTION III – MARKETS

Market Transparency

Pre-trade Transparency requirements for Regulated Markets (Article 44) and MTFs (Article 29)

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

Extract from the mandate from the Commission

CESR is requested to provide technical advice on:

- 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.

CESR advice

Explanatory text

The market models presented in this advice 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 (new kind of, or hybrid, market model) which are required to provide an appropriate degree of pre-trade transparency comparable to that required under the market models given in the list. This will make further development and innovation possible without circumventing the obligation to have an appropriate level of pre-trade transparency. 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 cases of trading mechanisms where there is not a sufficient level of pre-trade transparency.

The requirements for the publication of the depth of trading interest have been defined on the basis of the realities of the different market models and are intended 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.

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 advice.

The waivers in this advice for pre-trade transparency clarify the exemption from publication of bid and offer prices through a system of a RM or MTF. This does not preclude a RM or MTF from having a higher level of pre-trade transparency. Nor does is reduce the general obligation for a RM and MTF to maintain a fair, orderly and efficient market.

CESR did in the beginning of its work approach the implementing measures for art. 29 and 44 of MiFID as a requirement to make public pre-trade information advertised through the system of the RM or MTF as referring only to the information RM/MTF actually advertised through their system or rules. Following consultation with the Commission and within CESR, the approach has been changed to take into account what type and amount of pre-trade information in general RMs and MTFs should advertise through their system and make public.

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. The advice requires that the price being referenced is widely recognised as a reliable reference price and is widely publicised.

The pre-trade transparency obligation should be waivable 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.

The pre-transparency obligation should also be waivable for transactions that are not accessible to members/participants of the RM or MTF other than the one(s) that have prenegotiated the transaction. These "negotiated trades" are defined in the advice.

There is a need for an exemption for negotiated trades made within or at the current weighted spread for the size of the trade 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.

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 is sufficient only if there is no spread due to the nature of the price discovery mechanism or the present trading conditions.

However, CESR considers that negotiated trades should not be available to firms under the obligations of Art. 27 MiFID to avoid circumventing the obligations for systematic internalisers.

There is also a need for a waiver for certain negotiated trades to be made without being subject to the price condition. This waiver should relate to transactions which are subject to conditions other 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.

CESR's proposal in respect of waivers from pre-trade transparency for RMs and MTFs is 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 as well as the other waivers available when trading below this size.

CESR has proposed 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-trade transparency obligation on an RM or MTF. The minimum thresholds are fixed amounts defined for five categories to which shares are assigned based on the value of the daily average order book turnover in that share.

When making pre-trade information public, a RM and MTF should therefore ensure that the publication mechanism chosen is capable of publishing the information in a form which does not

impede consolidation and in a manner which can be accessed by all interested parties on a reasonable and non-discriminatory commercial basis. In CESR's view, this does not preclude RMs and MTFs from making different additional levels of pre-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.

The average in daily turnover in a share can change considerably over time, in both relative and absolute terms. To ensure that a share is in an appropriate band, CESR considers that an annual review of its annual daily volume should normally be sufficient. To provide for consistency among Member States, CESR proposes that this annual revision covers a fixed and harmonised period running from January 1st to December 31st and that this calculation is completed by the end of February.

It is important that the arrangements for determining the band for each share provide both for adjustment or review processes in light of changed circumstances between annual reviews.

The need for such reviews, and possible reallocations, will normally be caused by events that mechanistically alter a share's average daily turnover. These can for example flow from a change of capital (e.g. following a new issue, merger etc), but competent authorities should not be required to review the banding 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 band 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 some months to come.

CESR has also considered how to deal with shares admitted to a regulated market for the first time (e.g IPOs) as the data needed to assign the pre-trade band is initially missing. CESR is not convinced that the fact that such shares have no trading track-record for assigning the band should mean that they should have not benefit from the waiver until they have been trading for a number of months. CESR has therefore recommended that the competent authority should provisionally allocate a newly admitted share to a band on the basis of known information about the size of the issue, likely trading interest and the banding of any 'peer group' shares. Several RMs already take this approach in allocating a provisional block sizes to a share before it starts trading.

Level 2 advice

BOX 19

Content of the pre-trade transparency

1. 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 paragraphs 2-5 where this is available.

2. 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 (market by level).

3. 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 the volume that would potentially be executable at that price.

4. Where an RM or MTF operates a quote driven trading system, it should make public, 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.

5. Where an RM or MTF operates a trading system which does not align with any of the market models described in paragraphs 2-4 above either because it is a hybrid system or because the price determination process is of an entirely different nature, this system should also be considered as complying with pre-trade transparency obligations if the following conditions are met:

   a. a standard of pre-trade transparency should be provided that is comparable to the pre-trade transparency described in paragraphs 2-4 taking into account the characteristics of the trading system and the principles of fair and orderly trading and investor protection; and
   b. the five best bid and offer levels should be made public, if the characteristics of the price discovery mechanism so permit,or provide a level of pre-trade transparency that is comparable to that described in paragraphs 2-4 is provided; and
   c. RMs and MTFs should be 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 and b.

Exemptions from pre-trade transparency

Based on market model and type of order/transaction

6. The pre-trade transparency obligation may 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.

7. The pre-trade transparency obligation may 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).

8. Transactions which are not accessible to other members/participants of the RM or MTF could be made on the RM/MTF if the conditions defined below are fulfilled. These transactions should 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 should be 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.

9. Regardless of the size of orders (as referred to in Paragraph 11), the pre-trade transparency obligation could be waived for negotiated trades made on an RM or MTF, if:

   a. the transaction is made within or at the current weighted spread for size of the trade [1] 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

[1] Regarding the price limit for negotiated trades two CESR members consider that negotiated trades executed on a regulated Market at the weighed average spread (WAS) take advantage of the information displayed by those investors who contribute to the transparency and efficiency of the price formation process while depriving them from the opportunity to trade at an executable price. They also consider that such trades seriously undermine the obligation for Regulated Markets to provide for fair and orderly trading. In addition, they underline that it remains to be seen whether all potential conflicts of interest have been properly considered and addressed under those circumstances, and more specifically when the limit orders in the book are coming from clients of the same firm as the one executing a negotiated trade at the weighted average spread for another client.

c. the post-trade information published on the transaction fulfils the requirements of paragraph 55.

The waiver should not be available for transactions which, if executed outside RM or MTF, would fall under the Article 27.

10. In addition to the transactions referred to in paragraph 9 above, the pre-trade transparency obligation could 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 55.

Based on the size of order/ transaction

11. The pre-trade transparency obligation may be waived for orders large in scale compared with normal market size, as defined below:

12. Member States should 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 orders that are large in scale compared with normal market size. The size of the transaction applicable for a waiver should be at least the relevant minimum threshold set out in Table 1.

13. A waiver should not be required in respect of RMs and MTFs operating systems with designated market makers, provided the RM or MTF requires the market maker(s) to maintain quotes in a size that balances the needs of members and participants to deal in a commercial size and the risk to which the market maker exposes itself.

14. 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 calculate annually (or have appropriate arrangements for the calculations of) the average daily order-book turnover on the most relevant market and assign the share to the relevant band as specified in table 1.

15. This calculation should be completed by the end of February on the basis of the annual data of the previous calendar year.

16. Member States should provide for competent authorities to review and, as necessary, adjust the assignment of a share to a band in exceptional circumstances in which there is a significant change in for example an issuer's financial position, capital structure, share price and trading in the share which significantly and durably affects the average daily turnover in the share.

