COMMITTEE OF EUROPEAN SECURITIES REGULATORS

Date: 29 July 2010

CESR Technical Advice to the European Commission in the Context of the MiFID Review and Responses to the European Commission Request for Additional Information

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V. CESR's responses to questions 15-18 and 20-25 of the European Commission request for additional information in relation to the review of MiFID

This paper consolidates the different parts of the first set of CESR contributions to the Commission on the MiFID Review. It contains technical advice (sections I-IV) and responses (section V) to the request for additional information made by the Commission.

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Date: 29 July 2010
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TECHNICAL ADVICE

CESR Technical Advice to the European Commission in the Context of the MiFID Review - Equity Markets

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Executive Summary

The Markets in Financial Instruments Directive (MiFID) came into force on 1 November 2007. It introduced significant changes to the European regulatory framework for secondary markets. CESR initially assessed the impact of these changes in the first half of 2009 and published a report in June 2009. This report on 'impact of MiFID on equity secondary markets functioning' (Ref: CESR/09-355) recommended further work to address some issues identified.

Following the publication of the report, CESR held a series of meetings with representatives from regulated markets (RMs), multilateral trading facilities (MTFs), investment firms, buy-side firms and market data vendors and conducted a fact-finding to obtain information on dark trading taking place on RM, MTFs and investment firms' crossing processes. The information gained fed into the Consultation Paper (CP) on equity markets that CESR published in April 2010 as part of the MiFID review (Ref: CESR/10-394). 76 responses to that consultation, including confidential submissions, have been received. The responses to the CP, together with information received in response to CESR's Call for Evidence on micro-structural issues that was also published in April (Ref: CESR/10-142), informed the technical advice that CESR provides to the European Commission in this report. The data on dark trading taking place on RMs, MTFs and investment firms' crossing systems has been updated with figures for Q1/2010.

The main recommendations addressed in this report are covered by the following headings:

Pre-trade transparency regime for RM/MTFs:

Data from the fact-finding shows that more than 90 percent of trading on organised markets in Europe is pre-trade transparent. CESR recommends retaining the general requirement for pre-trade transparency on organised markets (RM/MTFs). However, exceptions to pre-trade transparency should continue to be allowed under certain circumstances.

In order to provide greater clarity for regulators and market participants and facilitate continuous supervisory convergence, CESR seeks to move from a 'principle based approach' to waivers from pre-trade transparency to an approach that is more 'rule based'. In addition, CESR recommends the Commission provide ESMA with specific powers to monitor and review the pre-trade transparency waivers going forward and to develop binding technical standards in this regard.

Regarding particular waivers, CESR recommends the Commission undertake/commission further analytical work based on empirical data to determine whether the existing large-in-scale (LIS) thresholds should be revised. CESR stands ready to provide the Commission with further assistance in this work, including recommending parameters and reviewing data. CESR also recognises the need for a harmonisation of the treatment of 'stubs' under the LIS waiver and recommends to clarify that venues using the reference price waiver should not embed a fee in the price of trades. With respect to the existing wording of the waivers, CESR continues to work on appropriate clarifications (as were outlined in Annex I of the CP) which may, as appropriate, be included in binding technical standards at a later stage.

In addition, CESR recommends that MiFID be amended to clarify that actionable indications of interest (IOIs) are considered to be orders and as such subject to pre-trade transparency requirements.

Definition of and obligations for systematic internalisers:

CESR recommends the Commission clarify the objective of the systematic internaliser (SI)-regime and consider a broader review of this regime within the MiFID review, including further consideration of whether to establish appropriate thresholds for the material commercial relevance of the activity to the market and whether to retain/remove the price improvement restriction. CESR stands ready to provide the Commission with further assistance in this work in the coming months, as appropriate.

Notwithstanding the recommendation for a broader review, CESR sees value in some clarifications to ensure consistent understanding and implementation of the regime, as well as some specific

amendments to the regime to improve the value of information provided to the market. CESR therefore recommends clarifying the criterion 'according to non-discretionary rules and procedures' in the definition of an SI and (inter alia) to revise the SI-obligations to require two-sided quotes and minimum quote sizes.

Post-trade transparency regime:

CESR recommends retaining the current framework for post-trade transparency but to introduce formal measures to improve the quality of post-trade data, shorten delays for regular and deferred publication and reduce the complexity of the regime. Detailed proposals for binding post-trade transparency standards and guidelines on the obligations for post-trade transparency (as were outlined in Annexes II and III of the CP) are being worked on with the industry and detailed recommendations on this will be provided at a later stage.

As a supplement to the introduction of new standards on data quality and guidelines on trade publication, CESR recommends requiring investment firms to publish their trades through Approved Publication Arrangements (APAs). All APAs would be required to operate data publication arrangements to prescribed standards, as set out in Annex I.

Application of transparency obligations to equity-like instruments:

CESR recommends to enhance the scope of the MiFID transparency regime by applying transparency obligations to equity-like instruments admitted to trading on an RM, including depository receipts, exchange-traded funds and 'certificates' as defined in CESR's advice. These instruments are considered to be equity-like, since they are traded like shares and, from an economic point of view, equivalent to shares. CESR believes that there are benefits for investors stemming from a harmonised pan-European pre-and post-trade transparency regime for these instruments.

Regulatory framework for consolidation and cost of market data:

CESR recognises that significant barriers to the consolidation of post-trade data remain and that, without further regulatory intervention, market forces are unlikely to deliver an adequate and affordable pan-European consolidation of transparency information. CESR therefore recommends that a European consolidated tape be mandated and its main features outlined in MiFID. Regarding the technical implementation, CESR recommends a solution involving the industry within a clear scope and relatively short timeframe set by the Commission and ESMA. The process for the development of the European consolidated tape by the industry should be launched and progress and implementation monitored by ESMA. In case of default at any stage of the process, MiFID should identify a clear course of action and require the establishment of a mandatory single European consolidated tape run as a not-for-profit entity on the basis of terms of reference and governance to be set out by ESMA.

Regulatory boundaries and requirements:

CESR addresses concerns about certain inconsistencies which may have impacted the level playing field. It is recommended that the requirements which apply to RM and MTFs under MiFID be further aligned.

As regards broker crossing systems (BCSs), CESR recommends that a new regulatory regime with tailored additional obligations be introduced for investment firms operating such systems. This would include: notification by investments firms that they operate a BCS; publication of a list of BCSs; a requirement for a generic BCS identifier in post-trade transparency information; publication of aggregate trade information at the level of each BCS at the end of the day; and identification of BCSs in transaction reports. CESR also acknowledges concerns expressed by some market participants and regulators about the speed of growth of BCSs and the potential impact of these OTC markets on price formation in the future. It is therefore recommended to impose a limit on the amount of business that can be executed by BCSs before they are required to become an MTF. CESR stands ready to provide the Commission with assistance in the refinement of these proposals in the coming months, where appropriate.

MiFID options and discretions:

CESR has identified certain options and discretions within MiFID's markets provisions and consulted on the desirability of eliminating them or turning them into rules. CESR recommends retaining the discretion regarding the use of pre-trade transparency waivers and to retain the role of CESR/ESMA in considering the use of the waivers to ensure their consistent and reasonable use. Taking the feedback from the consultation into account, the discretion of Member States to choose some of the criteria to define liquid shares and the discretion regarding requirements for admission of units in collective investment undertakings to trading on an RM should also be retained. However, CESR sees merit in converting the discretion of Member States under Article 22(2) of MiFID into a rule by prescribing that investment firms comply with their obligation to make an unexecuted client limit order immediately public by transmitting it to a pre-trade transparent RM/MTF.

Micro-structural issues:

CESR sets out the key themes emerging from its Call for Evidence on micro-structural issues and proposes an action plan for further work in this area. CESR also recommends the Commission amend MiFID to include specific references to ESMA competencies to develop binding technical standards on RMs'/MTFs' organisational requirements regarding sponsored access, co-location, fee structures and tick sizes, as appropriate. Pending the revision of MiFID, CESR will consider dealing with some of these issues under CESR guidelines.

Other MiFID provisions related to secondary markets:

Since the activity of MTFs in host Members States has become increasingly significant post-MiFID, CESR recommends extending the obligation in Article 56(2) of MiFID for competent authorities to cooperate, such that it extends to the activities of MTFs as well as RMs.

1. Introduction

1. The Markets in Financial Instruments Directive (MiFID), a major part of the European Union's Financial Services Action Plan (FSAP), came into effect on 1 November 2007. It introduced significant changes to the European regulatory framework, taking account of developments in financial services and markets since the Investment Services Directive (ISD), which it replaced, was implemented in 1995.

2. In November 2008, CESR published a Call for Evidence (Ref. CESR/08-872) on the impact of MiFID on secondary market trading in equities. In response, thirty-nine submissions (including four confidential submissions) and three confidential annexes were received from a range of European trade associations, RMs, MTFs, market data vendors, investment firms and other interested parties. CESR also organised a roundtable at the beginning of 2009 which attracted a broad range of market participants.

3. In June 2009, CESR published its report on the 'impact of MiFID on equity secondary markets functioning' (Ref. CESR/09-355). This report set out its findings and recommended further work to address issues identified. Following the publication of the report, CESR held a series of meetings with representatives from RMs, MTFs, investment firms and market data vendors. CESR also received further written representations from RMs, issuers, high frequency traders and market data vendors. Finally, CESR conducted a fact finding to obtain information on dark trading taking place on RMs, MTFs and investment banks' internal crossing processes.

4. In developing proposals for the Commission's MiFID review, it is important to keep in mind relevant changes in the operation of trading and market structure. Technological advance has continued to facilitate new developments in markets, an important example being the strong growth in algorithmic and high frequency trading. A Call for Evidence was published in this respect on 1 April 2010 for a one month call for comments. CESR will continue work on these micro-structural issues in parallel to the MiFID review.

5. This report is organised as follows. Section 2 describes issues relating to the MiFID pre- and post-trade transparency regime and puts forward recommendations aimed at addressing concerns raised following the implementation of MiFID including, in particular, lack of clarity of the MiFID pre-trade transparency waivers and quality of post-trade transparency information. Section 3 considers so-called 'equity-like' financial instruments and proposes to extend MiFID transparency obligations to such instruments. Section 4 (and Annex I) considers remaining barriers to consolidation of transparency information and puts forward two possible approaches to promote consolidation. Section 5 assesses whether there is a case for re-aligning regulatory boundaries and requirements and proposes to better align requirements between RMs and MTFs and puts forward proposals for new requirements for investment firms' crossing processes. Section 6 identifies options and discretions in MiFID which relate to RMs, MTFs and SIs and where a more harmonised approach might be desirable. Section 7 summarises the comments CESR received in response to its Call for Evidence on micro-structural issues and outlines a proposed action plan for CESR to take forward. Finally, Section 8 addresses other issues related to the MIFID markets provisions.

2. Transparency

6. A key objective of MiFID is to promote competition between trading venues for execution services so as to increase investor choice, encourage innovation, lower transaction costs, and increase the efficiency of the price formation process on a pan-European basis. A high degree of transparency is an essential part of this framework, so as to ensure a level playing field between trading venues so that the price discovery mechanism in respect of particular shares

is not impaired by the fragmentation of liquidity, and investors are not thereby penalised[1]. Transparency also facilitates the application of the best execution obligations.

7. In developing policy options for transparency, it has been assumed that the existing MiFID framework for competition and best execution obligations remain unchanged.

2.1 Pre-trade transparency

2.1.1 Organised trading platforms (RMs and MTFs)

8. MiFID introduced pre-trade transparency obligations for shares admitted to trading on an RM with the aim of providing the wider investing public with access to information on current opportunities to trade on a timely basis. Pre-trade transparency obligations were also devised as a way of mitigating the potential adverse impact of a fragmentation of markets and liquidity, ensuring a level-playing field between trading venues, promoting the efficiency of the overall price formation process on a pan-European basis and assisting an effective operation of best execution obligations[2].

9. MiFID places the same pre-trade transparency obligations on both RMs and MTFs[3]. This regime requires RMs/MTFs to make public, on reasonable commercial terms, details of best bids and offers and the depth of trading interests at these prices.

10. MiFID also allows competent authorities to grant RM/MTF waivers[4] from pre-trade transparency obligations for certain types of orders and systems. There are four waivers from pre-trade transparency obligations, for:

    a. orders that are large in scale;

    b. reference price systems;

    c. systems which formalise negotiated transactions; and

    d. orders held in an order management facility

11. MiFID recognises that there are circumstances where exemptions from pre-trade transparency obligations are necessary. It explains that the waivers have been set out bearing in mind the need to ensure a high level of transparency and to ensure that liquidity on trading venues and elsewhere is not impaired as an unintended consequence of obligations to disclose transactions and thereby to make risk positions public.

12. The CESR fact finding shows that more than 90 per cent of trading on organised public markets in Europe is pre-trade transparent. The data indicates an increase in trading on organised public markets without pre-trade transparency in 2009, compared to 2008 from a quarterly average of 6.4 per cent of total EEA trading on organised public markets in 2008 to a quarterly average of 8.9 per cent in 2009 (see Table 1 below). The fact finding also indicates that the majority of trading without pre-trade transparency on organised markets takes place using the waivers for negotiated trades and for orders that are large in scale.

