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CESR

The Committee of European
Securities Regulators
11-13 avenue de Friedland
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your message of

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Second Consultation Paper of the Committee of European Securities Regulators (CESR) of March 2005 on Possible Implementing Measures of the Directive 2004/39/EU on Markets in Financial Instruments (MiFID)
Ref: CESR 05-164

This position statement is also sent on behalf of the following organisations:

- *BÖAG Börsen AG*
- *Börse München*
- *Börse Stuttgart*

Dear Madam/Sir,

With the Second Consultation Paper on Possible Implementing Measures of the Directive on Markets in Financial Instruments CESR has presented a draft which as a whole – and this is to be expressly welcomed – adopts a pragmatic approach that takes up, and considers in a manner that can be said to be broadly appropriate, the arguments put forward so far by the market participants and their representatives in the course of the consultation process. This does not mean, however, that there is not the one or other point that still needs to be modified or clarified, in our opinion. This being premised, we should like to raise a few aspects that are of particular importance, in our view:

1. Definition of Systematic Internalisers (Article 4)
(CESR Consultation Paper, page 37 et seq.)

In addition to the qualitative criteria for determining systematic internalisation *(conducting the business model on an organised, systematic and frequent basis)* it is now proposed to supplement this with additional quantitative

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variables, with the assumption of systematic internalisation being linked to the criteria that an investment firm executes at least 20% of its client orders on own account outside a regulated market or MTF, or that the value of client orders executed in this way represents at least 0.5% of the total value of trading in the respective share on the most liquid market.

While in this connection the desire to use apparently "objective" quantitative thresholds, in addition to the qualitative criteria of *"organised"*, *"systematic"* and *"frequent"* which need to be concretised in the given case, to assess whether systematic internalisation is carried out is understandable, there are at the same time a number of considerations which argue against this:

- No apparent reasoning is given in the consultation paper for the thresholds set and this therefore appears to be purely arbitrary.
- Depending on how they are implemented at the national level, they could de facto become a *de minimis* rule that does not appear to be covered by the wording of the Directive – different administrative practices in the member states could, additionally, undermine the uniform implementation of this, for the purposes of the Directive, central regulatory element.
- The provisions of Article 27 especially define, from the perspective of investor protection, relevant general minimum standards for the systematic internalisation of client orders on which the investor must be able to rely irrespective of the absolute or relative size of the internaliser.
- The relative threshold of 20% for client orders executed on own account outside the regulated market or MTF also appears problematic from the aspect of competition; in practice this could result in systematic internalisers with the same absolute internalisation volume being treated unequally simply because of differences in the level of diversification of their other business.

Weighing all these aspects, considerations of investor protection and assuring a level playing field among systematic internalisers on the motto *"same business – same rules"* argue against the use of additional quantitative indicators in the definition of systematic internalisers despite its plausibility prima facie. bwf is therefore not in favour of implementing the rule in the proposed form and proposes that paragraph 12, page 40 is deleted.

2. Defining the scope of the quoting obligation for Systematic internalisers (Article 27)

(CESR Consultation Paper, page 42 et seq.)

Article 27 (1) sentence 1 MiFID restricts the obligation for systematic internalisers to those shares for which there is a liquid market. The core of the CESR

implementing measures in this context is therefore the definition of liquidity indicators that are suitable for these purposes.

Proposed is a mix of the following criteria:

- shares are traded daily and
- free float of at least 1 billion euro and
- at least 500 trades per day or
- average daily turnover of at least 2 million euro.

Since the definition of liquidity within the meaning of Article 27 is primarily concerned with limiting the risk for systematic internalisers, and their ability to unwind at short notice a trading position entered into in the course of internalisation, it would be more expedient, in our opinion, to drop the criterion of free float and, instead, to use the thresholds of trades per day and average daily turnover as a cumulative criterion. In this case, in the interest of the systematic internalisers, a doubling of the threshold for average daily turnover to 4 million euro could be considered. A correspondingly modified proposed formulation for paragraph 22, page 43, could therefore read as follows:

> *"22. A share should be deemed to have a liquid market for the purpose of Article 27, when it meets the following criteria:*
>
> *(a) Trading activity: The share is traded daily; and*
>
> *(b) ~~The free float of the share is at least 1 billion euro.~~*
>
> *~~The free float should be calculated by excluding those holdings exceeding 5 % of the voting rights, as defined in the Transparency Obligations directive. CESR notes that during the period when the Transparency obligations directive is not in force, the free float may be calculated by using a widely accepted/used EU-wide index calculations as a proxy;~~*
>
> *~~And additionally one of the following alternative criteria as chosen by a Member State~~*
>
> *~~(c)~~ Average number of trades per day: The daily average number of transactions in a share is more than 500; ~~or~~ and*
>
> *~~(d)~~ (c) Average daily turnover in a share: The average daily turnover in a share is more than ~~2~~ 4 million euro."*

In case CESR wishes to adhere to a liquidity definition using free float as an essential indicator variable we would suggest that the threshold should be lowered from 1 billion euro to 250 million euro since shares with a daily turnover of over 20 million euro would otherwise be classified in some cases as "not liquid". A result that would simply not be supportable from a practical

viewpoint, especially as the other qualification criteria CESR proposes: *average number of trades per day* and *average daily turnover* would continue to apply for definition purposes.

3. Content of pre-trade transparency for Regulated Markets and MTFs (Article 29 & Article 44)
(CESR Consultation Paper, page 44 et seq.)

On this point we already argued in detail in our position statement of 16.09.2004 that the future safeguarding of a continuous auction market model where the investors are informed about the orderbook situation at the pre-auction stage through the publication of *indicative price ranges* which is typical of floor trading here and has proven its worth over many years is a central and most pressing concern from the viewpoint of investment firms admitted to the stock exchanges in Germany, especially also from the aspect of competition among trading venues.

We therefore welcome it all the more emphatically that in the explanatory text on Chapter 4 CESR has now expressly clarified that the operation of such market models will continue to be possible in future also under the legal framework conditions of MiFID (*CESR Consultation Paper, page 42, paragraph 38)*.

In its implementation this is to be ensured by a correspondingly flexible treatment of the pre-trade transparency rules (*CESR Consultation Paper page 53 et seq.)* and not, as we had proposed, by way of a possible exemption from pre-trade transparency expressly provided for in the Directive – subject to a corresponding member state ruling – for certain market models *(pursuant to Article 29 (2) sentence 1 in conjunction with (3) letter c) and Article 44 (2) sentence 1 in conjunction with (3) letter c))*.

The present draft provides for an exemption based on market model solely for so-called *"crossing systems"* (*CESR Consultation Paper, page 55, paragraph 86)*. Indeed, *c*rossing systems differ from the aforesaid market model in that, among other things, they have no autonomous price discovery mechanism and it therefore appears as if establishing pre-trade transparency can generally be waived, while the published *indicative price range* is in fact a specific form of pre-trade transparency. However, it has to be borne in mind that since it describes a bandwidth, in contrast to an indicative theoretical equilibrium price, no corresponding indicative theoretical auction volume can be stated. Conversely, it might be possible to publish an *indicative price range* even if, owing to the orderbook situation, no indicative theoretical equilibrium price with related volume can be determined.

Owing to the special technical characteristic of the *indicative price range* as a price band indicator, as just outlined, to which no theoretical trading volume is directly and clearly assignable, there could be a conflict with the publication

of market depth expressly required in connection with pre-trade transparency in the wording of the Directive *(Article 29 (1) sentence 1 and Article 44 (1) sentence 1)* if this were strictly interpreted. Against this background an exemption ruling would still appear, in our view, to be the, as a whole, more suitable means of guaranteeing the continued operation in future of the market model described and which, in the end effect, would provide comparatively greater legal certainty for the trading venues and investment firms concerned. We therefore request once more that CESR reconsider the possibility of a corresponding exemption based on market model in light of these arguments.

Such an exemption rule based on the market model used could read as follows:

> *"The pretrade transparency obligation can be waived if trading on a RM or MTF is based on a market model, especially auctions, where the individual bids/offers are firm but they are not published and are used instead to form an indicative price range which informs market participants about the trading interests entered into the auction"*

In case the implementation of such an exemption rule should not be possible in CESR's view and the continued operation in future of the market models stated in the CESR Consultation Paper, paragraph 38, page 42 is to be assured – at least this is our interpretation of the text – by appropriate application of the rule proposed in paragraph 78, page 53 et seq., it must be ensured at all events that there is no undesirable subsumption under the market models described in paragraphs 74 to 77, page 53.