17. The competent authority for the RM and MTF where a share is admitted to trading for the first time - for instance, following an initial public offering - should determine an initial threshold by allocating the share into a band from the first day of trading by using a proxy based on peer stocks (i.e. with similar market capitalisation, free float etc.).

Publication of the pre-trade information

18. RMs and MTFs should make public pre-trade information real time during the trading hours of the RM or MTF.

19. Pre-trade information should be made available to the public by RMs or MTFs on a reasonable and non-discriminatory commercial basis either directly, through contractual arrangements, or

indirectly, through data vendors.

20. When making pre trade information public, RMs and MTFs should ensure that the publication arrangements chosen:

    a. ensure that the information to be published is reliable by monitoring without delay 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 this advice;
    c. function all the time that the RMs or MTFs publication obligations apply;
    d. are accessible to all interested parties on a reasonable and non-discriminatory commercial basis;
    e. publish the data in a manner that allows for its consolidation.

Table 1: Pre-trade waiver thresholds

Minimum size of transaction qualifying for a waiver				
Average Daily Value > EUR 50 m	Average Daily Value EUR 25-50 m	Average Daily Value EUR 1-25 m	Average Daily Value EUR 500.000 -1 m	Average Daily Value < EUR 500.000
EUR 500.000	EUR 400.000	EUR 250.000	EUR 100.000	EUR 50.000

Definition of Systematic Internalisation (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.

CESR advice

Explanatory text

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.

"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).

CESR is also proposing the use of quantitative criteria to assist in in determining whether a firm executing client orders on an organised and systematic basis is doing so on a frequent basis. These criteria are proposed as negative indicators and will help to indicate when a firm should be viewed as being unlikely to be a systematic internaliser. The proposed quantitative criteria provide independent indications of frequency. The ratio of a firm´s internalised order volume in a share to its overall trading volume in that share is an indication that a firm internalises frequently in relation to its total trading volume in a share. However, some larger firms may be adjudged to be frequent internalisers of client orders by the fact that they internalise a material proportion of the market in a share even though it may form a relatively small part of the firm's total trading in that share. To address this type of firm, the advice proposes a ratio of the value of client orders in a share that a firm executes on own account outside RMs to the total trading of that share on the most relevant market in the EU (as defined by Article 25).

CESR underlines that, according to Recital 53 of MiFiD 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.

CESR has also given consideration to how a systematic internaliser should cease its activities as a systematic internaliser either in one, several or all shares. On one hand a systematic internaliser, as a part of its business strategy should be able to decide to start or to stop conducting this activity in a given share. 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 those of their clients and other market participants. When an investment firm decides to cease internalising in one or several shares but continue with its internalisation business, it should make public that it is ceasing internalisation in the share or shares in advance using the same, or equally effective, publication channel as for the publication of its quotes.

Level 2 advice

BOX 20

21. For the purposes of MiFID Article 27, where an investment firm deals on own account by executing client orders outside RM or MTF, it should be considered as conducting the activity on an organised and systematic basis, when it undertakes it on the following basis:

    a. The use of a specific business model in which the activity has a commercial role

    and/or

    The existence of non-discretionary 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 the activity, whether or not the personnel or systems are used exclusively for that purpose;

    and

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

    And

    The following should be taken as indicators that a firm is not undertaking the activity on a frequent basis.

    a. The ratio of the value of all client orders in shares 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 less than 15%;

    and

    b. The ratio of the value of all client orders in shares 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 less than 0,5 %.

22. 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.

Scope of the rule (Article 27.1)

Extract from Level 1 text

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

Extract from the mandate from the Commission

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

CESR advice

Explanatory text

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 establish an 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 in which they are systematic internalisers.

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

In any case, CESR is of the opinion that all shares determined to be liquid – be it on the EU-wide or "narrower" basis – should 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 (for which it was a systematic internaliser), even if they were not liquid in its home Member State.

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

CESR´s proposal for defining liquidity for the purposes of Article 27 incorporates thresholds for the size of the free float market capitalisation of a share and the level of trading activity. First, all shares should have to meet the common criteria of being traded daily and having a free float market capitalisation of more than 500 million euro. In addition, the average daily trading activity in the

share should exceed 500 trades or EUR 2 million (or the EUR equivalent). Each Member State should determine which measure of trading activity it will use and apply only that measure in assessing all its shares. CESR notes that the proposed approach does not achieve a total level of harmonisation On the other hand, differing market structures suggest a need for more than one measure of trading activity but also make it extremely difficult to find common thresholds that could be used cumulatively. An approach allowing some flexibility should still meet the goal of Article 27.

Level 2 advice

BOX 21

23. A share should be deemed to have a liquid market for the purpose of Article 27, when it meets both criteria (a) and (b) above and additionally either criteria (c) or (d) as chosen by a Member State:

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

(b) The free float of the share is at least 500 million euro.

The free float should be calculated by excluding those holdings exceeding 5 % of the voting rights, as defined in the Transparency Obligations Directive, except where those holdings are held by mutual funds, pension funds and investment companies. During the period when the information on the basis of Transparency obligations directive is not available, the free float may be calculated by using a widely accepted/used EU-wide index calculation as a proxy;

(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.

24. Before 1st of April 2009 the thresholds in points c) and d) should be based on the order book data of that RMs where the share is admitted to trading.

25. The competent authority for the RM and MTF where a share is admitted to trading for the first time - for instance, following an initial public offering - shall determine whether a share meets the requirements above by using a proxy based on peer stocks (i.e. with similar market capitalisation, free float etc.).

The determination of the standard market size / classes of shares (Article 27.1 and 2)
The publication of the quotes (Article 27.3)
Multiple quotes (Article 27.1 and 3)
Withdrawal, updating and protection against multiple hits (Article 27.3 and 5)
Transactions exempted from the quote firmness (Article 27.3)
Retail size orders (Article 27.3)

Extract from Level 1 text

Shares shall be grouped in classes on the basis of the arithmetic average value of the orders executed in the market for that share. The standard market size for each class of shares shall be a size representative of the arithmetic average value of the orders executed in the market for the shares included in each class of shares.

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

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

Systematic internalisers shall make pulic their quotes on a regular and continuous basis during normal trading hours

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

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

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

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 clinets considerably exceeds the norm.

Furthermore, systematic internalisers may execute orders they receive from their professional clients at prices different than thaier quoted ones without having to comply with the conditions established in the furth 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 that the size customarily undertaken by a retail investor.

Extract from the mandate from the Commission

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

defining the classes in which liquid shares should be grouped as well as the criteria for its revision if necessary

defining what is to be considered an order large in scale compared to normal market size

defining the standard market size for each class of shares as well as the criteria for its revision if necessary

determining the arrangements through which competent autuhorities will calculate the arithmetic average value of the orders executed in the market for each share for the 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 quote is published on a regular and continuous basis and is easily accessible as well as, the means by which investment firm may comply with their obligation to make public their quotes, which shall include the following possibilities: Through the facilities of any regulated market which has admitted the instrument in question to trading; through the offices of a third party; through proprietary arrangements

-specifying the criteria for determining when the price or prices reflect prevailing market conditions

- which market circumstances that could be considered as exceptional that could allow a systematic internaliser to withdrafw 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 securitites 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.

CESR advice

Explanatory text

Calculation of the average order value

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.

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

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

In order to calculate the average order size, Article 27 requires orders executed which are large in scale compared to normal market size to 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.

Another issue relating to classification is whether the basis for calculations ("orders executed") should be interpreted to refer to 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 terms2. However, 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 .

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 running up to end 2008 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

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.