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[1] Article 5 of the MiFID Implementing Regulation

[2] The situation prior to MiFID is described by ESME, Fact finding regarding the developments of certain aspects of pre-trade transparency in equities under MiFID, p. 5et seq.

[3] See Articles 29(1) and 44(1) of MiFID. Pre-trade transparency obligations of systematic internalisers are laid down in Article 27 of MiFID and Articles 22 to 26 of the Commission Regulation (EC) No 1287/2006 of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards record keeping obligations for investment firms, transaction reporting, market transparency, admission of financial instruments to trading, and defined terms for purpose of that Directive, OJ L 241, 2.9.2006, p.1 ("MiFID Implementing Regulation").

[4] See Articles 29(2) and 44(2) of MiFID and Articles 18 to 20 of the MiFID Implementing Regulation.

Table 1: Trading in EEA shares executed under MiFID pre-trade transparency waivers[5]

	2008				2009				2010
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1**
Trading under pre-trade waivers*	282.3	263.4	213.0	182.7	146.9	203.9	206.8	240.6	222.6
All Trading in EEA shares on RMs and MTFs*	4234.6	3804.1	3692.5	2912.7	1934.1	2227.8	2289.8	2442.5	2624.8
Total as a % of all trading in EEA shares on RMs and MTFs	6.7%	6.9%	5.8%	6.3%	7.6%	9.2%	9.0%	9.8%	8.5%

*Values are in bn Euros
**Q1 2010 figures do not include data from Poland
Sources: (1) Value of trading on RMs and MTFs without pre-trade transparency: Member State competent authorities; (2) All trading in EEA shares on RMs and MTFs: Thomson Reuters

2.1.1.1 Waivers from pre-trade transparency

13. Post-MiFID, trading platforms have availed themselves of pre-trade transparency waivers and many have been innovative in developing proposals which they felt responded to user demands and were within the MiFID scope. However, there are some concerns that the regime does not operate satisfactorily in a number of areas. There have been some interpretation issues on the scope of the waivers, which have resulted in practical difficulties. This lack of consistency and certainty is seen by trading platforms and their users as endangering the level playing field.

14. CESR has recognised that there are difficulties with the application of the waivers and has agreed to a number of initiatives. In April 2009, it launched a procedure whereby competent authorities submit proposals for the use of the waivers for discussion within CESR (the CESR waiver process). This process aims to achieve supervisory convergence and to ensure a consistent application of the waivers. The results of CESR's assessments of order types and order matching methodologies proposed by operators of RMs/MTFs are published on the CESR website in the document 'Waivers from Pre-Trade Transparency Obligations under the Markets in Financial Instruments Directive (MiFID)'[6].

15. More fundamentally, there has been substantial debate amongst regulators and market participants about the structure of the waivers. In particular, some participants contend that the waivers were designed in 2006 to match the market structure that existed at that time, but are less suited to the competitive and innovative market structure facilitated by the introduction of MiFID.

16. Many trading platforms and their users consider that the waivers are too narrow, do not provide for market developments, and are stifling innovation. It has also been suggested that it would be desirable to have a more dynamic transparency regime which responds to innovation and market developments. On the other hand, some other trading platforms and market participants consider that the use of waivers adversely affects the efficiency of the price formation process.

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[5] These figures do not include trading under the waiver for order management facilities. This table and the table on the Large in Scale Waivers do not include information from the Estonian and Icelandic FSAs.
[6] See CESR/09-324 available at www.cesr.eu/popup2.php?id=5754.

Proposal

17. CESR considered carefully the most appropriate framework for pre-trade transparency in a post-MiFID environment and concluded that it would be desirable to:

    a. retain the generic requirement that all trading on organised markets (RMs/MTFs) must be pre-trade transparent;

    b. continue to allow exceptions to pre-trade transparency in certain circumstances; and

    c. seek to move from a 'principle based' approach to waivers from pre-trade transparency to a 'rule based' approach where a more precise description of the waivers would provide greater clarity for market participants and competent authorities and facilitate continuous supervisory convergence with regard to waivers within CESR/ESMA, taking into account financial innovation.

Summary of Feedback

18. Respondents almost unanimously supported the generic approach to pre-trade transparency described in the CP. Nearly all respondents supported a move from a principle-based to a rule-based approach to the pre-trade transparency waivers, which would provide greater clarity for market participants and competent authorities. However, about half of the respondents supporting the rule based approach stressed the need to retain some flexibility to adjust to market developments and recommended that there be a sufficiently robust process for CESR/ ESMA to take into account financial innovation and evolve these rules.

Recommendation

19. CESR recommends retaining the generic approach to pre-trade transparency outlined above and moving from a principle-based to a rule-based approach to pre-trade transparency waivers. When developing the rule-based approach, the current assessments of order types and order matching methodologies, as published in CESR's document 'Waivers from Pre-Trade Transparency Obligations under the Markets in Financial Instruments Directive (MiFID), should be the starting point for discussions.

20. Furthermore, CESR recommends that the Commission give ESMA the power to undertake regular (e.g. annual) reviews of the use of the pre-trade transparency waivers (including the proportion of trading taking place under them) and to form binding technical standards to adjust the waivers to provide certainty about their interpretation or to reflect market developments, where appropriate. These powers should relate to technical points/application of the waivers as opposed to points of overarching policy.

21. With respect to the existing wording of the waivers, CESR continues to work on appropriate clarifications (as was outlined in Annex I to the CP) which may, as appropriate, be included in binding technical standards at a later stage.

2.1.1.2 Large in scale waiver

Background

22. The large in scale (LIS) waiver is designed to protect large orders from adverse market impact. MiFID recognises that mandatory public exposure for large orders makes the costs of execution higher than if the order is not displayed publicly.

23. MiFID sets out order size thresholds (fixed amounts expressed in Euros) above which RMs and MTFs do not have to display orders submitted to their systems. There are 5 thresholds, one for each of the 5 liquidity bands into which shares are placed on the basis of their average daily order book turnover (ADT) over the previous calendar year.

24. In 2008, an average of 3.1% of trading on European RMs and MTFs took place using the LIS waiver. The percentage rose to 4.2% in 2009 (see Table 2 below). However, the whole of this increase, and approximately 75% of all trading using this waiver in 2009, is attributable to trading in one jurisdiction. Elsewhere, the waiver is used relatively little, accounting for only one per cent of overall trading.

Table 2: Trading in EEA shares executed under the large in scale waiver

	2008				2009				2010
	Q1	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**	**Q1**
Trades under LIS waiver*	115.8	148.1	106.1	86.1	63.5	100.6	90.4	119.6	99.5
Total as a % of all trading in EEA shares on RMs and MTFs **(Percentage excluding Member State that is the main user of waiver)**	2.7% (1.0%)	3.9% (1.5%)	2.9% (0.9%)	3.0% (0.8%)	3.3% (0.7%)	4.5% (1.6%)	3.9% (0.9%)	4.9% (0.8%)	3.8% (1.1%)

*Values are in bn Euros

Sources: (1) Value of trading on RMs and MTFs without pre-trade transparency: Member State competent authorities; (2) All trading in EEA shares on RMs and MTFs: Thomson Reuters

25. CESR considers that a waiver from pre-trade transparency for orders that are large in scale is still justified to allow investors to avoid market impact when executing large trades. However, CESR sought views on options for the calibration of the thresholds for large in scale orders and clarifications on the scope of this waiver.

Large in scale – thresholds

26. Many trading platforms contend that the gap between the average order size and the LIS thresholds (set in 2006) is too wide and that as a result market participants do not get adequate protection from market impact when submitting orders. MiFID sets the threshold for large orders in the most liquid shares at €500 000, stepping down in stages to €50 000 for large orders in the least liquid shares. By comparison, the average trade size on the London Stock Exchange was €22 266 in 2006 compared with €11 608 in 2008 and €9 923 in 2009[7]. These trading platforms hold that the thresholds for large orders should take into account changes in average trade size.

27. It is also claimed that the size of the thresholds in the current regime has the effect of encouraging market participants to execute trades away from RMs and MTFs. However, this claim is not clearly evidenced by any corresponding increase in the overall percentage share of OTC trading.

28. The main question is whether the current thresholds under the LIS waiver are appropriate and strike a proper balance between the general benefit of transparency and necessary protection from adverse market impact. CESR recognises that factors other than current order sizes are relevant in assessing whether MiFID existing thresholds provide adequate protection

[7] London Stock Exchange website: www.londonstockexchange.com Factsheets and News. (NB: these figures are based on an exchange rate of 1 GBP = 1.15 EUR)

for large orders. For instance, development of algorithmic trading and ability to trade shares on multiple platforms may need to be taken into account, as they may have rendered the execution of large orders more complex without necessarily affecting their market impact. As noted above, the volume of trading that occurs under the waiver has so far been relatively high in one Member State but very low elsewhere.

29. CESR sought views on the current LIS regime and requested that respondents provide a specific proposal for any reduction in the current thresholds.

Feedback and discussion

30. Respondents were almost evenly divided on the need to amend the LIS thresholds. Some considered that the current calibration was appropriate and should be maintained (a small number considered that the thresholds should be increased). Others considered that the current calibration should be changed and reduced. Some supported the suggested 25% reduction, others believed a more significant reduction was necessary (up to 75%). CESR received a limited number of specific proposals for reducing the LIS thresholds.

31. CESR does not consider it received enough data from market participants in order to form a view on this waiver. Further work, based on empirical data, is needed before a final decision can be taken on the LIS thresholds. CESR notes comments that the reduction in trade or order size is not in itself a sufficient rationale for amending the LIS thresholds. CESR also notes comments that the thresholds should be reduced and that further assessment is needed to determine the potential market impact generated by a large order in today's market environment compared to 3 or 4 years ago.

Recommendation

32. CESR recommends that the Commission undertake/commission further analytical work based on empirical data to better determine whether the existing LIS thresholds need to be reduced, and if so, the magnitude of the potential recalibration. This work should be based on specific parameters, including a reliable reference period and the market impact of an order that would be considered acceptable. It should also take account of the specific characteristics of national markets. CESR stands ready to provide the Commission with assistance in this work, including recommending parameters and reviewing any outputs.

33. In addition, CESR recommends that the Commission give ESMA the power to monitor the waiver on an ongoing basis (which would include periodic review of whether the LIS thresholds remain appropriate and whether there should be a cap on volumes executed under the waiver) and to develop binding technical standards in this regard in the future, if needed.

Large in scale – treatment of residual orders ('stubs')

34. The current scope of the large in scale waiver for large orders that do not get fully executed is not clear. The specific situation that arises is where an initial large order satisfies the relevant LIS threshold but, when partially filled/executed, is reduced to a 'stub' that falls below the relevant threshold.

35. Some CESR members have allowed 'stubs' to retain the protection of the LIS waiver. Trading platforms in these jurisdictions are not required to cancel or display partially filled large orders that are below LIS thresholds.

36. While there are divergent views on this issue, CESR recognises the benefit of a consistent approach and for this to be clarified in MiFID. Accordingly, CESR sought views on whether a 'stub' should be displayed if its residual size is below the relevant LIS threshold.

Feedback and discussion

37. A majority of respondents supported allowing stubs to remain dark. For those respondents, this option is the most consistent with the purpose of the LIS waiver, allows working a large order over the course of the day, avoids duplication of settlement charges in case the stub would have to be redirected to a lit venue, and reduces market impact for subsequent block orders in the same name. It is noted that asset managers monitor execution on an ongoing basis and make decisions about stubs rather than just leaving an unexecuted order in a market. Even if there is some theoretical deterioration in pre-trade transparency, the cost of any other option is considered to far outweigh any benefit. It is typically agreed by those respondents that, where a stub is modified by the trader itself, the LIS waiver should no longer apply.

38. Other respondents supporting stubs becoming lit were of the view that the intention of the LIS waiver is to mitigate adverse impact on large orders and considered that there are no grounds for a stub to benefit from this waiver as it will not generate the same market impact as a large order. Some respondents also stressed that allowing residual orders below the LIS threshold to remain undisclosed would create an inconsistency with the transparency requirements for new orders of the same size. One of these respondents further stressed that, if stubs remain dark, it allows market participants to circumvent regulation for the LIS waiver.

39. The majority of competent authorities in CESR share the view that, where large orders are submitted to a venue under the LIS waiver and are subsequently partially executed, the remaining stubs should become lit, believing that price formation is otherwise distorted and, in the case of lit venues, orders of equal size should be treated the same irrespective of whether they are the residual portion of a partly-executed large order. A minority of competent authorities believe stubs should be allowed to remain dark on the grounds that, if they become lit, they will simply be deleted or, if appearing on the book immediately after an execution, may effectively reveal the original size of the large order.

Recommendation

40. CESR believes that the current wording of the LIS waiver is ambiguous with regard to the treatment of stubs. CESR recommends strongly that the Commission provide clarification: that either the waiver does not apply to stubs (as per the majority view within CESR) or that the waiver does extend to stubs.

41. More generally, CESR believes it is important that the Commission also considers when amending MiFID to harmonise its application to 'stubs' what the LIS waiver is intended to achieve apart from the avoidance of excessive market impact of a large order. As the feedback to the consultation paper and the divergent views within CESR indicate, there are currently differing views on the underlying intention behind this waiver and there would be value in clarifying its aim.