Such a danger could arise for instance from paragraph 75, page 53, which generally covers market models based on the principle of "*periodic auction*" for which the publication of an indicative theoretical equilibrium price and an indicative auction value is stipulated as mandatory. Since the predication area of "*periodic auction*" remains vague and it is therefore difficult to demarcate it off from a *"continuous auction"*, we feel that a more precise formulation is absolutely essential at this point. If, in using the term "*periodic auction",* CESR has in mind the opening and closing auctions of the kind implemented in a number of fully electronic trading systems, we suggest that this should be clarified accordingly by using the formulation "*fully electronic periodic auction trading system*".

In our view, paragraph 77, page 53 is also problematic in much the same way in that it does not describe specific market models but refers quite broadly to those forms of trading where market members are involved in the price discovery mechanism as *"market personnel"*. However, in the CESR Consultation Paper of June 2004 *(CESR/04-261b)*, paragraph 25, page 10 "*market personnel*" was defined generally as "*operators that support liquidity, e.g. specialists, animateurs, committed principals, market makers etc.*"

Hence, within the framework of the Second Consultation Paper paragraph 77, page 53 would not only give rise to a double regulation of the market maker system already dealt with in paragraph 76, page 53, but the local stock broker of the German kind for instance, who, as we argued in detail in our position statement of 16.09.2004, regularly provides the market with liquidity especially in narrowly traded stocks, would also be covered by the scope of application of paragraph 76, page 53, and a desired subsumption of the market model under paragraph 78, page 53 et seq. would no longer be possible. As it is, the concept of *"market personnel"* seems very synthetic to us and would appear less suitable on the whole, given the broadness of the definition, as a classification criterion for transparency requirements that are to be given more concrete form within the framework of the implementing measures. For the above reasons we propose that paragraph 77, page 53 should be deleted altogether and not be replaced.

Furthermore, it should be clarified at all events in paragraph 78-b), page 54 that the obligation to publish at least the five best bid and offer levels is restricted to those market models which generally provide for the publication of bids and offers and that the formulation "*if the price discovery mechanism so permits*" refers to the price discovery mechanism as such and not to the purely technical possibility of publication. Otherwise, the regulatory intent formulated in paragraph 38, page 48 would miss the mark. We therefore propose that paragraph 78.b, page 54 should be formulated more specifically as follows:

> *"78.b) The five best bid and offer levels are made public, if the characteristics of the price discovery mechanism so permits. Otherwise it shall provide a level of pre-trade transparency that is comparable to that described in paragraphs [73-77] taking into account the characteristics of the trading system and the principles of fair and orderly trading and investor protection; and"*

4. Quoting obligations of Systematic internalisers - Withdrawal and updating of quotes (Article 27)

(CESR Consultation Paper, page 56, paragraph 99)

The rule now proposed in paragraph 99, page 56 that systematic internalisers may only withdraw their firm quotes during the trading hours of the regulated market on which the given share is admitted to trading if trading in the share on the regulated market has been suspended appears, in our view, to be reasonable and appropriate from the viewpoint of a "*level playing field*" and is expressly supported by bwet seq. This all the more so since systematic internalisers can, as it is, significantly limit the risk associated with the obligation to publish firm quotes by one-sided quoting and/or reducing the quoting volume.

5. Size customarily undertaken by a retail investor (Article 27.3)

(CESR Consultation Paper, page 57, paragraph 105)

Although the observed market behaviour of retail investors as regards the size of orders does vary from market to market and across different investor groups, the concept of a uniform threshold as well as its measurement on the basis of the monetary value represented should be adhered to for reasons of practicability and transparency. The proposed value of 7,500 euro appears appropriate.

6. Display of Client Limit Orders (Article 22.2)

(CESR Consultation Paper, page 58 et seq.)

In this connection CESR is adhering essentially to its previous view that also in cases where a client limit order that is not immediately executable by an investment firm is transmitted to a regulated market or MTF, this may only be undertaken on condition that a *"visibility and accessibility test"* is met.

bwf had strongly criticized the approach adopted by CESR on this point already in its position statement of 21.01.2005. We uphold in full the criticism we voiced then and urgently request that CESR reconsider its own position. Thereby, the express intent of the implementing measure of Article 22 (2) to ensure *"earliest possible execution"* of the said orders, as stipulated in the wording of the Guideline, is not disputed.