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. In addition, the calculation of average order values published during the second consultation, shows a distribution that is rather linear and does not demonstrate an absolute need for a logarithmic scale. CESR is therefore recommending a simple tiering in bands of EUR 10,000 up to EUR 50,000 and in EUR 20,000 bands above that figure to accommodate the effective distribution of average order values. (The bands should be at the eurozone equivalent for non-euorozone currencies.)

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2 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).

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 EUR 20,000 - 29,999 band would be €25,000. However, for the first band (0-€9.999), it is suggested that the SMS should be € 7.500 to take into account that the distribution of the average order value is likely to be biased compared to the other bands. Moreover, such SMS for the first band is more consistent with the size of orders customarly undertaken by a retail investor as defined in the advice.

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. In addition, converting the monetary SMS into a number of shares will mean loosing the benefit of the simplicity provided by grouping the shares into classes altoghether. Nevertheless, if some firms definitively feel the need for it, they could adjust their systems accordingly.

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

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.

To provide for consistency among Member States, CESR proposes that this annual revision covers a fixed and harmonised period running from January 1st and December 31st and that the competent authorities publish the class into which the share has been grouped and the resulting Standard Market Size on March 1st or the first following business day.

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 better arrangements.

“Ad hoc” revisions of the average value of transactions.

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.

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 some months to come.

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 and review the suitability of the initial SMS three months after trading commences afterward. Several RMs already take this approach in allocating a provisional block sizes to a share before it starts trading.

Coming into force

For annual revisions, when 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 market on March 1st.

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 on April 1st.

Publication of the class of shares to which each share belongs

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.

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 the consolidated list of classes into which shares have been grouped and the SMS for each share should be made available at a single access point, i.e., the CESR website.

In case of ad hoc revisions, the competent authority should inform market participants in advance that the ad hoc review will take place as soon as it has decided to recalculate the average value. It should indicate at the same time when the new average value and any resultant re-classification of the share will become effective.

Continuous quoting

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 in that share, 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 in a given share must be predetermined and made public by the firm.

Quotes reflecting market conditions

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

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

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

Updating of quotes

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. A firm should not update its quotes in a capricious or discriminatory manner. However, it would not be reasonable to impose a minimum time limit to price updating and CESR has therefore not proposed any level 2 measures.

Withdrawal of quotes

CESR considers the Level 1 requirement to be sufficient. Exceptional circumstances are difficult to list comprehensively. In reality, a systematic internaliser which withdraws its quotes will have to justify the withdrawal both to its supervisor and its clients.

Transactions in several securities as a part of one transaction

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

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

CESR considers 10 to be a reasonable amount of shares to constitute a portfolio transaction. CESR does not consider it necessary to impose a minimum value as it is the nature and not the value of the transaction that justifies the exemption.

Orders subject to other conditions than the current market price

In CESR's view the exemption provided by Art.27 para.3 subpara.5 is intended to cover, for example, trades where the price is determined as an average of prices during a day (eg Volume Weigthed Average Price Orders).

Size customarily undertaken by a retail investor

The typical size of a retail order differs from one Member State to another. Typical sizes also vary according to the type of retail investor and the channels by which their orders arrive at the market. CESR members have collected information from a range of intermediaries in their countries, including traditional broker dealers, retail banks and internet brokers. The advice recommends a single EU-wide figure and that this should be set at 7,500 euro.

Level 2 advice

BOX 22

Calculation of the average *size*

26. 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 should receive information on all trades made in the EU in that share. During a transitional period running up to end of 2008, calculation of the average value of orders will be made using only orderbook data of the most relevant RM.

Orders large in scale compared to normal market size

27. An order executed that is large in scale compared to normal market size for the purposes of Art.27 MiFID should 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

28. The classes into which shares should be grouped for the purposes of applying Standard Market Size, (SMS) should be set in bands of €10,000 up to €50,000 and in bands of €20,000 above that figure (or the Euro equivalent).

Definition of SMS for each class of shares

29. The SMS for each class of shares should be the mid-point in each band (e.g. €25,000 for the band from €20,000 - €29,999), with the exeption of the first band for which the SMS should be set at EUR 7.500.

30. SMS groups and SMSs 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

31. Member States should require competent authorities to recalculate annually the average arithmetic value of the orders executed in shares in which there is a liquid market between January 1st and December 31st, on the basis of the methodology set out in Article 27, paragraph one. The competent authorities should publish the class into which the share has been grouped and resulting SMS on March 1st of the first following business day.

32. 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.

33. 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 RM

34. The competent authority for the RM 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 - should 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 3 months after trading commences.

Coming into force

35. The SMS should become effective on April 1st. In case of "ad hoc revisions" as referred above, the SMS should become effective at the date set by the Competent Authority at the time of publication of the SMS.

Publication of the information

36. 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. In addition, the consolidated list of classes into which shares have been grouped and SMS for each share should be made available on CESR website.

37. A systematic internaliser should 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 in the relevant share, details of which should be predetermined and made transparent to investors.

38. A systematic internaliser could 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 should remain responsible for the publication of its quotes, irrespective of the publication mechanism chosen.

Quotes reflecting market conditions

39. 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 should maintain a record of its quoted prices.

Updating of quotes

40. No level 2 proposed.

Withdrawal of quotes

41. No level 2 proposed.

Obligations for Systematic internalisers when handling and executing client orders

Limiting the total number of transactions

42. 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.

43. 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.

44. 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

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

Orders subject to other conditions than the current market price

46. Orders from professional clients subject to execution conditions other than the current market price for the purposes of Article 27 of MiFID should 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)

Handling orders in case that systematic internaliser publish multiple quotes

47. No level 2 proposed.

Size customarily undertaken by a retail investor

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

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

49. When calculating the arithmetic average value of orders executed 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 box 19 above.

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.

CESR advice

Explanatory text

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

Visibility and Accessibility test

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

CESR considers that, in the context of Article 22.2, "easily accessible" should meet two tests. First, the non-executed limit order should be displayed so as to reach the 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

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

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

- It transmits the client limit order to an MTF.

The publication of standard client limit orders where an existing RM and/or MTF offers 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 2 of this advice), 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.

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 or indicative price range disseminated by the RM or MTF in the pre-negociation phase ("visibility test"), and where the transmission of the limit order to such a 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 a limit order to such a trading venue would be considered as meeting Article 22.2 requirements, without prejudice to best execution obligations(see below).

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.

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.

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.

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 this advice.

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.

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.

Level 2 advice

BOX 23

50. An investment firm could 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.

51. The obligation would be met where the limit order is sent to an order driven RM or an 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.

52. 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 20 (box 19).

53. 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. The requirement to display, directly or indirectly, 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.

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

CESR

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 45 [for RMs]

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.

Article 30 [for MTFs]:

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 28 [for Investment Firms]:

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.

Extract from the mandate from the Commission

CESR is requested to:

- 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.

- Specify the means by which investment firms may comply with their post-trade transparency obligations including the following possibilities: 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 trades; through the offices of a third party; through proprietary arrangements

- 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.

CESR advice

Explanatory text

Post-trade information needs to be published in order to provide sufficient data for identifying trends on the market, checking the quality of completed trades and assisting intermediaries is assessing which trading venues consistently offer the most competitive prices.

RMs, MTFs (and investment firms) should publish the information either for each individual transaction or in aggregated form for a volume of transactions executed at one point in time by means of one price determination. These options reflect the different practices currently used and permit a trading venue to balance the needs of market participants with IT costs of making detailed data available.