2.1.1.3 Reference price waiver

Background

42. The reference price waiver is designed for passive price taking systems that match supply and demand without price discovery and at a fixed reference price (e.g. the opening or closing price, or at a reference price recorded at some other point during the day). Reference price systems were operated in some Member States prior to the implementation of MiFID. Post-MiFID the business of trading systems using this methodology has evolved, from satisfying demand for trading primarily in less liquid shares to trading in the most liquid part of the market, and from offering single venue reference price systems to offering trading referenced to consolidated/multiple venue prices (e.g. a reference price related to the European Best Bid and Offer).

43. The CESR fact finding shows that the volume of trading executed in reference price systems is currently lower than trading under the LIS waiver or the negotiated trade waiver. Only four European jurisdictions have granted the waiver, and trading under that waiver accounted for 0.1% of all trading in EEA shares on RMs/MTFs in 2008. Trading using this waiver has increased since 2008, but it remains a small proportion of total trading in EEA shares on organised public markets, accounting for 0.5% on average in 2009, and 1.0% in the first quarter of 2010 (see Table 3 below).

Table 3: Trading in EEA shares executed under the reference price waiver

	2008				2009				2010
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
Trading under reference price waiver*	3.1	3.5	3.3	3.8	5.1	7.7	12.9	21.0	25.9
Total as a % of all trading in EEA shares on RMs and MTFs	0.1%	0.1%	0.1%	0.1%	0.3%	0.3%	0.6%	0.9%	1.0%

*Values are in bn Euros

Sources: (1) Value of trading on RMs and MTFs without pre-trade transparency: Member State competent authorities; (2) All trading in EEA shares on RMs and MTFs: Thomson Reuters

44. Post-MiFID, reference price systems have gained in popularity and, in particular, are provided by new entrant MTFs, although not exclusively. For some, it is their only trading model. Broadly, the policy rationale for the reference price waiver remains. However, market developments have moved beyond CESR's observation in its previous technical advice to the EC in April 2005. Non-disclosure by these systems is no longer primarily due to the concern that the publication of orders, especially in the less liquid shares for which the systems were most frequently used, would increase the incentive to manipulate the continuous market before the reference price was fixed.

45. Some concerns have been raised that reference price systems are being used to execute small orders and it has been suggested that this is inconsistent with the general intention of the waivers to provide protection against market impact. On the other hand, some market participants have expressed concerns that the reference price waiver is overly restrictive and provides little scope for market developments and innovation. They consider it would be beneficial to have more flexibility, allowing more scope for execution within the (visible) market spread.

46. CESR sought views on whether the waiver should be amended to include minimum thresholds for orders submitted to a reference price system, and any other comments on this waiver.

Feedback and discussion

47. Almost all respondents wanted the reference price waiver to be retained. Most were against the introduction of a minimum threshold for orders entered into a reference price waiver. Their main argument was that the purpose of the waiver is not to protect orders from market impact but to allow for "passive pricing". It was noted that the introduction of a minimum threshold would no longer allow small or "child" orders to be executed on reference price systems and would either lead to increased execution costs for small/child orders on lit venues or discourage execution of such orders on organised venue altogether. It was also noted that reference price systems typically offer the possibility for participants to set a minimum execution size for their orders.

48. Other respondents supported the introduction of a minimum threshold in order to protect price formation, stay close to the original intention of the waiver (which they viewed as being to avoid price impact for large orders), and avoid transactions in price referencing systems from "free riding" on price discovery in pre-trade transparent venues. These concerns are shared by some CESR members, especially in the face of growing usage of this waiver. Some respondents proposed minimum thresholds, including a minimum size of €2,000 and up to 80% of the large-in-scale threshold.

49. Some respondents were in favour of a more flexible use of the reference price waiver, suggesting that crossing anywhere within the spread (as opposed to just at mid-point, the best bid or the best offer) be allowed. Others argued that crossing within the spread should only occur at mid-point, with one considering that no execution should take place on a dark system at a price that was already displayed on a lit market. The same respondent also stated that a limit should be imposed on the amount of dark trading in any given instrument that could take place on any individual trading venue.

50. CESR is of the view that venues making use of the reference price waiver should execute trades at gross prices and not incorporate any embedded fee in the price. This is to ensure that the prices published in trade reports clearly correlate with the venue's stated pricing methodology (e.g. executions taking place at mid-point).

Recommendation

51. CESR recommends that the Commission clarify that venues using the reference price waiver must not embed a fee in the price of trades.

52. CESR also recommends that the Commission give ESMA the power to monitor the waiver on an ongoing basis (which would include periodic review with respect to pricing methodologies, whether there should be mandatory minimum order sizes and whether there should be a cap on volumes executed under the waiver), and to develop binding technical standards in this regard in the future, if needed. According to some CESR members, the Commission should also consider including a minimum order size in the reference price waiver as part of the MiFID review and only leave the adjustment of that minimum order size to ESMA binding technical standards.

2.1.1.4 Negotiated trade waiver

Background

53. The waiver for negotiated trades provides an exemption from pre-trade transparency for transactions that are not accessible to other members of an RM or MTF other than the one(s) that have pre-negotiated the trade. The rationale for the waiver was - among others - to enable intermediaries to achieve best execution for their clients 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 be achieved outside the order book (e.g. when the order book cannot fill the whole order). The negotiated trade waiver is also needed in cases where it is not possible to trade certain orders through a central trading mechanism e.g. where an order book has a significant minimum order size, permits the trading of only round lots or imposes other standard conditions such as settlement that some types of orders cannot meet. Negotiated trades have traditionally also been used for principal transactions which are subject to conditions other than the current market price such as principal VWAP or portfolio trades.

54. Negotiated trades existed pre-MiFID in many Member States. The waiver is used post-MiFID particularly by RMs.

55. In 2008, an average of 3.2% of trading on European RMs and MTFs took place using the negotiated trade waiver. There was an increase to an average of 4.2% of total EEA trading on RMs and MTFs in 2009 (see Table 4 below).

Table 4: Trading in EEA shares executed under Negotiated Trade Waiver

	2008				2009				2010
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1**
Trades under negotiated trade waiver*	163.4	111.9	103.6	92.8	78.4	95.6	103.5	100.0	97.1
Total as a % of all trading in EEA shares on RMs and MTFs	3.9%	2.9%	2.8%	3.2%	4.1%	4.3%	4.5%	4.1%	3.7%

*Values are in bn Euros
**Q1 2010 figures do not include data from Iceland and Poland
Sources: (1) Value of trading on RMs and MTFs without pre-trade transparency: Member State competent authorities; (2) All trading in EEA shares on RMs and MTFs: Thomson Reuters

56. CESR took the view that the negotiated trade waiver should be retained subject to clarifications and did not put forward any specific proposals on the waiver for negotiated transactions.

Feedback

57. The outcome of the consultation broadly supported this view. A majority of respondents stressed the need for clarification of the waiver as some venues offered two different post trade transparency services - one for negotiated trades, which were subject to the venue's rule book, and another that was simply a printing service for OTC trades – and it was important for participants to know which they were using. Three respondents stressed that the negotiated trade waiver unfairly discriminated against trading systems that either did not have a displayed order book or did not offer continuous trading.

Recommendation

58. CESR recommends the existing waiver for negotiated transactions be retained, recognising that further clarification on the scope of this waiver may be desirable (as per paragraph 21 above).

59. CESR also recommends that the Commission give ESMA the power to monitor the waiver on an ongoing basis (including with respect to such clarifications and whether there should be a cap on volumes executed under the waiver) and to develop binding technical standards in this regard in the future, if needed.

2.1.1.5 Order management facility waiver

Background

60. This waiver provides an exemption from pre-trade transparency for orders held in an order management facility, 'pending their being disclosed to the market'. The rationale for this waiver is that order management facilities provided by RMs/MTFs help intermediaries and their clients in executing their orders in the most efficient way. CESR's view in the technical advice it provided to the Commission during the formulation of MiFID implementing measures was that the provision of these facilities should be left to the discretion of RMs and MTFs.

61. CESR did not conduct a fact finding exercise to gather data on the use of this waiver. Most (if not all) RMs make use of this waiver for iceberg, stop market and/or stop limit orders. Some MTFs have also introduced similar functionalities.

62. Some trading platforms have raised concerns that the waiver is overly restrictive, does not allow for innovation and prevents them from providing the same order types and functionalities as investment firms. They claim that this is creating an unlevel playing field.

63. One way to address level playing field concerns between investment firms and RMs/MTFs would be by 'levelling up' the disclosure requirements for investment firms. This would require all orders submitted by investment firms to RMs/MTFs to be publicly displayed. Among other things, this would result in investment firms not being allowed to submit market orders or other orders with a zero time in force (e.g. IOC, FOK).

64. Another way to address level playing field concerns between investment firms and RMs/MTFs would be by 'levelling down'. This means that RMs/MTFs would be permitted to offer the same functionality with their order management facilities as investment firms can arrange. This would allow purely dark orders (in price and size) to be managed by RMs/MTFs that would never appear in the order book or be visible to market participants before execution.

65. CESR did not put forward any specific proposals on the waiver for order management facilities.

Feedback and discussion

66. Most respondents were content with the current application of the waiver or did not provide specific proposals for amendments. Some reiterated however their concerns about a restrictive application and an unlevel-playing field between order management systems operated by RMs/MTFs and those operated by investment firms.

67. CESR considers that the business conducted by RMs/MTFs is different to that of investment firms. There is therefore little ground to suggest that RMs/MTFs should operate under the same rules as a broker dealer and that the order management waiver be amended to address potential level playing field concerns in the use of this waiver.

Recommendation

68. CESR recommends that the existing waiver for order management facilities be retained, recognising that further clarification on its conditions may be desirable (as per paragraph 21 above).

69. CESR also recommends that the Commission give ESMA the power to monitor the waiver on an ongoing basis (including with respect to such clarifications) and to develop binding technical standards in this regard in the future, if needed.

2.1.1.6 Indications of interest (IOIs)

Background and Call for Evidence

70. In April 2010, CESR issued a Call for Evidence on micro-structural issues in the equity markets[8]. Among other issues, CESR sought views on indications of interest (IOI). An IOI is the name commonly used to refer to a message sent between investment firms to convey information about available trading interest. IOIs are also used by dark pools to attract order flow and to maximise trading opportunities by enabling investors to find the contra-side of

[8] CESR/10-142 – CESR Call For Evidence on Micro-structural issues of the European equity markets, 1 April 2010.

orders. The information provided in an IOI can include the symbol of the security, the side (i.e. buy or sell) and volume/price of trading interest.

71. MiFID requires pre-trade transparency as an overarching principle for RMs/MTFs. It is unclear where IOIs stand within this framework. In addition, MiFID requires RMs/MTFs to have non-discretionary rules for fair and orderly trading. If IOIs were used to provide information to a select group of market participants to the exclusion of others, this may be inconsistent with the intention of MiFID. The CESR Call for Evidence invited comments as to whether MiFID should be amended to clarify that actionable IOIs should be subject to pre-trade transparency requirements and whether there would be circumstances where it would be appropriate for IOIs to be provided to a selected group of market participants.

Feedback and discussion

72. Respondents made a clear distinction between IOIs used OTC for bilateral transactions and IOIs used on organised trading venues. It was noted that electronic communication methods (including IOIs) are widely used to send information about available trading interest to selected counterparties as a way of finding the opposite side of a trade in large transactions. These methods existed pre-MiFID.

73. Generally, respondents indicated that it is not common for an RM/MTF to offer an IOI functionality. A large majority agreed that actionable IOIs sent from an RM/MTF must be subject to the pre-trade transparency regime and very few respondents believed that there could be limited circumstances where the use of selective information by RM/MTFs would be appropriate.

Recommendation

74. CESR recommends that MiFID be amended to clarify that an actionable IOI (i.e. an indication of interest that includes all necessary symbols (e.g. side (buy or sell), size, price) to agree on a trade is to be considered as an order and subject to applicable pre-trade transparency requirements. As part of this, CESR recommends that the Commission make clear actionable IOIs may not be used within a trading system such that they are transparent to direct participants without being made public. CESR believes that actionable IOIs should be visible to all or dark to all, and there should be no scope for a trading venue's direct participants and the public to be treated differently.

2.1.2 Systematic internaliser regime

Background

75. MiFID was the first EU directive to introduce the concept of specific regulation for systematic internalisation. Although the basic concept is applicable regardless of asset class, MiFID obligations attaching to SIs relate to the trading of shares. The core of these requirements, which are set out in Article 27 of the directive, is for SIs to publish firm quotes in shares that are classified as 'liquid' under MiFID when dealing in sizes up to standard market size.[9]

76. In the CESR Call for Evidence, questions were raised on the small number of investment firms currently classified as SIs and identified as such in the CESR MiFID database. To date, 10 investment firms have informed their home Member State regulators that they carry out systematic internalisation. CESR has no view on what should be the appropriate number of SIs in Europe. The number of SIs may just not be higher. Another possible reason may be difficulties with the practical application of the SI definition in various Member States. There are also issues regarding the way in which SIs have been fulfilling their quoting obligations.

[9] Standard market sizes are set out in the MiFID Implementing Regulation, Annex II, Table 3.