However, in the case of Article 22 (2) sentence 2 (transmission to a regulated market or MTF) the legislator of the Directive has already given more specific form at Level 1, as it were, to a possible implementation measure in that an investment firm can regularly comply with the obligations arising from Article 22 (2), subject to consent by the national regulatory authorities, by transmitting the client limit order to a regulated market or MTET SEQ. A further concretisation in the sense of the proposed *"visibility and accessibility test"* is not required here, in our view, since the national regulatory authorities - after all the CESR members – always have the option not to apply the rule to a regulated market or MTF if there are doubts that the earliest possible execution of the client limit order cannot be guaranteed.

Conversely, the approach adopted by CESR so far on this point would be tantamount to nothing less than establishing a second, competing transparency regime. Accordingly, in future there would be regulated markets and MTFs of different kinds and quality. On the one hand, there would be those trading venues which *"only"* fulfil the pre-trade transparency rules as follow from Articles 44 and 29 of the Directive text and the implementation measures derived therefrom and, on the other, those, as it were, *"higher quality"* regulated markets and MTFs that qualify additionally for the execution of customer limit orders transmitted pursuant to Article 22 (2) sentence 2. Such a classifi-

cation, however, neither serves the protection of investors as required in Article 22 (3) nor takes account of the fair and orderly functioning of markets.

Moreover, in practice the proposed rule could have contrary effects directly opposed to the intent of the rule. For instance, if we take a client limit order not immediately executable by an investment firm in a share which is traded on a regulated market in a market maker system which, according to the CESR proposal in paragraph 127, page 61, does not meet the requirements of Article 22 (2) simply because the order would not be *"visible"* on the regulated market, the investment firm would not be able to transmit the order to the regulated market and would be compelled to make alternative arrangements, regardless of whether the investor's chances of earliest possible execution of his order are then lower than on the regulated market. This is likely to be more or less invariably the case even should the order not be promptly executable against the market maker's quote.

Despite partial attempts at concretization *(for instance in the CESR Consultation Paper, page 60, paragraph 121 et seq.)* there is still little clarity about what form such "*procedures and arrangements which result in the prompt, fair and expeditious execution of client orders" (Article 22 (3.a) MiFID)* could take in practice, what costs this would involve for the investment firms concerned and how this is to be properly demarcated from the MTFs that require licences.

To conclude, it therefore appears to be absolutely essential to delete the restriction *"order driven"* in the first sentence and the second sentence in the CESR recommendation in paragraph 127, page 61 completely. Accordingly, in the preceding explanatory text a *"visibility and accessibility test"* should no longer be a criterion in cases where a client limit order is transmitted to a regulated market or MTF, instead, the pre-trade transparency rules prevailing at these trading venues in accordance with Articles 44 and 29 should be deemed sufficient. A correspondingly modified paragraph 127, page 61, would read as follows:

> *„127. The obligation would be met where the limit order is sent to a~~n order driven~~ Regulated Market (RM) or a Multilateral Trading Facility (MTF). ~~The transmission of the limit order to a quote driven RM or MTF would not fulfil the obligation set out in Article 22.2 unless the client limit order could be made visible and rapidly executable in some other manner.~~"*

Regardless of this fundamental criticism of the proposed implementing measures of Article 22 (2) sentence 2 MiFID it is to be welcomed that the Second Consultation Paper versus the previous CESR position suggests a generally more flexible and pragmatic assessment of the interrelation between market model, transparency and liquidity *(page 58 et seq., paragraphs 109 & 110, page 60, paragraph 119)*

Therefore, should CESR wish to adhere to the procedure of a separate *"visibility and accessibility test"* also in cases where a client order is transmitted to a regulated market or MTF, despite the considerable scruples voiced above, we request that account be taken of the following proposed revisions and clarifying additions.

Paragraph 110, page 59, assumes that the types of trading mentioned *(call auction systems, partially open order books)* are the only form in which less liquid shares can be traded on a regulated market. Such a formalistic restriction does not appear to do justice to practical requirements. Even if the given shares can also be traded in parallel in the fully electronic trading system *(continuous orderbook trading)*, it is to be observed that the trading activities, and thus liquidity, are concentrated on the first named trading forms.