In order to give reliable information on trading which took place, post-trade information should cover each transaction only once. Where trades are executed outside the automated systems of the RM (which should themselves ensure that information on the same trade is not duplicated), CESR proposes that the investment firm acting as seller should be responsible for publication.

For certain types of transactions post-trade information may be more of little utility to the public. In some circumstances such information could even send misleading signals as to the real trading conditions in the market. It is therefore proposed that the publication of certain transactions where the transaction is subject to conditions other than the current market price of the share should be required only if the transaction contains information that is important for the efficient price formation of the share in question. When published such transactions should always be marked (flagged) in order to avoid misleading signals.

Taking into account the importance of post-trade information and the objectives of the Directive it is extremely important that information should be disclosed as soon as it is technically possible (except where delayed publication is justified). Therefore CESR has taken a strict view on the timing in order to promote an efficient and competitive market. Taking into account the characteristics of the market and the complexity of the trade, the three minute deadline after execution of the trade should be seen as the maximum permissible time limit to publish details of a completed transaction.

Since the information on trading on RMs and MTFs is considered vital for investors, the publication methods shall ensure that such information is available all the time their trading systems are functioning. This means that the publication arrangements should operate all the time trading takes place i.e. normal trading hours.

For cost-benefit and risk reasons, CESR has considered it sufficient that for an investment firms the arrangements should be available throughout their normal trading hours. Where an investment firm incidentally executes a trade outside these trading hours, it should publish the required post-trade information before the next opening of the most relevant market. However, CESR advises that the effects of these procedures on the market should be reviewed in due course and the requirements revised if necessary.

When making post-trade information public, a RM, MTF or investment firm must therefore ensure that the publication mechanism chosen is capable of publishing the information in a form which does not impede consolidation and in a manner which can be accessed by all interested parties on a reasonable and non-discriminatory commercial basis. In CESR's view, this does not preclude RMs, MTFs and investment firms from making different levels of 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.

The purpose of the delayed publication is to encourage the provision of liquidity to the market by giving the intermediary some time to lay off its position. Therefore 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.

CESR's proposal in respect of the minimum size threshold levels across the EU for transactions that may qualify for deferred publication sets out to ensure that deferred publication 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.

CESR proposes the use of a percentage of average daily turnover as the basis for calculating the minimum thresholds for deferred publication. However, because the thresholds cover a wide range of stocks in each size band, CESR has also proposed a monetary cap for the two bands which include the shares with highest average daily turnover. 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.

CESR proposes that shares be split into three bandings based on the average daily value of trading. 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. However, it is also desirable that deferred publication should be available only for material risk. The advice therefore proposes that for shares in the least liquid band, there should be a minimum size of trade that qualifies for deferred publication.

CESR notes that in general it is possible to use all facilities providing trading in a share to lay off the risk. Therefore, in principle the thresholds should be calculated on the basis of all trading (within the EU). However, such data is not currently available. The second widest data-set would comprise all trades executed on regulated markets. But because of current differences in approach to on and off market trading in the EU, use of this data would give an unbalanced outcome. Therefore, CESR proposes that the thresholds should initially be calculated using order-book data. When available, the full data should be used, with appropriate recalibration of the threshold level that would trigger a specific delayed publication provision. In the case of shares traded on quote-driven markets, the thresholds should be calculated using the value of customer trading

CESR proposes that the competent authority responsible for calculations should be the same authority as in Article 25 because that authority receives the necessary information automatically.

Although the MiFID will allow for trading information to be consolidated EU-wide, CESR is aware that at the moment there is currently only a limited amount of readily accessible data available for calculating some of the thresholds set out in this advice. Therefore CESR propose to use, for an interim period, the order book data of the most relevant market.

Level 2 advice

BOX 24

Content and publication of post-trade information

55. Regardless of whether a trade was executed on an RM, MTF or by an investment firm outside them, the following information should 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 systematic internalisation, under the obligations of Article 27, the name of the sytematic internaliser;
    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 8;
    g. (if applicable) indicator that the transaction was subject to other conditions than the current market price of the share as defined in paragraph 56;
    h. (if applicable) indicator that the trade was subject to delayed publication as defined in paragraph 63; and
    i. any amendments to previously disclosed information.

56. 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.

57. The procedures for disclosing the information in paragraph 51 should 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 should be responsible for disclosing the information. Where the seller is not an EU investment firm (but the buyer is), the publication obligation should be on the buyer.

58. Post trade information should be made public as close to real time as possible taking into account the characteristics of the trading venue where the transaction was executed and the complexity of the trade. This should in any case not happen later than three minutes after the transaction was executed.

59. For RMs, MTFs and investment firms the publication arrangements should operate through their normal trading hours. Incidental trades outside normal trading hours should be published by RMs and MTFs before the opening of their next trading day and by investment firms before the opening of the next day of the most relevant market according to Article 25.

60. Post-trade information could be made available to the public by RMs and MTFs on a reasonable and non-discriminatory commercial basis either directly, through contractual arrangements, or

indirectly through data vendors.

61. Post-trade information could 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 and non-discriminatory commercial basis.

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

    a. ensure that the information to be published is reliable by monitoring without delay 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 paragraph 58 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 and non-discriminatory commercial basis;
    e. publish the data in a manner that allows for its consolidation.

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

63. 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 table 2.

64. Member States should 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. Once the full data is available, the table should be revised.

65. 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.

66. 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 order-book turnover trading on the most relevant market for the share or in the case of quote driven markets the average daily value of total customer trading.

67. Where the resultant relative amount for a share is greater than the specified fixed amount for that threshold, then the specified fixed figures should be the determining factor. In the case of the lowest turnover band the waiver should be available only when the size of the trade exceeds at least the minimum cash amount as specified in the advice.

68. Where competent authorities approve deferred publication of principal portfolio trades, they should do so only when the portfolio contains at least one security that meets the threshold for deferred publication. Where there is more than one security in the portfolio that qualifies for deferred publication threshold, the regime for the security in the highest turnover band shall apply for the portfolio as a whole.

69. 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 calculate annually (or have appropriate arrangements for the calculations of) the average daily order-book turnover on the most relevant market and assign the share to the relevant band as specified in table 2.

70. This calculation should be completed by the end of February on the basis of the annual data of the previous calendar year.

71. Member States should provide for competent authorities to review and, as necessary, recalculate the ADV of a share and the relevant threshold in exceptional circumstances in which there is a significant change in for example an issuer's financial position, capital structure, share price and trading in the share which significantly and durably affects the average daily turnover in the share.

72. The competent authority for the RM and MTF where a share is admitted to trading for the first time - for instance, following an initial public offering - should determine an initial threshold from the first day of trading by using a proxy based on peer stocks (i.e. with similar market capitalisation, free float etc.).

Table 2: Deferred publication arrangements

Maximum permitted delay for trade publication	Minimum qualifying size of trade (and cash ceilings)		
	Average Daily Value (ADV) > EUR 50 m	Average Daily Value EUR 1-50 m	Average Daily Value < EUR 1 m
60 minutes	The lowest of 10 % of ADV or EUR 7,5m.	The lowest of 10 % of ADV or EUR 3,5 m.	More than 5 % of ADV but at least EUR 25.000
180 minutes	The lowest of 20 % of ADV or EUR 15 m.	The lowest of 15 % of ADV or EUR 5 m.	More than 15 % of ADV but at least EUR 75.000
End of day (+roll-over to Noon of next trading day if undertaken in final 2 hours of trading	The lowest of 30 % of ADV or EUR 30 m.	The lowest of 25 % of ADV or EUR 10 m.	More than 25 % of ADV, but at least EUR 100.000
End of next trading day	More than 100 % of ADV	More than 100 % of ADV	More than 50 % of ADV but at least EUR 100.000
End of second trading day following trade			More than 100 % of ADV but at least EUR 100.000.