77. CESR identified the following key issues relating to the SI regime:

    a. Whether or not the SI definition requires clarification.

    b. Whether or not the SI obligations should be recalibrated to ensure that they are meaningful and add value for market users.

2.1.2.1 Criteria for determining whether an investment firm is a systematic internaliser

78. MiFID 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 RM or MTF.

79. Article 21(1) of the MiFID Implementing Regulation sets up further criteria indicating under which conditions the activity of a systematic internaliser is to be considered as 'organised, frequent and systematic':

    a. the activity has a material commercial role for the firm, and is carried out in accordance with non-discretionary rules and procedures;

    b. the activity is carried on by personnel, or by means of an automated technical system, assigned to that purpose, irrespective of whether those personnel or that system are used exclusively for that purpose;

    c. the activity is available to clients on a regular or continuous basis.

80. At present, the main problems with the definition rest in Article 21(1)(a) of the MiFID Implementing Regulation. The reference to non-discretionary rules may provide scope for firms to decide that any discretion they exercise in determining whether or not to execute client orders against own account or whether or not to offer price improvement leaves them outside the scope of the definition. However, it should be noted that a firm should always use discretion when deciding whether or not to execute a client order against its own account as the firm has to meet best execution obligations. In addition, the non-discretionary element of a SI is a relevant component of the definition to avoid including ad hoc transactions that would not be systematic.

81. The materiality criteria also offer scope for firms and regulators to adopt different views as to whether a firm falls within or outside the definition. In expanding on Article 21(1)(a), Recital 15 of the Regulation states that: '*An activity should be considered as having a material commercial role for an investment firm if the activity is a significant source of revenue, or a significant source of cost. An assessment of significance for these purposes should, in every case, take into account the extent to which the activity is conducted or organised separately, the monetary value of the activity, and its comparative significance by reference both to the overall business of the firm and to its overall activity in the market for the share concerned in which the firm operates. It should be possible to consider an activity to be a significant source of revenue for a firm even if only one or two of the factors mentioned is relevant in a particular case.*' On this basis, firms have a degree of flexibility in assessing whether activity that could be considered as organised is material either in terms of monetary value of the activity or its significance in terms of the firm's overall activity or role in the market.

82. CESR considers it important that the criteria defining whether or not a firm falls within the SI regime should be as clear as possible. Accordingly, CESR sought views on whether the SI definition could be made clearer by:

    a. removing the reference to non-discretionary rules and procedures in Article 21(1)(a) of the MiFID Implementing Regulation; and

    b. providing quantitative thresholds of significance of the business for the market to determine what constitutes a 'material commercial role' for the firm under Article 21(1)(a) of the MiFID Implementing Regulation.

Feedback and discussion

83. There were divided views on whether the SI definition would be made clearer by removing the reference to non-discretionary rules and procedures. Similarly, there were varying opinions on whether quantitative thresholds of the business for the market should be introduced to determine whether SI business represented a "material commercial role" for a firm. In particular, some considered that materiality to the market was a more important factor to consider when determining whether a firm was an SI.

84. CESR has considered whether further clarity on the SI criteria may be provided by clarifying the reference to 'non-discretionary rules and procedures'. In the context of the SI regime, CESR considers that 'non-discretionary rules and procedures' refers to a set of pre-defined, common standards developed by the investment firm for providing a service such that it does not differentiate between comparable clients. In other words, based on the categorisation of its clients the investment firm does not exercise discretion regarding access to this service and provides the same prices for the same volume of trading interest in the same market situation, irrespective of the individual client within its categorisation.

85. CESR has also considered whether further clarity may be provided by removing the reference to 'non-discretionary rules and procedures' from the SI definition and making it part of the SI requirements/obligations. However, CESR notes comments from respondents that the non-discretionary criterion is necessary in the SI definition to distinguish this activity from other investment firm business and that such an amendment has the potential to broaden the scope of the regime beyond its original intention. For example, investment firms may legitimately exercise discretion when dealing on own account with wholesale counterparties by varying their pricing depending on the individual characteristics of the counterparty (e.g. perceived counterparty risk).[10] CESR does not consider that the SI regime was intended to apply to this type of business.

86. More generally, a number of respondents questioned whether the SI regime was delivering benefits to the market and suggested that the underlying regulatory objective should be reviewed. In addition, some considered there was insufficient clarity about the overall regulatory intention of the SI regime to enable full consideration of CESR's proposed amendments.

87. Broadly, CESR considers that the regulatory objective of the SI regime is to provide transparency and investor protection (particularly for non-professional investors). To ensure that the regime was delivering on these objectives, CESR put forward some specific proposals based on the application of the existing provisions in MiFID. However, CESR notes the general comments on the intention of the regime and recognises that it may be necessary for a more fundamental consideration of the overall regulatory intention of the SI regime.

88. Based on these considerations, CESR does not believe it is appropriate to recommend fundamental changes to the SI criteria before a broader review has taken place as per the recommendation below. However, CESR does consider that some operational/technical changes would be beneficial at this time, which are set out below in Section 2.1.2.2.

Recommendation

89. As noted above, CESR recommends the Commission consider a broader review of the SI regime as part of the MiFID review that would include further consideration of:

    a. whether appropriate thresholds should be established to determine whether activity has material commercial relevance to the market; and

[10] Recital 53 of MiFID states that it is not the intention of this Directive to require the application of pre-trade transparency rules to transactions carried out on an OTC basis, the characteristics of which include that they are ad-hoc and irregular and are carried out with wholesale counterparties and are part of a business relationship which is itself characterised by dealings above standard market size, and where the deals are carried out outside the systems usually used by the firm concerned for its business as a systematic internaliser.

b. whether price improvement restrictions are still appropriate for SIs when dealing with orders up to retail size.

CESR stands ready to provide the Commission with further assistance in this work.

90. Regarding the criteria for determining whether an investment firm is a SI, CESR recommends:

a. To clarify the reference to 'non-discretionary rules and procedures' in Article 21(1)(a) of the MiFID Implementing Regulation but retain it in the definition;

b. To amend Article 21 of the MiFID Implementing Regulation to reflect the guidance provided in Recital 15. This amendment is intended to provide further clarity in determining whether business activity has 'material commercial' significance for the firm and for the market.

2.1.2.2 SI obligations

91. The present regime permits SIs to quote one-sided and in a size of only one share – a practice adopted by some but not all SIs. This means that many SIs are publishing quotes that tell the market little about the size of business they are prepared to take on. This information deficiency is accentuated by the fact that it is not possible for market users to assess the volumes and prices of trades conducted by individual SIs. This results from the MiFID Implementing Regulation exempting SIs from revealing their identity[11] in post-trade reports, provided they publish quarterly trading statistics. CESR is of the view that there is a strong case for making SI information more meaningful.

92. Currently, SIs are not allowed to offer price improvement for all orders up to customary retail size (currently set at €7,500) and all retail orders, regardless of size. The rationale for such restriction on price improvement is to provide for equal treatment of retail clients of systematic internalisers and for making quotes displayed meaningful. Whilst the constraints on price improvement were not identified as being problematic in the previous Call for Evidence, CESR also considered whether this particular aspect of the regime needs to be revisited.

93. To address these issues, CESR sought views on some specific amendments to the quoting obligations, restrictions on price improvement and post-trade transparency requirements for SIs.

Feedback and discussion

94. A majority of respondents considered that SI quoting obligations should be made more meaningful, and a number agreed with CESR's proposal to establish a minimum quote size of 10% of standard market size in liquid shares. A majority of respondents also considered that retail participation and best execution could be enhanced by removing the price improvement restrictions for orders up to retail size. However, CESR notes comments that this would make SI quotes less meaningful and would potentially lead to unequal treatment of retail investors.

95. There were divided views on requiring the individual identification of SIs in post-trade transparency reports. Although, some respondents considered that individual identification would level the playing field with RMs/MTFs CESR notes comments that this requirement would significantly impact on firms committing capital/taking risk positions and would increase the costs associated with providing liquidity.

[11] MiFID requires SIs to publish all completed transactions and to identify themselves as the trading venue (e.g. through a BIC) unless they publish quarterly statistical information about their systematic internalisation business (in which case they can publish trades with the generic identifier of 'SI').

Recommendation

96. CESR recommends amending the SI quoting obligations to make them more reflective of and useful to the type of business being undertaken. In particular, CESR recommends that:

    a. SIs be required to maintain two-side quotes;

    b. SIs be required to maintain a minimum quote size equivalent to 10% of the standard market size of any liquid share in which they are a systematic internaliser;

    c. the provision exempting SIs from individually identifying themselves in post-trade reports if they publish quarterly trading data should be retained;

    d. periodic trading data reports for SIs making use of the exemption described in point c be required on a more frequent basis (e.g. monthly).

97. As noted above, CESR also recommends the Commission consider in the broader context of a review of the SI regime whether the price improvement restrictions are still adequate for SIs when dealing with orders up to retail size.

2.2 Post-trade transparency

98. The MiFID post-trade transparency obligations apply to RMs, MTFs and investment firms and are intended to promote the efficiency of the overall price formation process, to assist the operation of the best execution obligation and to mitigate the potential adverse impact of market fragmentation. The information is also used, primarily by buy-side firms, to analyse the cost of transactions and to price portfolios.

99. MiFID broadened the post-trade transparency requirements across Europe most notably by requiring OTC trading to be transparent. However, whilst in some Member States MiFID introduced a higher level of post-trade transparency, in other Member States, as the MiFID deferred publication regime allowed for longer delays than were permissible pre-MiFID, transparency was reduced.

100. In their responses to the Call for Evidence and at CESR roundtables, many market participants expressed concerns about the effect of the fragmentation of post-trade transparency information, especially in relation to OTC trading. In particular, concerns were expressed over the quality of post-trade information, the timing of publication of post-trade information and various barriers to consolidation of post-trade data.

101. As indicated in the June 2009 Report[12], CESR recognises the importance of having trade information of sufficient quality and is concerned about the deterioration which has followed MiFID implementation. CESR also recognises the need for timely post-trade transparency information. CESR's recommendations to improve the quality of transparency information and to reduce delays in the publication of data are outlined in Sections 2.2.1 and 2.2.2 respectively. Recommendations to promote consolidation of transparency information are presented in Section 4 below.

2.2.1 Quality of post-trade information

Background

102. In February 2007, CESR published Level 3 guidelines and recommendations on publication and consolidation of MiFID market transparency data (Ref.: CESR/07-043) in order to facilitate the understanding of MiFID requirements and guard against a potential adverse impact of fragmentation of transparency information post MiFID.

[12] CESR report on 'Impact of MiFID on equity secondary markets functioning', 10 June 2009 (Ref. CESR/09-355), CESR website: http://www.cesr-eu.org/index.php?page=document_details&id=5771&from_id=53.

103. However, many market participants, some of which were subject to an OTC post-trade transparency regime pre-MiFID, have noted that the quality of the transparency data has deteriorated significantly since MiFID was implemented in November 2007. These concerns were particularly pronounced in jurisdictions where all equity transparency information was previously published by the main RM. In those jurisdictions, the main RM not only consolidated equity data but monitored the quality and took appropriate remedial action as necessary.

104. According to market data vendors, investment firms do not always take the necessary steps to ensure that equity trade data is accurate and reliable, leading to a confusing picture of the OTC market. This contrasts with equity data from RMs and MTFs which is generally considered to be of high quality.

The importance of having trade information of sufficient quality is recognised and the deterioration which has followed MiFID implementation is considered to be concerning. CESR also recognises that there is not a single solution to improve the quality of data and that the problems raised reflect different issues, ranging from lack of clarity in the publication obligations to potential deficiencies in firms' compliance with their MiFID obligations.

Feedback and discussion

105. CESR consulted on an approach involving the development of a set of standards to improve the clarity, comparability and reliability of post-trade transparency information and established a CESR/Industry Working Group to work with CESR to finalise these standards. There was near unanimous support from market participants for the overall approach proposed by CESR. Participants agreed that the quality of post-trade information was a vital issue and needed a co-ordinated regulatory and industry approach to ensuring post-trade transparency information was of a high quality.

Recommendation

106. To address the concerns relating to the quality of post-trade transparency information, CESR recommends amending MiFID and the MiFID Implementing Regulation to:

   a. embed standards aimed at improving clarity, comparability and reliability of post-trade transparency that would cover matters such as condition codes for trade types and process for correcting erroneous post-trade reports; and

   b. provide greater clarity in terms of: i) what constitutes a single transaction for post-trade transparency purposes; and ii) which investment firm shall make information related to an OTC transaction public.

107. CESR also recommends that ESMA be given powers under MiFID to set binding technical standards covering post-trade data quality. This would allow for ESMA to deal with data quality issues as they arise and help to ensure that post-trade data quality can become and remain consistently high.

2.2.2 Timing of publication of post-trade information

2.2.2.1 Real-time publication of transactions not eligible for delay

Background

108. MiFID requires transactions to be published as close to real time as possible, but no later than 3 minutes after the trading time. Indeed, the 3 minute deadline should only be used in

exceptional circumstances where the systems available do not allow for a publication in a shorter period of time. During CESR's Call for Evidence, it was suggested that the quality of post-trade transparency information is negatively impacted because some investment firms routinely use the full 3 minutes to publish a transaction, rather than publishing a trade in real time and using the full 3 minutes on an exceptional basis.