Moreover, in the interest of equal treatment and in conformity with paragraph 38, page 48, auction systems which inform the investor about the orderbook situation by publishing an *indicative price range* should be treated, in the formulation of the explanatory text, equally with those systems which publish an *indicative equilibrium price* with related volume. We therefore propose that paragraph 110, page 59 should be modified as follows:

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

Likewise, in paragraph 119, page 60 a clarifying reference should be made to the possibility of publishing an indicative price range:

> *"119. Where the non-immediately executed limit order is transmitted to a RM or MTF running a trading system (e.g. call auction) where the order is not immediately displayed as such but is reflected in the indicative price and volume or the indicative price range disseminated by the RM or MTF in the prenegotiation phase ("visibility test"), and where the transmission of the limit order to such trading system would provide the order with a large audience and make it potentially easily and rapidly executable, once it becomes executable in terms of market price, the transmission of limit*

order to such trading venue would be considered as meeting Article 22.2 requirements, without prejudice to Best execution obligations."

7. Transactions large in scale compared to normal market size

(CESR Consultation Paper, page 66 et seq.)

The proposal to create uniform European minimum standards for the criteria for exemption from pre-trade transparency and the possibility of deferred publication in case of transactions large in scale is supported in principle by bwet seq. The intention to set different thresholds, depending in each case on the allocation of individual shares to certain liquidity bands, for exemptions from pre-trade transparency, on the one hand, and the deferred establishment of post-trade transparency, on the other, also appears appropriate.

However, the classification into different liquidity classes *(CESR Consultation Paper, page 73, Table 1 & Table 2)* should be made as clear and simple as possible in deference to practical requirements. We therefore propose that the breakdown of the liquidity classes for both rules should be simplified and should be limited to a total of three liquidity bands. The two mid-liquidity bands in Table 1 should be combined.

Furthermore, the lower threshold in each mid-liquidity band should be raised to 5 million euro since the minimum volume of 250,000 euro required in Table 1 for stocks at the lower end of the liquidity band would otherwise appear disproportionately high. On the other hand, the threshold for exemptions from pre-trade transparency in the revised mid-liquidity range in Table 1 should be set at 300,000 euro.

In addition, we see the need for adjustments in the permissible time frame for delays in establishing post-trade transparency. In principle CESR's approach of measuring the available time frame on the basis of the ratio of the level of the risk position relative to the average daily volume in the given share appears appropriate. However, the parameters discussed below should on the whole receive stronger consideration:

- Average daily turnover is itself exposed to considerable fluctuations

- Liquidity is not spread evenly over the trading day, so the available time frame should therefore be measured in such a way that it realistically allows for a risk position to be unwind also in a comparatively less liquid trading phase (for instance around midday)

- With the desired containment of the *"market impact"* associated with unwinding a risk position (which is precisely the purpose of the rule discussed here) the market's absorptive capacity is a non-linear, degressive function. In other words, if the volume of the risk position is doubled, it takes more than double the time to unwind the position, other things being equal.

In light of the said imponderables it therefore appears to be appropriate and necessary to widen the first two time frames stated in Table 2. We suggest an additional risk buffer of a total of 60 minutes. The obligation to make an earlier publication depending on when the position is actually run off would not be affected thereby.

To conclude, Table 1 and Table 2 would read as follows in the modified and, with regard to the liquidity bands, harmonised version:

Table 1: Pre-trade waiver thresholds

Minimum size of transaction qualifying for a waiver			
	High liquidity shares > *50 million EUR*	*Mid-liquidity shares* ***5****-50 million EUR*	*Less liquid shares* < ***5*** *million EUR*
	500,000 EUR	***300,000 EUR***	*100,000 EUR*

Table 2: Deferred publication arrangements

Maximum permitted delay for trade publication	***Minimum qualifying size of trade (and cash ceilings)***		
	High liquidity shares > *50 million EUR*	*Mid-liquidity shares* ***5****-50 million EUR*	*Less liquid shares* < ***5*** *million EUR*
120 *minutes*	*More than 10% of ADV or more than 10 million EUR*	*More than 10% of ADV or more than 3.5 million EUR*	*More than 5% of ADV but at least 10,000 EUR*
180 *minutes*	*More than 20% of ADV or more than 20 million EUR*	*More than 15% of ADV or more than 5 million EUR*	*More than 15% of ADV but at least 30,000 EUR*
End of day (+roll-over)	*More than 30% of ADV*	*More than 25% of ADV*	*More than 30% of ADV*

Yours faithfully,

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