ADMISSION OF FINANCIAL INSTRUMENTS TO TRADING (ART. 40)

Extract from Level 1 text

Art. 40:
1. Member States shall require that regulated markets have clear and transparent rules regarding the admission of financial instruments to trading.

Those rules shall ensure that any financial instruments admitted to trading in a regulated market are capable of being traded in a fair, orderly and efficient manner and, in the case of transferable securities, are freely negotiable.

2. In the case of derivatives, the rules shall ensure in particular that the design of the derivative contract allows for its orderly pricing as well as for the existence of effective settlement conditions.

3. In addition to the obligations set out in paragraphs 1 and 2, Member States shall require the regulated market to establish and maintain effective arrangements to verify that issuers of transferable securities that are admitted to trading on the regulated market comply with their obligations under Community law in respect of initial, ongoing or ad hoc disclosure obligations.

Member States shall ensure that the regulated market establishes arrangements which facilitate its members or participants in obtaining access to information which has been made public under Community law.

4. Member States shall ensure that regulated markets have established the necessary arrangements to review regularly the compliance with the admission requirements of the financial instruments which they admit to trading.

5. A transferable security that has been admitted to trading on a regulated market can subsequently be admitted to trading on other regulated markets, even without the consent of the issuer and in compliance with the relevant provisions of Directive 2003/71/EC of the European Parliament and of the Council of "…"on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC. The issuer shall be informed by the regulated market of the fact that its securities are traded on that regulated market. The issuer shall not be subject to any obligation to provide information required under paragraph 3 directly to any regulated market which has admitted the issuer's securities to trading without its consent.

Extract from the mandate from the Commission

- Specify the characteristics of different classes of instruments to be taken into account by the regulated market when assessing whether an instrument is issued in a manner that allows it to be traded on a fair, orderly and efficient manner, in the case of transferable securities, define the conditions under which financial instruments are freely negotiable

- clarify the arrangements that the regulated market is to implement so as to be considered to have fulfilled its obligation to verify that the issuer of a transferable security complies with its obligations under Community law in respect of initial, ongoing or ad hoc disclosure obligations.

- clarify the arrangements that a regulated market that admits transferable securities to trading has to establish in order to facilitate its members or participants in obtaining access to information which has been made public in the conditions established under Community law.

CESR advice

Explanatory text

General

CESR has prepared this advice on implementing measures for admission to trading on a Regulated Market taking into account that Member State Competent Authorities may continue to operate a listing regime under the provisions of the Consolidated Listing Directive (CLD). While Regulated Markets will not be required to operate a 'top tier' segment of officially listed securities, some Member States expect the officially listed segment to continue to hold an important place in the admission of securities to public trading.

The core objectives of admission to trading requirements are to support fair, orderly and efficient trading of financial instruments by ensuring that market users have sufficient information to evaluate those instruments and to ensure that the instruments are inherently capable of being reliably priced. The major disclosure requirements for most transferable securities are established by three other Directives - the Prospectus Directive, Transparency Obligations Directive and the Market Abuse Directive. Together, these directives establish initial, ongoing and ad-hoc disclosure obligations on issuers of securities as regards making information available to the public on the issuers, the nature of the securities they have issued, and their financial health as an undertaking. CESR has therefore focused this advice on issues and instruments not addressed by those directives.

Characteristics of instruments to be admitted to trading

In respect of the negotiability of transferable securities (Art 4 (1) (18)) CESR considers that, in general, it is desirable that securities admitted to trading on a regulated market should be freely negotiable and freely transferable. However, it recognises that the laws of some Member States still provide for certain types of issuer to retain the right to approve a transfer of securities. This is already recognised in the exemptions from free negotiability permitted under the CLD, provided that the operation of the approval process does not 'disturb' the market. CESR considers it reasonable to extend this exemption to regulated markets in their admission processes provided that the approval process is considered unlikely to adversely affect the fair, orderly and efficient operation of the market. For the avoidance of doubt, CESR also considers that partly paid securities should be treated as freely negotiable unless specific restrictions have been placed on their transferability during the period in which they are partly-paid.

In the case of the admission of shares, it is desirable that there should be a sufficiently broad shareholder base in any class of shares. In particular, the shareholder base should include investors other than controlling interests, the management or parties connected to them. CESR is not recommending that regulated markets should always replicate the normal 25% free float requirements of the CLD. Although this is a useful benchmark for regulated markets to bear in mind, such a high percentage requirement may not necessarily be essential to support an open market in an issue, especially a relatively large issue, whether of shares or depository receipts.

Additionally in respect of shares, CESR considers that a Regulated Market should normally admit shares only where the issuer has (or is acquiring) an established business and thus have an appropriate track record. However, CESR also considers it important to provide for an option for admitting start-up businesses, such as investment companies or scientific research companies, when there is satisfactory information and/ or other arrangements relating to the issuer that will support the fair, orderly and efficient operation of the market in the shares. Such conditions might be met where, for example, the Competent Authority has exercised its powers (under Article 23(1) of the Prospectus Regulation) to require additional disclosures of the issuer, where controlling vendors or management enter into commitments limiting their ability to sell shares over a specified period or the company has sufficient working capital for its immediate business objectives.

In the case of bonds, CESR is recommending no additional implementing measures at this stage. CESR recognises that bonds are generally less frequently traded than shares and have different characteristics. In particular, bond pricing is normally closely correlated to a publicly visible yield curve and, unlike shares, has relatively little correlation to the changing profitability of the issuer (unless that change is sufficiently significant to have implications for the issuer's ability to meet its obligations under the securities). CESR notes however that there is work undertaken by the Commission and IOSCO regarding bonds. Based on the outcome of that work the proposal should be reviewed and revised if necessary.

In respect of money-market instruments with an initial maturity of less than 12 months (and which are therefore not covered by the Prospectus Directive), CESR has confined its advice to a recommendation that sufficient information should be available to enable market users to understand the terms of the instrument. At present, these instruments are rarely admitted to trading on Regulated Markets and, though this could change in future, CESR sees no reason to recommend additional requirements. While it is recognised that they are not covered by the three above-mentioned disclosure directives, information on issuers of these instruments (but not necessarily on the guarantor of the issues) is generally widely available – often because the issuer has issued other instruments that are subject the Prospectus Directive. Additionally, these instruments are generally priced by reference to other short-term yields and the relative credit status of the issuer

In the case of securitised derivatives, CESR's advice mirrors the advice for derivatives generally. The securities should meet all elements of the requirements relevant to the type and structure of the security being admitted.

In the case of units and shares in collective investment undertakings, CESR notes that there is currently no EU-wide definition of precisely what this term encompasses and that different Member States have different approaches to the types of funds they permit to be distributed in their jurisdictions. Regardless of the national differences (especially in regard to close-end funds), CESR has addressed the requirements for all such instruments in the specific section for such instruments (and not as shares). CESR has proposed that a Regulated Market should require any open or close ended fund that it intends to admit to trading should have complied with any regulatory requirements that are pre-conditions to public distribution in that Member State. CESR´s reading of the Prospectus Directive is that it does not prevent host Member States from setting additional requirements for the public distribution of closed end funds, except for the information contained in the prospectus This does not withdraw the right of the jurisdiction of the regulated market to exempt any types of collective investment undertakings from any applicable notification, registration etc. requirements as a precondition to admission to trading, if that jurisdiction chooses to do so.