109. CESR notes that in the US there is a requirement to publish information related to 'on exchange' transactions in real time and to publish information related to OTC transactions (which, in the US includes transactions executed on alternative trading systems (ATS) as close to real time as possible but no later than 90 seconds after the trade. The US Financial Industry Regulatory Authority (FINRA) is proposing to reduce the reporting deadline to 30 seconds from the trading time.

Feedback and discussion

110. Respondents were split almost evenly on whether this proposal would be beneficial, with a slight majority in favour of reducing the limit to 1 minute. Those in favour of the proposal believed it would result in improved timeliness of post-trade transparency information while those against the proposal believed that for manually executed or complex trades (such as portfolio trades), particularly during periods of high market volatility, it would be very expensive, if not impossible, for firms to report these trades within 1 minute.

111. CESR strongly believes that clarifying Article 29(2) of the MiFID Implementing Regulation and reducing the time allowed from 3 minutes to 1 minute would improve the transparency of the market, thereby ensuring the price formation process remains fair for all market participants. CESR recognises that, while it may be difficult in certain situations to publish trades within 1 minute and may result in some systems costs, the anticipated benefit of improved transparency should outweigh any costs. CESR believes market participants should have systems and processes in place that allow them to meet the 1 minute deadline even during times of high market volatility, and believes that these are, in fact, the circumstances in which it is most important that post-trade transparency information is timely and accurate. Furthermore, standards and guidelines on the transparency obligations may also facilitate investment firms' timely publication.

Recommendation

112. CESR recommends that in order to improve the timeliness of post-trade transparency information, Article 29(2) of the MiFID Implementing Regulation should be amended as follows:

    a. the obligation which requires RMs, MTFs and investment firms trading OTC to publish post-trade trade information in real time should be strengthened by adding that transactions would need to be published as close to instantaneously as technically possible, and

    b. the deadline for the reporting of these transactions should be reduced from 3 minutes to 1 minute.

113. CESR also notes that systems should not be designed to "batch" the publication of trades so they only get published at fixed intervals, but rather should be published as soon as entered into the system.

2.2.2.2 Deferred publication regime

Background

114. MiFID requires the European Commission to re-examine Table 4 of Annex II of the MiFID Implementing Regulation (deferred publication thresholds and delays). In CESR's Call for

Evidence, market participants were asked whether MiFID categorisation of shares was appropriate for the deferred publication regime and whether the post-trade transparency regime was working effectively.

115. Some market participants are concerned that delays are often too long to ensure adequate transparency and that, in some instances, investment firms seemed to avail themselves of the maximum delay under MiFID even when their positions had already been unwound.

Feedback and Discussion

116. CESR proposed reducing the delays allowed under the deferred publication regime so that the longest delay permitted would be until the end of the trading day. There was a slight majority of respondents in favour of reducing the deadlines as proposed by CESR. Some respondents were concerned however that there would be a reduction in liquidity provision, particularly close to the end of the trading day.

117. CESR believes the overall benefit of improved transparency and reduced information asymmetries across the market outweighs any potential costs. The greatest concern appeared to be over the "end of day" delay for trades executed close to the end of the day, and so CESR recommends extending this deadline to early the following trading day for trades executed late in the day. This will ensure that the vast majority of deferred trades should be reported no later than the end of the trading day on which they are executed, while still providing some protection for trades occurring late in the day.

118. Some respondents also suggested that the definition of the end of the trading day be clarified to ensure that all market participants were aware when trades eligible for deferred publication to the end of the trading day would need to be reported. CESR agrees that it is important for all market participants to be aware what defines the end of the trading day and has made a recommendation to this effect.

Recommendation

119. CESR recommends maintaining the existing deferred publication framework (Table 4 of Annex II of the MiFID Implementing Regulation) which currently encompasses four liquidity bands but to recalibrate delays and thresholds so as to:

   a. shorten the delays to ensure that almost all transactions are published no later than the end of the trading day, with only the very largest trades that occur late in the trading day publishing prior to the opening of trading on the next trading day;

   b. shorten the intra-day delay of 180 minutes to 120 minutes; and

   c. raise all intra-day transaction size thresholds.

   A specific recommendation for deferred publication thresholds and delays are outlined in Table 5 below.

Table 5: Proposed deferred publication thresholds and delays

Class of Shares in terms of average daily turnover (ADT)			
ADT < EUR	**EUR 100 000**	**EUR 1 000 000**	**ADT ≥ EUR**

	100 000	**≤ ADT < EUR 1 000 000**	**≤ ADT < EUR 50 000 000**	**50 000 000**
	Minimum qualifying size of transaction for permitted delay			
60 minutes	EUR 15 000	Greater of 10% of ADT and EUR 30 000	Lower of 15% of ADT and EUR 5 000 000	Lower of 15% of ADT and EUR 10 000 000
120 minutes	EUR 30 000	Greater of 20% of ADT and EUR 80 000	Lower of 25% of ADT and EUR 10 000 000	Lower of 25% of ADT and EUR 20 000 000
Until (a) end of the trading day if trade occurs prior to 15:00; or (b) prior to the opening of trading on the next trading day if trade occurs after 15:00.	EUR 50 000	Greater of 30% of ADT and EUR 120 000	Lower of 35% of ADT and EUR 15 000 000	Lower of 35% of ADT and EUR 35 000 000

120. CESR recommends clarifying that the opening and end of the trading day with regards to deferred publication be defined as follows:

a. For a transaction eligible for deferred publication executed on an RM or MTF, the opening and end of the trading day refers to the start and end of the normal trading hours of the RM or MTF on which the transactions was executed. In any case, this should not be earlier than 8.00 and later than 17.30 in the time zone of that RM or MTF.

b. For a transaction eligible for deferred publication executed outside an RM or MTF, the opening and end of the trading day refers to 08:00 and 17:30 (respectively) in the time zone of the most relevant market in terms of liquidity for that share, as defined in Article 9 of the MiFID Implementing Regulation.

Similarly, CESR recommends that, for a transaction eligible for deferred publication executed on an RM or MTF, references to 15:00 in Table 5 should relate to the time zone of the given RM or MTF. For a transaction eligible for deferred publication executed outside an RM or MTF, references to 15:00 should relate to the time zone of the most relevant market in terms of liquidity for that share.

3. Application of transparency obligations for equity-like instruments

Background

121. It has been proposed by some market participants and competent authorities that certain equity-like instruments admitted to trading on a RM should be subject to the same transparency requirements as shares under MiFID. At present, some Member States have applied MiFID transparency obligations to depositary receipts (DRs) whilst others have not. When traded on organised trading platforms, DRs are typically subject to the trading platforms' rules governing transparency and, in many cases, trading platforms have implemented the same transparency obligations which apply to shares admitted to trading. Likewise, exchange traded funds (ETFs) and 'certificates' which are admitted to trading on RMs are typically subject to the same transparency regime as shares[13].

122. CESR has considered whether such 'equity-like' instruments should be subject to pan-European mandatory transparency obligations (i.e. pre and post-trade). In considering this question, CESR has decided not to focus on legal interpretation issues, recognising that because of specific legal characteristics, an instrument might fall within the MiFID definition of shares in one jurisdiction but not in another one ('certificates' being a case in point). Rather, CESR considered whether these instruments were, from an economic point of view, equivalent to shares and whether there would be benefits stemming from a harmonised pan-European transparency regime.

123. For instance, whilst the Net Asset Value (NAV) of a given ETF is often calculated at the end of the trading day using the closing price of the underlying securities and, in some cases, intraday NAV (iNAV) is also available, investors will typically not buy and sell ETFs at their NAV or iNAV on the secondary market. This is because the price of an ETF on organised trading platforms or OTC is affected by supply and demand forces. CESR considers that additional transparency might help investors make timely and informed investment decisions when buying/selling ETFs.

Feedback and discussion

124. In general there is broad support for the application of transparency requirements to the above mentioned equity-like securities. However, market participants expressed their desire to have a fully harmonised and properly calibrated regime with clear definitions which also takes into account the time necessary to implement these new requirements, potentially in the form of a gradual approach. There is broad agreement to use the same MiFID equity transparency calibration regime as for equities under MiFID.

125. Although proposed in the consultation paper, after further consideration, CESR does not think that it would be appropriate to extent the transparency regime for shares to all ETCs as some ETCs have significantly different characteristics to shares. However, where an ETC takes the form of an ETF it would be covered by the proposed extension of the transparency regime.

126. CESR believes that the instruments defined below share many characteristics with shares, including liquidity, structure, transparency of underlying instruments and types of investors. CESR therefore believes it would be beneficial to the market to require these kinds of instruments to meet the same transparency requirements as shares. CESR does however recognise the importance of ensuring that only appropriate instruments are covered by these requirements and have set out the features of the instruments that would be appropriately covered by these transparency requirements.

Recommendation

[13] Some RMs have implemented a publication service for transactions in ETFs executed OTC. In a separate initiative, some investment firms have voluntarily began to publish post-trade transparency information when trading ETFs OTC.

127. CESR recommends applying the MiFID transparency regime for the following equity-like financial instruments admitted to trading on an RM:

 a. DRs (whether or not the underlying financial instrument is an EEA share)[14];

 b. ETFs (whether or not the underlying is an EEA share, a fixed income instrument or a commodity)[15]; and

 c. 'Certificates'[16].

 In practice, this would mean that the MiFID transparency obligations would apply whether the instrument is traded on RM, MTF or OTC[17].

128. The following is a general outline of each type of financial instrument listed above. This does not however constitute legal definitions of the securities.

 a. Depositary receipts - DRs are negotiable certificates that represent ownership of a given number of a company's shares and can be listed and traded independently from the underlying securities. DRs are typically traded in US dollars or local currencies and issued by a depositary bank. Several forms of DRs can be listed and traded on EU RMs, including Global Depositary Receipts (GDRs) and American Depositary Receipts (ADRs).

 b. Exchange-traded Funds - ETFs are open-ended collective investment schemes admitted to trading on an RM. ETFs attempt to replicate an index (or other defined set of assets) and therefore provides investors with an economic exposure to the assets. ETF issuers provide a process for the issuance and redemption of units in the fund. ETF investors, other than authorised participants, transact in the units of an ETF through purchases and sales on the secondary market rather than through subscriptions and redemptions in the primary market. Market makers provide ongoing liquidity in ETFs on organised trading platforms and OTC. A list of the underlying assets held by the ETF and their Net Asset Value are usually published daily to the market. Trading value is usually close to net asset value, with any tracking error being the result of trading and rebalancing costs associated with holding the underlying index constituents optimising portfolio. ETFs may be physical (where the fund invests directly in the underlying assets that compose the portfolio) or synthetic (where the ETF gains exposure to the index by entering into a swap agreement with a swap counterparty).

 c. Certificates - These are securities issued by a company that rank above ordinary shareholders but below unsecured debt holders for the repayment of their investment in the company. These securities either do not have voting rights, or have voting rights that are less than those of ordinary shareholders on a unit-by-unit basis. They may pay a fixed coupon or a higher dividend than ordinary shares, and shareholders have the right to receive dividends ahead of ordinary shareholders in the company. In some jurisdictions these instruments are considered to be shares and are therefore already included in the transparency regime. CESR is aware of a possible broader understanding of this term but wants to make clear that, for the purposes of its review, the above narrow definition is considered appropriate.

129. CESR would emphasise that transparency obligations should only apply to the secondary trading of ETF and not to primary market transactions (as explicitly excluded from MiFID under Article 5(c) of the MiFID Regulation.

130. CESR recommends that the Commission undertake additional work to determine the appropriate thresholds for application of the pre-trade large-in-scale and post-trade deferred

[14] See definition in paragraph 129a below.
[15] See definition in paragraph 129b below.
[16] See definition in paragraph 129c below.
[17] In the case of DRs this may include distinctions depending upon whether the underlying financial instrument is an EEA share for the purpose of the market transparency calculations.

publication regimes. However, prima facie, CESR believes that, given the equity-like instruments trade like equities and on the same platforms, the existing calibration regime for shares is likely to be appropriate for equity-like instruments,

4. Consolidation of transparency information

131. Prior to the implementation of MiFID, in the vast majority of Member States, trading in shares was concentrated on an RM. Alternatively, where trading was permissible away from an RM's system, it was typically reported to an RM (though this was not required in some Member States). These arrangements had the effect of concentrating trade information for each share in one, or a few, places providing market participants with a consolidated view of trading in a particular share. MiFID, on the other hand, has fostered the rise of new trading venues and introduced competition in trade publication services by giving investment firms, when trading as SIs or OTC, choice in where they publish their transparency information. As a result, data can now be available from a number of different sources, depending on where it is published. Fragmentation of transparency information, if not addressed properly, raises concerns because it could undermine the overarching transparency objective in MiFID, and may result in less transparent markets than was the case pre-MiFID. In order to achieve efficient price discovery and facilitate the achievement, and monitoring, of best execution, trade information published through different sources needs to be reliable and brought together in a way that allows for comparison between the prices prevailing on different trading venues.

132. With the implementation of MiFID there was an expectation that market forces would provide market participants with a way of accessing a consolidated set of data and a number of initiatives have been put in place with this aim. Since MiFID implementation many data vendors have been delivering consolidated data. However these services are not of a standard that fully satisfies market participants. Market participants believe that whilst some concerns exist in relation to the fragmentation of pre-trade information, regulators should focus first on barriers to consolidation of post-trade transparency information.

133. CESR is of the view that regulatory intervention (in addition to addressing issues surrounding the quality of transparency information) is necessary in order to facilitate consolidation. CESR agrees that the focus should be on post-trade transparency information as a priority.

4.1 Regulatory framework for consolidation

Background

134. A recurring theme in the analysis of why consolidated data is not being delivered to the market to the standard it needs is the inadequate quality and consistency of the raw data itself, the inconsistencies in the way in which firms report it for publication, and the lack of any formal requirements to publish data through bodies with responsibilities for monitoring the publication processes.

135. CESR and market participants generally agree there is a need for an affordable consolidation of post-trade information but there are different views about how best to achieve it. Below are CESR recommendations to ensure the quick development of a European consolidated tape for transparency information at a reasonable cost.

4.1.1 Multiple approved publication arrangements

136. The first recommendation for improving the quality of data consolidation sets out to supplement the introduction of new standards to improve data quality and achieve greater consistency in trade publication practices (as outlined in Section 2.2.1) by requiring investment firms to publish their trade reports through Approved Publication Arrangements (APAs). Under this proposal, competent authorities would approve entities wishing to act as an APA, and APAs would be required to operate data publication arrangements to prescribed

standards. More details are set out below, addressing the standards that would be set for APAs and the adequacy of the present provisions for requiring publication arrangements to facilitate consolidation.

Requirements for investment firms

137. Investment firms that execute transactions in shares[18] OTC would be required to make public the post-trade transparency information using an Approved Publication Arrangement (APA). An APA could be:

  a. an RM;

  b. an MTF; or

  c. another organisation.

138. Investment firms should be allowed to use any APA in the EEA and may, if they wish, use more than one APA, although they would need to ensure that each transaction is not published more than once by a primary publication arrangement. As is currently the case, investment firms would be responsible for ensuring that post-trade data provided to an APA is reliable and monitored continuously for errors.

Requirements for APAs

139. An APA would need to be approved by its competent authority. Before approving an APA, competent authorities would need to ensure that the applicant met stringent criteria. Proposals for these criteria are set out in Annex I.

140. In addition to having to demonstrate that they meet these requirements at the time of approval, APAs would be subject to ongoing monitoring by the competent authority in respect of continuing compliance. The competent authority would also ensure that the APAs were undertaking appropriate checks to ensure they were publishing data with all relevant fields appropriately completed and accurate, and that the error-checking mechanisms each APA had in place were appropriate.

141. APAs would be required to provide access to post-trade information submitted by an investment firm upon request by the firm's competent authority. To meet this obligation, APAs would need to maintain post-trade information for 5 years after the APA has disseminated the post-trade transparency information to the public.

142. In addition, APAs would be required to provide ad hoc and periodic information to an investment firm's competent authority relating to the quality of data provided by the investment firm.

143. It is also proposed that CESR/ESMA maintain and publish a list of APAs. APAs would be required to provide CESR/ESMA a list of investment firms using their facilities to publish trade reports and keep it up to date. This information would be available only for CESR members.

Feedback

144. There was almost unanimous support for the proposed APA regime. Most respondents believe it would help to improve the quality of post-trade transparency information and prevent the reporting of trades in unusual locations (i.e. in locations not usually used by the investment firm) or in formats that prevent the consolidation of post-trade transparency information across Europe. Respondents were however split on whether the proposal would in fact result in the development of a European consolidated tape.

[18] Including shares admitted to trading on an RM as well as 'equity-like' instruments as per Section 3.

Recommendation

145. CESR recommends implementing the APA regime and the framework and standards provided in Annex I.

4.1.2 Cost of market data

Background

146. MiFID currently requires that transparency information be made available to the public on a non-discriminatory basis at reasonable cost. Some European data vendors have recently cut their data prices significantly. However, concerns remain that the cost of real-time market data is restricting the availability of affordable consolidated European post-trade data. Market data providers have estimated that a total fee for a full data set of pre- and post trade data of all EU venues would cost about € 450 per user per month. In comparison, the cost of consolidated post-trade data in the US is US$ 70 (around €50) per user per month. CESR recognises that there are significant differences between the European and US market data regime (e.g. competitive model in Europe compared to a monopoly in the US, a much higher number of trading venues and shares traded in Europe).

147. CESR made two proposals in its consultation paper. The first was to prevent platforms and APAs from requiring market participants to purchase both pre-trade and post-trade transparency information. The second was to require all platforms and APAs to provide their post-trade transparency information to market participants for free 15 minutes after the initial reporting of the trade.

Feedback and discussion

148. A majority of respondents believed unbundling pre-trade and post-trade transparency information would reduce the cost of post-trade transparency information. However a number of respondents did not believe it would reduce the cost, or believed that, without appropriate controls in place, the combined cost of pre- and post-trade data might increase if this proposal was implemented. Most venues (RMs, MTFs and APAs for OTC data) already provide post-trade transparency information for free 15 minutes after publication. There was majority support from respondents for implementing this proposal.

149. CESR believes these proposals are likely to reduce the cost of market data. The proposal to unbundle pre-trade and post-trade data would be likely to improve the competitiveness of the market for data by ensuring that market participants could choose whether to purchase pre-trade data or post-trade data, while platforms could still offer a package including both. CESR also believes that the proposal to require data to be provided for free after 15 minutes would ensure a consolidated tape of post-trade transparency information could be produced for free on a 15 minute delay basis.

Recommendation

150. CESR recommends that the Commission require the unbundling of pre-trade and post-trade transparency information. CESR also recommends that all post-trade transparency information must be made available free of charge after a delay of no more than 15 minutes.

151. CESR believes it must be made clear under MiFID that any third-party used to re-sell or disseminate data (such as data vendors or APAs) should meet the requirements set out above. This means that RMs, MTFs and APAs would need to ensure that data vendors unbundle pre-

trade and post-trade transparency information provided by each organisation. CESR also notes that the requirement for organisations to provide post-trade transparency information for free would not require them to provide the data initially and then separately 15 minutes later. Rather these organisations could achieve the latter by ensuring an organisation that disseminates the information does so for free 15 minutes after initial publication.

4.1.4 MiFID transparency calculations

Background

152. For the purposes of MiFID transparency calculations for each stock, competent authorities currently use data provided by the primary RM trading each stock (and in some instances, MTFs). In order to ensure the continued accuracy of these calculations, each competent authority should use all post-trade transparency data for each stock, including information from RMs, MTFs and OTC reporting arrangements (e.g. APAs under the approach for consolidation proposed above). In order to do this, each RM, MTF and OTC reporting arrangement would be required to provide data to the relevant competent authority for this purpose.

Feedback

153. There was virtually unanimous support for this proposal when it was put forward in the Consultation Paper and it is considered a sensible improvement upon the current regime.

Recommendation

154. CESR recommends requiring each RM, MTF and OTC reporting arrangement to provide data free of charge to the relevant competent authority and, where appropriate, ESMA for the purpose of MiFID transparency calculations.

4.1.3 EU mandatory consolidated tape

Background

155. CESR noted in the Consultation Paper that the proposals to improve data quality could be supplemented by the development of a mandatory consolidated tape that would provide comprehensive consolidation and offer market users a single point of access to post trade information. CESR outlined in the Consultation Paper the key characteristics of such a consolidated tape, covering the data it provided, its operation, fees/charges, etc, and posed a broad range of general and specific questions.

Feedback and discussion

156. A majority of respondents to CESR's Consultation Paper did not believe it was necessary to introduce a consolidated tape led by the authorities/regulators until the other proposals in the Consultation Paper (such as those regarding APAs and the cost of market data) had been implemented and it was seen whether they were sufficient to facilitate the development of an industry-led consolidated tape. A minority of respondents believed that the aim of an industry-led European consolidated tape could not be achieved and so a consolidated tape led by the authorities was now necessary. A small number of respondents believed as a matter of principle that an authority-led consolidated tape should not be developed.

Recommendation

157. CESR strongly believes that it is necessary to develop a consolidated tape of European post-trade transparency information. CESR does not believe that this currently exists in a form that is at a reasonable price or useful for the vast majority of market participants.

158. CESR is of the view that an obligation to establish a European consolidated tape as well as the rules for and the main features of the tape need to be outlined in MiFID. The European consolidated tape should have at least the following features:

   a. For all shares admitted to trading on an EEA RM, a European consolidated tape must provide post-trade transparency information for all transactions taking place on an EEA RM, MTF or through an investment firm as an OTC transaction (as required by MiFID), irrespective of where within the EEA the trade was executed.

   b. To ensure a high quality of data, all information on the consolidated tape must come from either an RM, MTF or APA (i.e. it cannot come directly from investment firms).

   c. It must disseminate information that is provided by each RM, MTF or APA in real-time and in as low latency a form as is reasonably possible.

   d. The operator of the consolidated tape must receive post-trade data from RMs, MTFs and APAs on an unbundled basis (i.e. separate from pre-trade data, as discussed above).

   e. The consolidated tape must be offered to users on a share-by-share basis so they have the option of purchasing transparency information about only those shares in which they have an interest. This would not prevent the operator of the consolidated tape from also offering packages of shares (such as share indices). Similarly, users should be free to purchase transparency information without having to buy any value-added products.

   f. The consolidated tape must be available to all market participants in a format that is conducive to data analysis, including execution quality or transaction cost analysis.

   g. The consolidated tape must be easily accessible to markets and investors and be available at a reasonable cost. A reasonable cost may differ depending on the user of the data (e.g. an individual user may be charged a different sum to an investment firm), although the cost must be the same for all participants within the same class of user.

   h. The consolidated tape would need to meet certain standards covering but not limited to security, dissemination (i.e. publication of information), operating hours, resources, operational reliability, contact arrangements, transparency of charges, conflicts of interest, outsourcing and monitoring. The operator of the consolidated tape would be responsible for the detection of possible multiple publication (same transaction being sent to more than one primary source).

   i. The operator of the consolidated tape would need to keep the published data available for at least a period of 5 years to assist in the MiFID transparency calculations. The operator of the consolidated tape would need to provide access to trade reports to the competent authority for the share in question for a period of 5 years after the reporting of the trade. The operator of the consolidated tape would need to make its services available to any person wishing to subscribe to its data.

159. Regarding the technical realisation of the European consolidated tape, CESR recommends to implement the tape on the basis of a project developed by the industry. This approach would leverage the anticipated benefits expected from the introduction of the APA regime and the requirements for the unbundling of trade data. It places the emphasis on the users, creators and disseminators of transparency data to design a solution that best meets their collective needs (including the necessary IT infrastructure and data formats) and gives the industry scope to determine a fair allocation of costs and charges associated with delivery of the solution.

160. Having legally mandated the establishment and the essential features of a European consolidated tape through an amendment of MiFID, there should be a clear and relatively

short timetable for the industry to deliver the consolidated tape. ESMA should have the power and mechanisms to launch the process through which the European consolidated tape is built by the industry with appropriate interim milestones, and to monitor progress, implementation and operation of the consolidated tape thereafter. As part of this role, ESMA should also be allowed to intervene with respect to prices charged for market data.

161. The Commission and ESMA should be responsible for eventually determining if at least one European consolidated tape containing the features outlined in MiFID had been achieved. In case of default at any point in the process (including a failure to achieve a firm commitment of the industry), MiFID should identify a clear course of action and require the establishment of a mandatory single European consolidated tape run as a not-for-profit entity on the basis of terms of reference and governance to be set out by ESMA.

5. Regulatory boundaries and requirements

5.1 Regulated markets vs. MTFs

Background

162. In response to the CESR Call for Evidence, RMs expressed concerns that they are faced with an unlevel playing field vis-à-vis MTFs. While the MiFID provisions governing RMs and MTFs are to a large extent similar, RMs are concerned that they are subject to more stringent – and costly – regulatory requirements than their MTF competitors. For example, MiFID allows different capital requirements for RMs and investment firms operating MTFs. Rules relating to admission to trading of financial instruments and the verification of issuer disclosure obligations apply only to RMs and, unlike MTFs, RMs wishing to trade an issuer's shares admitted to trading on another RM can do so only 18 months after the original admission and may do so only following publication of a summary note of the issuer's prospectus. In some Member States additional requirements on RMs that go beyond MiFID have been implemented. Whether these or other differences create an unlevel playing field was not specifically mentioned in the responses to CESR.

163. However, a key difference between requirements for RMs and MTFs operated by investment firms, which may be a potential source of unlevel playing field is the concept of "proportionate approach[19]" for organisational requirements that apply to MTFs and the discretion that may be attached to such test of "proportionality" by competent authorities. In this regard, an extension of requirements for RM under Article 39(a) to (c) of MiFID to investment firms or market operators operating an MTF may provide more clarity that RM and MTFs should be subject to the same organisational requirements as regards the operation of their trading platform.