For open-end funds, it is desirable that there should be arrangements capable of creating a viable market. This can be achieved by several, optional ways. Moreover, in order to allow investors to have appropriate information on the value of the fund, the net asset value of the fund should be published regularly.

It is important to recognise that the proposals in this advice in respect of collective investment schemes are restricted to issues relating specifically to the admission of their units to trading on a Regulated Market. Other issues regarding collective investment schemes (e.g. eligible assets for UCITS) are treated in the specific legislation regarding such instruments.

CESR's proposed requirements in respect of the admission of derivative contracts are more detailed than for most other instruments. This reflects the different nature and functions of the instruments and the fact that no other directive comprehensively addresses these issues. CESR has based its requirements on those typically used in many markets both in and outside the EU. Much of the focus in respect of derivatives should necessarily be on the price reliability and visibility of the price (or measure) of the asset (or other factor) underlying the contract and on the processes for settlement and, where relevant, physical delivery. The advice recognises that in some cases, notably in commodity derivatives, the futures markets can play a significant role in establishing the price of the underlying.

Arrangements for verifying issuer compliance with disclosure requirements

The primary obligation in respect of proper disclosure of information lies with issuers. Responsibility for enforcement of that obligation rests with the Competent Authority laid down in the relevant disclosure directives. The responsibility of the Regulated Market in respect of verification of initial disclosure obligations should therefore be strictly limited to that of confirming that the required processes of approval, publication or exemption have been fulfilled. The Regulated Market should adopt a formal internal procedure for verification as part of its systems and controls and this should require sufficient documentation to demonstrate that an effective process has been followed.

Where an issuer, or the person seeking admission, is exempted from the requirement to publish a prospectus, a Regulated Market should require the issuer, or the person that has applied for admission, to provide a copy of any exemption certificate that has been issued or provide written confirmation, or a documented external legal opinion, that the conditions for exemption have been met.

To ensure that it is able to verify an issuer's ongoing compliance with EU law on ongoing and ad hoc disclosure, a Regulated Market needs also to ensure that it has an organised process. It should also have appropriate information-sharing mechanisms with the relevant competent authority of the home Member State of an issuer, as determined by the Transparency Directive.

Facilitation of access to information

It is important that members and participants of Regulated Markets have ready access to information on issuers published under the requirements of the main disclosure directives. However, in CESR's view the provisions of those directives for the availability and dissemination of information limit the obligations that need to be placed on a regulated market under MiFID to facilitate access to that information.

In particular, the TOD requires the issuer or the person who has applied for admission to trading on an RM without the issuer's consent to disclose regulated information to the public in a manner that ensures fast access to such information on a non-discriminatory basis. Further, an issuer must make this information available to the officially appointed mechanism chosen by the home Member State of the issuer for the central storage of regulated information. The issuer or person applying for admission to trading also has to use such media as may reasonably be relied upon for the effective dissemination of information to the public throughout the European Union.

The requirement in MiFID (which was drafted in parallel to the drafting of the TOD) covers only exchange members or participants whereas the scope of TOD extends to the public at large. It makes sense therefore that the arrangements of RMs would not need to duplicate the mechanisms for providing access to regulated information established under the TOD.

However, information published on the basis of the Prospectus directive will not be covered by the arrangements for the dissemination and storage of information provided for under the TOD. Regulated Markets should therefore facilitate access to such information by making available information – for example through their web-site or other information systems – details of where prospectus information may be obtained.

Level 2 advice

BOX 25

Requirements for instruments to be admitted to trading on a regulated market

73. Requirements for Transferable securities (Annex I, Section C, (1)):

Transferable securities should be considered freely negotiable when they can be traded between the parties to a transaction, and subsequently transferred without restriction. In parallel with this, all shares within a class should be capable of being fungible.

However, shares which may be acquired only subject to approval may be considered freely negotiable if the use of the approval clause does not disturb the market.

Securities that are not fully paid may be considered as freely negotiable if arrangements have been made to ensure that the negotiability of such securities is not restricted and that dealing is made open and proper by providing the public with all appropriate information.

- Additional requirements for "shares" (in the meaning of Article 4 (18) (a))

There should be sufficient shares in public hands and sufficient breadth of distribution to be capable of creating a viable market.

An issuer should normally operate an established business with appropriate track record, but waivers to this requirement should be permitted where there are satisfactory information and/or other arrangements to ensure that the shares of such companies are capable of being traded in a fair, orderly and efficient manner.

- Additional requirements for bonds and other securitised debt instruments (in the meaning of Article 4 (18) (b))

  No level 2 proposed at this stage.

- Additional requirements for other securities (in the meaning of Article 4 (18) (c)) to be applied according to the nature of the security being admitted:

  a. The terms of the security should be unambiguous and allow for a correlation between the price of the security and the price of the underlying asset (or the value measure of the underlying factor);
  b. The price (or other value measure) of the underlying should be considered reliable and be publicly available;
  c. There should be sufficient information typically needed to value the security;
  d. The arrangements for determining the settlement price of the security should ensure that this price properly reflects the price (or other value) of the underlying asset (or factor) and minimise the potential for manipulation or distortion;
  e. Where the settlement of the security requires or provides for the possibility of the delivery of an underlying asset rather than cash settlement:

     i. there should be adequate settlement and delivery procedures for the underlying asset;

     ii. there should be adequate arrangements to obtain relevant information about the underlying asset (e.g. in the case of commodities the quality grade)

74. Requirements for Money-market instruments

There should be adequate information available on the terms of the instrument when money market instruments with an initial maturity less than 12 months are admitted to trading.

75. Requirements for units in collective investment undertakings

When admitting the units of collective investment undertakings to trading the RM should satisfy itself that as a precondition:

- If the collective investment scheme is a UCITS, it has complied with the notification procedure as required by the UCITS Directive 85/611/EC, as subsequently amended;
- If the collective investment scheme is a non-harmonised collective investment undertaking, it has complied with any applicable national registration requirements by the jurisdiction of the regulated market;
- If the collective investment scheme is a closed end fund, it has complied with any applicable national procedures in order for closed end funds to be distributed in the jurisdiction of the regulated market.

The jurisdiction of the regulated market should be able to exempt any types of collective investment undertakings from complying with any applicable notification, registration or other procedures mentioned above, if such requirements are not seen as a necessary precondition to admission to trading by that jurisdiction.

Additionally, for open end funds:

- The arrangements for trading should be capable of creating a viable market. In particular, there should be adequate breadth of distribution and sufficient number of units issued or appropriate market making arrangements or the management company of the scheme should provide appropriate alternative arrangements for investors to redeem the units.

- The value of the units should be made sufficiently transparent to investors by the periodic publication of net asset value.

Additionally for closed end funds:

- There should be sufficient number of shares in public hands and sufficient breadth of distribution to be capable of creating a viable market.

- The value of the units should be made sufficiently transparent to investors, either by publication of information on its investment strategy and/or by the periodic publication of net asset value.