164. CESR sought views on proposals to provide a greater alignment of RM and MTF requirements.

Feedback and discussion

165. A number of respondents supported the CESR proposals to align certain requirements for RMs and MTFs. While it was accepted that the proposals may impose some additional costs, these were thought to be outweighed by resultant benefits. It was also noted that costs would be minimal where existing MTFs already comply with similar requirements. Others considered that the existing MiFID provisions were sufficient, or that further work was necessary to

[19] Article 13(4) in MiFID says that an investment firm shall take reasonable steps to ensure continuity and regularity in the performance of investment services and activities. To this end the investment firm shall employ appropriate and proportionate systems, resources and procedures.

determine the impact of these proposals. Some suggestions included possible exemptions for 'junior markets' or a threshold beyond which an MTF would have to become an RM.

Recommendation

166. In addition to the requirements set out in Article 13 of MiFID, CESR recommends that investments firms operating an MTF should:

    a. have arrangements to identify clearly and manage the potential adverse consequences for the operation of the MTF or for its participants, of any conflict of interest between the interest of the MTF, its owners or its operator and the sound functioning of the MTF, and in particular where such conflict of interest might prove prejudicial to the accomplishment of any functions delegated to the MTF by the competent authority;

    b. be adequately equipped to manage the risks to which it is exposed, to implement appropriate arrangements and systems to identify all significant risks to its operation and to put in place effective measures to mitigate this risks;

    c. to have arrangements for the sound management of the technical operations of the system, including the establishment of effective contingency arrangements to cope with risks of systems disruptions.

5.2 Investment firms operating internal crossing systems/processes

Background

167. A number of investment firms in the EU operate systems that match client order flow internally. Generally, these firms receive orders electronically, utilise algorithms to determine how they should best be executed (given a client's objectives) and then pass the business through an internal system that will attempt to find matches. Normally, algorithms slice larger 'parent' orders into smaller 'child' orders before they are sent for matching. Some systems match only client orders, while others (depending on client instructions/ permissions) also provide matching between client orders and 'house' orders.

168. Investment firms operating these systems are subject to client-oriented conduct of business rules, including best execution, rather than the market-oriented rules designed for RMs and MTFs. They are required to provide post-trade transparency for OTC transactions in shares admitted to trading on an RM. Investment firms are also required to have arrangements in place for identifying conflicts of interest and to notify competent authorities when they suspect a transaction might constitute insider dealing or market manipulation.

169. There has been considerable debate over the past year about the nature and scale of business executed by broker dealers in their internal crossing systems/processes and the way it is regulated. It has been suggested that use of these systems is significant and that they have been increasing their share of trading, in part because the systems are not subject to the same levels of transparency as are required of RM and MTF systems.

170. To establish a factual context for considering these issues, CESR conducted a fact finding towards the end of 2009[20]. In total, 11 investment firms from four different jurisdictions provided data, though the data from several firms whose systems became operational during the period covers only the latter parts of the period

171. The data supplied indicates that the proportion of total EEA trading executed by large investment firms in these systems is very low, ranging from an average of 0.7% in 2008 to an average of 1.15% in 2009 (increasing to 1.5% in the first quarter of 2010) (see Table 6 below).

[20] For purposes of the fact finding, broker operated crossing systems/processes were defined as internal electronic matching systems operated by an investment firm that execute client orders against other client orders or house account orders. Information related to internal electronic systems used exclusively for systematic internalisation was excluded and only trades executed in crossing systems/processes where post-trade transparency information is published are included (i.e. internal transactions where a house account order matches against another house account order are excluded).

Table 6: Trading executed in brokers' crossing processes/networks[21]

	2008				2009				2010
	Q1	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**	**Q1**
Value (in bn euros)	37.7	39.7	43.4	39.9	28.0	36.9	47.7	55.7	58.9
Crossing as a % of OTC Trading	1.5	1.2	2.0	3.0	2.4	2.1	4.4	4.0	4.4
Crossing as a % or total EEA trading	0.6	0.6		0.7	0.9	0.9	0.9	1.4	1.5

Sources: (1) Value of trading executed on brokers' crossing systems/processes: information collected from 11 European investment firms and aggregated by competent authorities; (2) Total value of OTC trading in EEA shares: Thomson Reuters; (3) Total trading in EEA shares: Thomson Reuters

172. Investment firms consider that internal matching of client orders, whether manual or automated, is core to traditional brokerage activity. They view it as being only one of a range of means that they use to execute client business and as providing execution efficiency.

173. Some CESR members consider that the current legal framework does not support a requirement for investment firms to register their internal crossing networks as MTFs. In particular, these systems do not have participants in the way that a standalone MTF does. In some jurisdictions, some investment firms operating internal crossing systems have decided to operate an MTF but are having to modify their business models significantly to bring the new activity within the MTF definition.

174. CESR put forward proposals to introduce bespoke requirements for firms operating internal crossing systems and to impose a limit on the amount of client business that could be executed in a broker crossing system (BCS) before it would be required to become an MTF.

Feedback and discussion

175. There were divided views on CESR's proposed definition of a BCS. Some respondents were comfortable with the definition. Others considered that the definition was too broad, or that internal crossing systems should be regulated within the existing MiFID regimes for MTFs and systematic internalisers.

[21] It should be noted that the value of OTC trading published by Thomson Reuters and used here, and as a consequence the value of EEA trading published by Thomson Reuters, may be inflated due to multiple reporting of a single transaction.

176. A number of respondents supported the bespoke requirements for BCS. They considered these would provide greater clarity on the regulatory requirements. Other respondents questioned whether additional requirements were necessary given the relatively small volume of business done in internal crossing systems. A number of respondents (both institutional investors and sell-side firms) expressed concerns about a requirement to identify BCS (individually using their BIC) real-time in post-trade transparency reports. Some considered that current transparency requirements were sufficient. They believed this proposal would subject clients to unnecessary market impact and has the potential to damage liquidity provision. As an alternative, a generic BCS identification was suggested with end of day reporting of BCS trades. In this context, respondents noted the voluntary industry initiative by a number of investment firms for end of day reporting[22].

177. There were divergent views on the proposal to place a limit/threshold on BCS business before it would be required to become an MTF. Those in favour of the proposal considered a threshold should be based on total European trading and that further work should be done to clarify the nature of OTC trading. Those against the proposal noted that internal crossing systems are client-oriented, discretionary models which are fundamentally different to the business of an MTF. This proposal would require a change in business structure, creating significant operational implications and additional costs. Respondents suggested that further analysis was needed to determine whether it was appropriate to place a limit on BCS business. They considered this approach may not be effective in delivering regulatory objectives (e.g. greater transparency). Others noted the importance of assessing the cost/impact of the proposal.

Recommendation

178. CESR recommends that a new regulatory regime be created for investment firms operating broker crossing systems (BCS), CESR considers a BCS to be an internal electronic matching system operated by an investment firm that executes client orders against other client orders or, occasionally, house account orders on a discretionary basis.

179. Investment firms operating a BCS would be subject to the following:

  a. A requirement for investment firms operating such systems to notify their competent authority and provide a description of the system, including (at least) details on access to the system, the orders that may be matched in the system, the trading methodology, the arrangements for post-trade processing and trade publication;

  b. A requirement for competent authorities to place on the CESR/ESMA website the name of any firm that has notified it that it operates a broker internal crossing system with the respective BIC code to identify the crossing system;

  c. A requirement for investment firms to add a generic BCS identifier for its crossing system to their post-trade transparency information for all transactions executed on such systems. Investment firms would be required to make public aggregated information at the end of each day, including the number, value and volume of all transactions executed in their internal crossing system;

  d. A requirement that investment firms identify in their transaction reports to competent authorities whether the transaction was executed in a BCS and, if so, which BCS was used;

  e. In addition, investment firms that operate a BCS would be brought within the scope of the MiFID Article 41(2). This would require a competent authority demanding the

[22] Markit BCS shows the volume of European cash equities executed in Broker Crossing Systems (BCS); including Citigroup; Credit Suisse; Deutsche Bank; JP Morgan; Morgan Stanley; and UBS. For these purposes, the Markit Boat website defines a Broker Crossing System as an internal automated process operated by a broker-dealer that matches buy and sell orders on a discretionary intra-spread basis within a pricing methodology referencing an appropriate BBO. Markit BCS data is a subset of total volume reported across all publication venues as 'OTC' and 'SI' and is presented in aggregate form at a country level. Markit Boat website: http://www.markit.com/en/products/data/boat/boat-bcs-reports.page?

suspension or removal of a financial instrument from trading on an RM or MTF to make a similar demand to a BCS; and

f. CESR notes that an investment firm operating a BCS would also be required to satisfy organisational requirements set out in Article 13 of MiFID, including taking all reasonable steps to prevent conflicts of interest through the operation of organisational and administrative arrangements; and to ensure continuity and regularity of performance of investment services/activities through appropriate and proportionate systems, resources and procedures;

180. CESR also recommends the Commission impose a limit on the amount of client business that can be executed by investment firms' crossing processes/networks before the crossing system is required to become an MTF. This implies that, for instance, obligations such as pre-trade transparency and fair access would be applicable once internal crossing processes reached a certain percentage of the market (i.e. similar to the proposed US approach), either on its own or in combination with other crossing systems/processes with which they have a private link. CESR stands ready to assist the Commission in determining what an appropriate limit would be.

6. MiFID options and discretions

181. CESR undertook an internal mapping exercise of discretions within MiFID in order to identify areas where a more harmonised approach might be desirable. Regarding some options and discretions which are related to the work on the MiFID Review on equity markets, CESR therefore wished to take the opportunity to ask for the views of market participants on certain options and whether to turn certain discretions into rules. A few other options and discretions granted to competent authorities in the MiFID provisions might rather be addressed by further harmonisation of supervisory practices within the regular CESR Level 3 work if considered appropriate after internal discussion among CESR members[23].

6.1 Waiver of pre-trade transparency obligations

Background

182. Articles 29(2) and 44(2) of MiFID and Articles 18 to 20 of the MiFID Implementing Regulation foresee discretion for Competent Authorities to waive the obligation for RMs and MTFs to provide for pre-trade transparency under Article 29(1) and 44(1) of MiFID based on market models or the type and size of orders.

183. Some of the waivers such as the order management facility waiver for Iceberg and stop orders in Article 18(2) of the MiFID Implementing Regulation are used in a wide variety of Members States while others, e.g. the reference price waiver, are used in a more limited number of countries. This does not necessarily point at a divergent application of the waiver but rather results from the fact that the business models of RMs and MTFs in the Member States vary. Furthermore, the practice of granting waivers varies in Member States. While in most jurisdictions the waiver provisions in MiFID have been implemented in a way that requires approval of individual arrangements, either by individual decision or by approval of (amendments to) the rules of an RM or MTF, in other Member States there is no such requirement.

Feedback

184. Feedback from respondents to the CP generally indicated a preference for all Competent Authorities automatically to allow use of the pre-trade transparency waivers.

[23] This covers the following discretions of competent authorities: to waive the obligation to make public limit orders that are large in scale compared with normal market size in Article 22(2), to authorise RMs and MTFs to defer publication of details of transactions based on their type or size in Articles 30(2) and 45(2) of MiFID and Article 28 of the MiFID Implementing Regulation,

Recommendation

185. Despite the feedback from respondents, CESR considers it appropriate to retain the existing discretion regarding the use of the pre-trade transparency waivers and to retain a role for CESR/ESMA in considering the use of the waivers to ensure their consistent and reasonable use.

6.2 Determination of liquid shares

Background

186. Article 22(1) of the MiFID Implementing Regulation specifies the conditions for determining liquid shares for the purposes of the SI-regime in Article 27. In particular, it sets the conditions which must be met before a share admitted to trading on an RM can be considered to have a liquid market. In order to be liquid, a share must be traded daily and have a free float of not less than EUR 500 million, and one of the following conditions must be satisfied:

    a. the average daily number of transactions must not be less than 500; or

    b. the average daily turnover for the share must not be less than EUR 2 million.

187. In respect of shares for which they are the most relevant market, Member States are permitted to specify by public notice *that both conditions are to apply*. Up to date, only a limited number of Member States have exercised this discretion.

188. CESR consulted on whether a deletion of this discretion was desirable and, if it were, whether the future harmonised criteria for the definition of a liquid share should cover both (a) and (b) or only one of the two criteria.

Feedback

189. Generally, respondents to the CP wanted a single, harmonised approach to the determination of liquid shares and wanted this to incorporate both point (a) and point (b) above.

Recommendation

190. Competent Authorities have employed differing approaches hitherto to determining which shares should be considered liquid, and this seems to have operated without significant difficulty. The preference expressed in the responses to the CP would result in a significant change to the population of shares considered liquid, particularly for smaller EEA countries. Given these two points, CESR would recommend that the existing discretion be retained.

6.3 Immediate publication of a client limit order

Background

191. The order handling rules under Article 22(2) of MiFID prescribe that investment firms have to take measures to facilitate the earliest possible execution of a client limit order in respect of shares admitted to trading on an RM, when the order is not immediately executed under prevailing market conditions. The firm is required to make public immediately that client limit order in a manner which is easily accessible to other market participants, unless the client expressly instructs otherwise.

192. MiFID creates discretion for Member States to decide that investment firms comply with this obligation by transmitting the client limit order to an RM and/or an MTF.