76. Requirements for derivatives (points 4 -10 of section C of the Annex 1)

a. The terms of the derivative contract should be unambiguous and allow for a correlation between the price of the derivative and the price of the underlying asset (or the value measure of the underlying factor);

b. The price (or other value measure) of the underlying should be considered reliable and be publicly available. However, in cases where a RM admits to trading derivatives, as defined in Section C 5, 6, 7 and 10 of Annex I to MiFID, and the derivative contract is likely to assist in price discovery for the underlying due to the price (or other value measure) of the underlying not being publicly available, the RM should ensure that it has in place appropriate supervisory arrangements for monitoring of trading and settlement in such derivatives, and that contract terms and conditions ensure proper settlement and delivery, whether physical delivery or by cash settlement.

c. There should be sufficient information typically needed to value the derivative;

d. The arrangements for determining the settlement price of the contract should ensure that the price properly reflects the price (or other value) of the underlying asset (or factor) and minimise the potential for manipulation or distortion;

e. Where the settlement of the derivative requires or provides for the possibility of the delivery of an underlying asset rather than cash settlement:
   i. there should be adequate settlement and delivery procedures for the underlying asset;
   ii. there should be adequate arrangements to obtain relevant information about the underlying asset (e.g. in case of commodities, the quality grade)

RM's obligation to verify issuer's compliance with disclosure obligations

Initial disclosure obligations

77. The RM should have documented procedures for satisfying itself of issuers' compliance with their initial disclosure obligations.

Those procedures should ensure the verification by the RM that a competent authority has approved the prospectus or, where required on the basis of Article 18 of the Prospectus Directive, notified the competent authority of the host Member State of the issuer of the approval of the prospectus and that the prospectus has been published.

If there is no obligation to prepare a prospectus on the basis of the Prospectus Directive, the RM should seek documented confirmation from the issuer or the person applying for the admission to

trading without the consent of the issuer that the exemption applies.

Ongoing and ad hoc disclosure obligations

The RM should have documented procedures for satisfying itself of issuers' compliance with their ongoing and ad hoc disclosure obligations including any information sharing mechanisms with the relevant competent authority of the home Member State of the issuer as determined under the Transparency directive.

RM's obligation to facilitate its members or participants in obtaining access to information which has been made public under Community law

78. CESR is of the view that, in respect of information disclosed on the basis of the MAD and TOD, the provisions in these directives and the subsequent implementing measures, together with the level 1 provisions of the MiFID, are sufficient and no additional level 2 provisions are proposed.

79. Whenever a prospectus related to a new admission on that market is published, The RM should without undue delay inform members and participants where it can be obtained.

ANNEX 1
PROCESS AND WORK PLAN

1. On 20 January 2004, the European Commission published its first set of provisional mandates requesting CESR's technical advice on possible implementing measures for the MiFID by 31 January 2005 (Ref. CESR/04-021).

2. The second set of mandates requesting CESR's technical advice on possible implementing measures for the MiFID by 30 April 2005 was published by the European Commission on 25 June 2004 (Ref. CESR/04-323).

3. Both mandates from the Commission asked that CESR should have regard to a number of principles and a working approach agreed between DG Internal Market and the European Securities Committee in developing its advice. These were as follows:

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

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

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

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

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

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

4. Furthermore, in giving its advice on possible implementing measure, CESR has been asked by the EU Commission to take full account of the following criteria:

   - The protection of investors and market integrity by establishing harmonised requirements governing the activities of authorised intermediaries;

   - The promotion of fair, competitive, transparent, efficient and integrated financial markets as well as the promotion of competition;

- To strike a right balance between the objective of establishing a set of harmonised conditions for the licensing and operating of investment firms and regulated markets and the need to avoid excessive intervention in respect of the management and organisation of the investment firm;

- The amount of detail included in the advice should be very carefully calibrated case by case; the advice should ensure clarity and legal certainty but avoid formulations which would lead to overprescriptive, excessively detailed legislation, adding undue burdens and unnecessary costs to the firms and hampering innovation in the field of financial services.

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

Expert Group on intermediaries' issues: The expert group has been chaired by Mr Callum McCarthy (Chairman of the UK's Financial Regulator, The Financial Services Authority [FSA]); rapporteur of the group is Mr Carlo Comporti. This expert group covered the provisional mandates related to: organisational requirements; conflicts of interest; conduct of business obligations when providing investment services to clients; best execution; prompt, fair and expeditious execution of client orders and client consent prior to executing orders outside the rules and systems of a regulated market or MTFs.

Expert Group on market issues: This expert group has been chaired by Mr Karl-Burkhard Caspari (Vice President at the German Regulator, the Bafin); rapporteur of the group is Mr Jari Virta. This Expert Group covers the mandates relating to admission of financial instruments to trading, post-trade transparency disclosure by investment firms, pre-trade transparency requirements for MTFs, post-trade transparency requirements for MTFs, pre-trade transparency requirements for Regulated Markets and post-trade transparency requirements.

Expert Group on cooperation and enforcement issues: This expert group has been chaired by Mr Michel Prada (President of the French Securities Regulator, the Autorité des Marchés Financiers [AMF]); rapporteur of the group is Mr Alexander Karpf. This expert group covered the provisional mandates related to transaction reporting between competent authorities and exchange of information for which CESR delivered its advice by 31 January 2005.

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

6. In line with CESR's commitment to transparent working procedures and in order to have the technical input for the Expert Groups from external experts already at an early stage, CESR formed a specific Consultative Working Group of market participants drawn from across the European Markets. They were not intended to represent national or a specific firms' interest and do not replace the important process of full consultation with all market participants. The Consultative Working Group met four times with the Expert Groups and provided most valuable assistance to them for developing drafts of the final technical advice.

7. CESR has undertaken to consult widely all interested parties according to the principles set out in the Final Report of the Committee of Wise Men and as set out in CESR's "Public Statement on Consultation Practices" (Ref.: CESR/01-007c). The detailed steps of the consultations conducted by CESR for each mandate under MiFID are given in the work plan.

8. CESR published a Call for Evidence for each for the two set of mandates on 20 January 2004 (Ref.: CESR/04-021) and on 29 June 2004 (Ref.: CESR/04-323) seeking input on the respective key issues which it should consider in dealing with the first set of mandates. The deadline for responses was respectively 19 February 2004 and 29 July 2004 and more than 40 responses were received in both occasions.

9. On 17 June 2004 CESR published its first consultation paper on the first set of mandates under the MiFID (Ref.: CESR/04-261b). The public consultation closed on 17 September, except for

mandates on best execution obligation and market transparency obligations (see the next paragraph). The deadline for these mandates has been postponed to end of April 2005.

10. On 21 October 2004 CESR published its first consultation paper 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.

11. On 17 November 2004 CESR published a second consultation paper on the first set of mandates (Ref.: CESR/04-603b) which include areas covered in the current advice. This consultation, which closed on 17 December 2004, focused on key issues of policy identified in the responses to the first consultation and the practical aspects of implementation. CESR received 34 responses to the consultation.

12. By addendum of 29 November 2004 to the formal request for technical advice on possible implementing measures on the MiFID of 29 November 2004 the European Commission decided to accept the request formulated by CESR and extended the deadline granted to CESR for preparing advice on client order handling rules (Article 22.1) to 30 April 2005.

13. On 22 December 2004 CESR released a Call for Opinions (Ref.: CESR/04-689) regarding a single subject: advice to the Commission under Article 19.7 in relation to agreements between the investment firms and their professional clients. The period for responses to this call for opinions closed on 20 February 2005. More than 25 responses were received

14. On 3 February 2005 a second consultation paper regarding admission of financial instruments to trading on regulated markets (Article 40) was released (Ref: CESR/05-023b) for a period of one month CESR received almost 30 responses.

15. Concerning the second consultation paper on the second set of mandates (CESR/05-164) this was released on 3 March 2005. The paper covered the general obligation to act fairly, honestly and professionally in the best interest of the client (Article 19.1), definition of "investment advice" (Article 4.1), best execution (Article 21) and market transparency (Article 4, 22.2., 27 to 30, 44 and 45). Almost 70 submissions by interested parties were received during the one month consultation period.

16. By addendum of 11 March 2005 the EU Commission decided to accept the request formulated by CESR to extend the deadline granted for preparing advice on professional client agreement (Article 19.7), investment research (Article 13.3 and 18) and admission of financial instruments to trading (Article 40) by the end of April 2005.

Public hearings

17. Three public hearings on MiFID took place at CESR. On 8 and 9 July 2004, the first public hearing on Intermediaries, Markets and Cooperation and Enforcement covered aspects on first set of mandates. On 19 November 2004, a public hearing was held by CESR on the second set of mandates on investment advice, commodities, derivatives, general obligation to act fairly, honestly and professionally and in the best interest of the client, suitability and appropriateness tests and transaction executed with eligible counterparties. A third public hearing covering aspects of the last consultation document, such as market transparency, lending to retail clients, generic and specific investment advice and best execution took place on 23 March 2005. More than 100 participants attended the three hearings.

Consumer Day

18. Since the representatives of consumers and retail investors, with few exceptions, did not take active part to the process of public consultation conducted by CESR, CESR decided to organise a Consumer Day to attract the consumers' and retail investors' organizations into the consultative process in order to have input on the key issues also from investors' side of the market. The Consumer Day on CESR work under MiFID took place on 22 March 2005 and 14 representatives of national and European consumer organisations and associations attended.

CESR Work Plan for the mandates under the MiFiD

As of 30th April 2005

Date	Activity
20 January 2004	Provisional mandates - 1st set of mandates
19 February 2004	Deadline for comments to the "call for evidence" for the 1st set of mandates
1 March 2004	Consultative Concept Paper on Transaction Reporting, Cooperation and Exchange of Information between Competent Authorities
12 April 2004	Deadline for responses to the Consultative Concept Paper on Transaction Reporting, Cooperation and Exchange of Information between Competent Authorities
17 June 2004	First consultation on the 1st set of mandates
29 June 2004	Formal mandates – 2nd set of mandates
29 July 2004	Deadline for comments to the "call for evidence" for the 2nd set of mandates
17 September 2004	Deadline for comments on the 1st set of mandates
4 October 2004	Deadline for comments on the 1st set of mandates (best execution and market transparency)
21 October 2004	First consultation on the 2nd set of mandates
17 November 2004	Second consultation on the 1st set of mandates
17 December 2004	Deadline for the second consultation 1st set of mandates
20 December 2004	Call for Opinions on Professional Client Agreement
21 January 2005	Deadline for comments on the 2nd set of mandates
31 January 2005	Final approval – 1st set of mandates
3 February 2005	Call for Opinions on Admission of Financial Instruments to Trading on Regulated Markets
20 February 2005	Closure of Call for Opinions on Professional Client Agreement
3 March 2005	Closure of Call for Opinions on Admission of Financial Instruments to Trading on Regulated Markets
4 March 2005	Second consultation on the 2nd set of mandates (investment advice, general obligation to act fairly, honestly and professionally and in the best interest of the client, best execution, market transparency)
4 April 2005	Deadline for the second consultation on the 2nd set of mandates (investment advice, general obligation to act fairly, honestly and professionally al and in the best interest of the client, best execution, market transparency)
30 April 2005	Final approval - 2nd set of mandates and some aspects of the 1st set of mandates

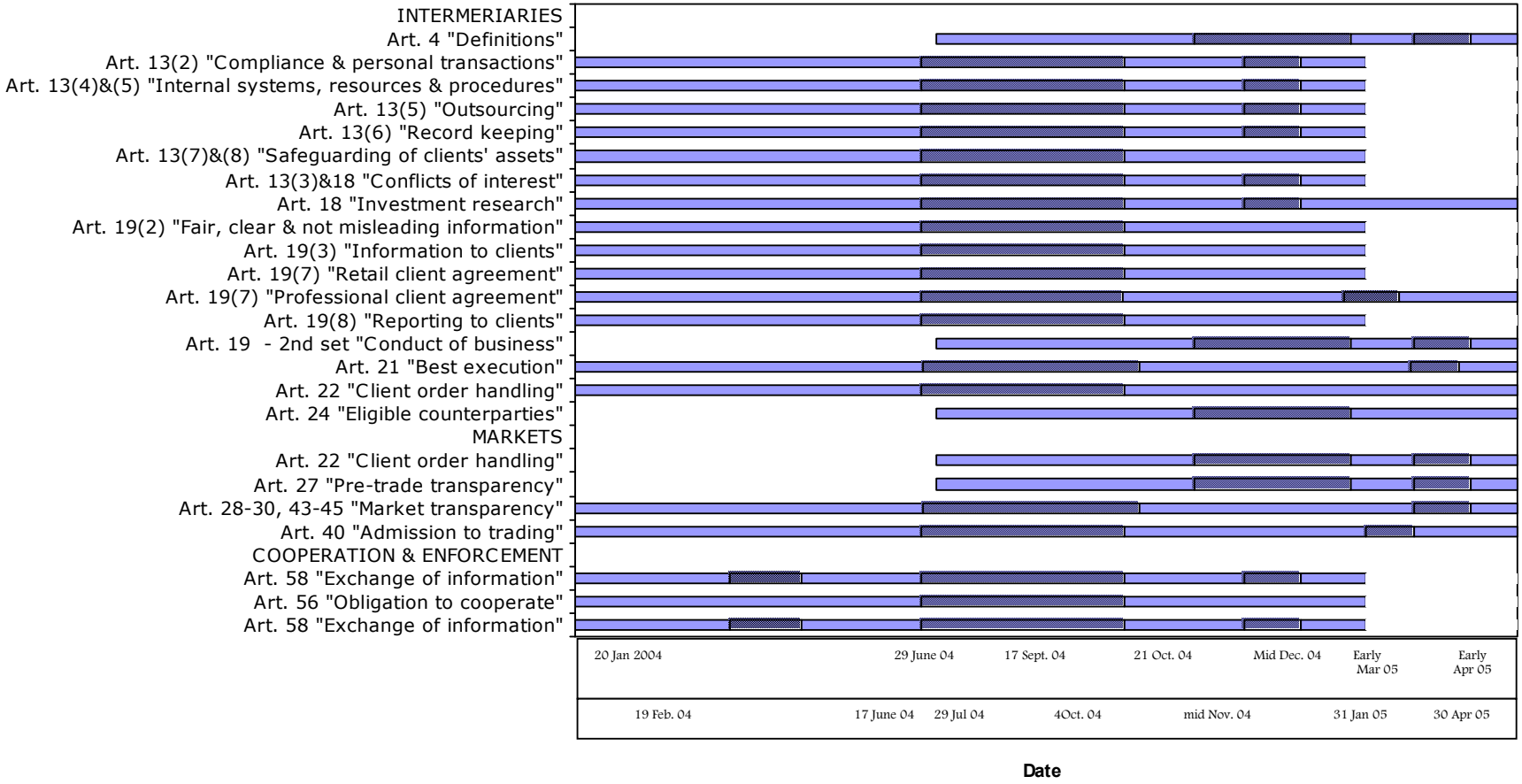
Completed

Consultative Concept Paper or Call of Opinions

Period of first consultations

Period of second consultations

CESR Work Plan for the mandates under the MiFiD



ANNEX 2

LIST OF MARKET PARTICIPANTS OF CONSULTATIVE WORKING GROUP

The members of the Consultative Working Group are:

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