193. The vast majority of CESR members apply this discretion. In practice, clients also often expressly instruct their investment firms not to disclose the limit order immediately to the public as foreseen in MiFID. CESR therefore consulted on replacing the discretion with a rule under Article 22(2). This rule would allow investment firms to comply with the obligation to

make the client limit order immediately public in an easily accessible manner by transmitting the client limit order to an RM and/or MTF.

Feedback

194. Respondents to the CP wanted the discretion to be embedded in MiFID as a rule and for clients to continue to be able to instruct their investment firms not to disclose unexecuted limit orders.

Recommendation

195. CESR recommends that the Commission embeds the discretion discussed above as a rule in MiFID. However, this should not impact on the option of clients to instruct their investment firms not to display their unexecuted limit orders.

6.4 Requirements for admission of units in a collective investment undertaking to trading on an RM

Background

196. Article 36(2) of the MiFID Implementing Regulation grants discretion to Member States to provide that it is not a necessary precondition of the admission of units in collective investment undertakings to trading on an RM that the RM satisfy itself that the collective investment undertaking complies or has complied with registration, notification or other procedures which are a necessary preconditions for the marketing of collective investment undertakings in the jurisdiction of the RM.

197. CESR consulted on whether this option should be retained since only few Member States have made use of this discretion to date. CESR members from those Member States considered that the admission of units in collective investment undertakings to trading on an RM in a Member State and the marketing of a collective investment undertaking in that Member State were two separate and distinct activities. They also believed that marketing of units of collective investment undertakings to domestic investors was adequately controlled by other investment fund and intermediary legislation, and that there was no evidence that operation of the discretion had raised any concerns.

Feedback

198. A majority of respondents to the CP indicated that they wanted the existing discretion to be retained.

Recommendation

199. Given the above, CESR recommends that the existing discretion provided to Competent Authorities in MiFID be retained.

7. Micro-structural issues in European secondary markets

7.1 Summary of the responses to the Call for Evidence on European micro-structural issues

200. In April 2010, CESR issued a Call for Evidence on micro-structural issues in the European equity markets. The key themes emerging from the responses received to the Call for Evidence and the next steps CESR proposes are outlined below.

7.1.1 High frequency trading

Defining high frequency trading

201. Respondents to CESR's Call for Evidence on micro-structural issues defined high frequency trading (HFT) in various ways. Rapid, automated execution of trading strategies was one key theme (e.g. high velocity order entry), with HFT firms being highly sensitive to latency and regular users of co-location services. Many, although not all respondents suggested that HFT activity was characterised as being market-neutral, with positions closed out by the end of the day. Some noted that this type of trading was proprietary in nature. Importantly, though, no single, agreed definition of HFT emerged and estimates of its significance in the markets (provided mainly by trading platforms) varied from 13% to 40% of total trading

Drivers and growth of HFT

202. The drivers of HFT were considered to be numerous: the availability of specialist programming/IT staff; profit opportunities from arbitrage across new venues and asset classes; reduced frictional costs; increased volumes and volatility due to macro events; and standardised minimum tick sizes across venues for each security. The limitations on HFT were considered to be: tick sizes forcing order book queuing; decreased volumes and volatility due to macro events; increased HFT competition reducing profits; costs of trading (including investing to reduce latency further), clearing and settlement; regulatory restraint/taxes; and the cost of connecting to multiple venues and managing order flow between them.

203. Some respondents felt HFT would continue to grow as costs fell and the adoption of sophisticated trading strategies and technology increased. Others felt that HFT was driven by arbitrage opportunities and would rapidly reach a natural limit, especially if venue consolidation started to occur.

Impacts of HFT

204. The majority of respondents argued that HFT firms had played a role in supplying the markets with liquidity. This had helped to reduced bid-offer spreads and had reduced demand and supply imbalances, thereby helping to limit volatility. Others argued that HFT firms had benefitted the markets by eliminating arbitrage opportunities and aligning prices across markets. However, others questioned whether HFT firms had encouraged volatility in order to benefit from market movements and noted that they had the option to withdraw their liquidity at any time.

205. The risks posed by HFT firms that were put forward by respondents included (inter alia): systemic risks through increased bandwidth usage, order entry/deletion and rogue algorithms; increased market abuse, with detection becoming more difficult in a fragmented and highly automated environment; sudden liquidity withdrawal; and potential de-correlation of prices from market fundamentals if trading strategies focussed solely on short term profits.

Regulating HFT

206. The majority of respondents felt HFT-specific regulations were not required. Some respondents noted that it was important for trading venues' systems to keep pace (e.g. trading capacity and monitoring capabilities) and that additional market surveillance was needed to combat possible market abuse. However, others felt that all HFT firms should be caught by MiFID's provisions or that they should at least be required to meet capital requirements.

7.1.2 Sponsored access

207. Respondents to the Call for Evidence noted that sponsored access arrangements increased trading volumes and liquidity and allowed users to reduce latency and control their executions. Concerns about sponsored access revolved around the risk of erroneous activity, the possible impact on the integrity and orderly functioning of markets, and the risks to sponsoring firms. There was strong support for consistent pre-trade risk management and controls for both sponsoring firms and venues that allowed sponsored access flow.

7.1.3 Co-location

208. Responses to the Call for Evidence reflected the value of co-location in reducing latency and noted that this increased trading activity and liquidity. It was also regarded as a tool for levelling the playing field between firms, which could compete to acquire co-location space, and trading venues. However, concerns were expressed around ensuring venues provided equality of access to participants, including transparency of pricing, and that regulatory action to ensure this might be warranted. Some respondents felt that access to co-location should be limited to regulated firms and venue members, whereas others felt a broader range of interested parties (e.g. data vendors) should be able to use co-location space as well. In addition, some were concerned that lower latency might facilitate abusive strategies, or that its costs might be prohibitive for some.

7.1.4 Fee structures

209. Responses reflected that many venues had moved towards the maker/taker model in recent years, recognising the importance of liquidity providers in the markets and encouraging order flow. Importantly, respondents felt that fee structures should remain a purely commercial issue but that trading venues should ensure their fees were transparent to all market participants.

7.1.5 Tick sizes

210. Almost all market participants agreed that the reduction in tick sizes had helped tighten bid-offer spreads, with some arguing that this had helped increase liquidity and reduce volatility. However, other argued that small tick sizes might fragment liquidity at the top of the order book or allow participants to edge their orders ahead at minimal cost. In terms of harmonising tick sizes across the markets, some felt that existing industry initiatives had been sufficient. However most perceived at least a "back-up" role for regulators in this area to ensure tick sizes were reasonable and standardised.

7.2 CESR Action Plan on Micro-structural Issues

211. Based on the above responses to the Call for Evidence on micro-structural issues, CESR proposes the following actions.

7.2.1 High frequency trading

212. CESR considers that further work is necessary to better understand high frequency trading strategies and the risks that they pose to the orderly functioning of markets.

213. CESR considers that further scoping work is necessary (including consultation with industry) to develop some specific guidelines on the application of appropriate systems and controls for investment firms and trading platforms in a highly automated trading environment (e.g. volatility measures/circuit breakers for trading platforms in the context of pan-European trading).

214. CESR recommends that further work be done on direct members of RMs/MTFs that currently fall under the MiFID Article 2(1)(d) exemption for non-market making firms that trade only on a proprietary basis. As a starting point, this work should include a fact finding exercise on RM/MTF members that are not investment firms and which account for significant volumes on any given trading platform.

7.2.2 Sponsored Access

215. CESR considers that guidance on sponsored access is necessary. CESR notes that a considerable amount of work has been done at domestic and international levels to establish high-level standards for sponsored access arrangements. In addition, there are existing

provisions in MiFID that could be applied to investment firms and trading platforms in the context of these arrangements (e.g. organisational requirements for investment firms and RMs/MTFs).

216. Accordingly, CESR recommends that further work be done (including consultation with industry) to develop specific guidelines on sponsored access. This work should identify the risks from 'naked' access and focus on pre- and post-trade controls, outsourcing arrangements and consider the implications for both investment firms and trading platforms.

217. As a result, CESR recommends the Commission amend Level 1 (and, where appropriate, Level 2) so as to include a specific reference to ESMA competence to develop binding technical standards in precisely defined areas as regards RMs/MTFs organisational requirements. These standards would not involve broad policy choices, but would specify requirements in focused areas relating to fair and orderly markets, including sponsored access. Pending the revision of MiFID, such requirements for sponsored access could be dealt with under CESR guidelines.

7.2.3 Co-location services

218. CESR considers that existing MiFID provisions could be applied to co-location services (e.g. RMs/MTFs must have transparent rules, based on objective criteria, governing access to their systems/facilities). Accordingly, CESR recommends that further scoping work be done (including consultation with industry) to develop specific guidelines on the application of MiFID to these arrangements. Guidelines should focus on co-location arrangements provided by trading platforms (either directly or via an outsourcing agreement) and provide that services (including fees) are transparent and available to trading participants on an objective basis.

219. As a result, CESR recommends the Commission amend Level 1 (and, where appropriate, Level 2) so as to include a specific reference to ESMA competence to develop binding technical standards in precisely defined areas as regards RMs/MTFs organisational requirements. These standards would not involve broad policy choices, but would specify requirements in focused areas relating to fair and orderly markets, including co-location services. Pending the revision of MiFID, such requirements for co-location services could be dealt with under CESR guidelines.

7.2.4 Fee structures

220. CESR considers that existing MiFID provisions for RMs/MTFs could be applied to fee structures (e.g. RMs/MTFs must have transparent rules, based on objective criteria, governing access to their systems/facilities). Accordingly, CESR recommends that further scoping work be done (including consultation with industry) to develop a proposal on how MiFID provisions should apply to these arrangements. This proposal should focus on providing that fee structures are made transparent and available to members on an objective basis.

221. As a result, CESR recommends the Commission amend Level 1 (and, where appropriate, Level 2) so as to include a specific reference to ESMA competence to develop binding technical standards in precisely defined areas as regards RMs/MTFs organisational requirements. These standards would not involve broad policy choices, but would specify requirements in focused areas relating to fair and orderly markets, including fee structures. Pending the revision of MiFID, such requirements for fee structures could be dealt with under CESR guidelines.

7.2.5 Tick size regimes

222. Based on the responses to the call for evidence, CESR does not consider that regulatory intervention is necessary on tick size regimes at this time. However, CESR consider that regulators should have the necessary tools to ensure that variations in tick sizes across trading platforms do not impact on the orderly functioning of the market as a whole. As a result, CESR

recommends the Commission amend Level 1 (and, where appropriate, Level 2) so as to include a specific reference to ESMA competence to develop binding technical standards in precisely defined areas as regards RMs/MTFs organisational requirements. These standards would not involve broad policy choices, but would specify requirements in focused areas relating to fair and orderly markets, including, if needed, tick sizes. Pending the revision of MiFID, such requirements for tick sizes could be dealt with under CESR guidelines.

8. Other MiFID provisions related to secondary markets

223. The obligation to cooperate placed on competent authorities of different Member States under Article 56(2) of MiFID limits itself to the cross-border activities of RMs and does not currently extend to MTFs. However, MTFs have become increasingly significant to secondary market trading across Europe since MiFID came into force. As a result, it is considered appropriate that competent authorities also establish proportionate cooperation arrangements if the activities established by an MTF in a host Member State become of substantial importance for the functioning of the securities markets and protection of investors in that host Member State.

224. CESR therefore recommends that the Commission extend the obligation in Article 56(2) of MiFID for competent authorities to cooperate, such that it extends to the activities of MTFs as well as RMs.

ANNEX I – PROPOSED GUIDANCE FOR APPROVED PUBLICATION ARRANGEMENTS

Dissemination

APAs must publish the information required under Article 27 of the MiFID implementing regulation within the timeframe required under Article 28 of MiFID.

APAs must:

- facilitate the consolidation of the information with similar data from other sources, including making the information accessible by automatic electronic means in a machine-readable way;
- ensure the information is accompanied by instructions outlining how users can access the data;
- make the information available to the public on a non-discriminatory commercial basis at a reasonable cost; and
- provide transparency with respect to the prices charged to end-users of the data;

Security

APAs must ensure there is:

- certainty on a continuous basis as to which firms submit trade information by employing appropriate authentication mechanisms;
- no corruption of data in the input process at the APA; and
- no unauthorised access to trade information at the APA.

APAs must ensure there are controls over their facilities and the individuals providing the services to ensure trade information is monitored securely and confidentiality of the data received is retained, and to prevent the misuse of the information. At a minimum, the following controls must be in place at the APA:

- the working environment must be secure;
- the computer-based systems must incorporate:
  - access controls;
  - procedures for problem management and system changes; and
  - arrangements to monitor system performance, availability and integrity.
- the working environment must be free of unauthorised surveillance;
- individuals providing the APA service must be under a duty to keep confidential any trade information to which they have access; and
- if there is a breach of any security measure relating to the provision of a APA service, the clients involved and the APA’s authorising competent authority must be notified immediately and, if requested, a detailed report of the breach must be provided and appropriate corrective steps taken.

Identification of incomplete or potentially erroneous information

APAs must have appropriate systems and controls in place to identify on receipt trade reports from investment firms that are incomplete or contain information that is likely to be erroneous. These systems and controls may include various automated price and volume alerts, taking into account:

- the sector and the segment in which the security is traded;
- liquidity levels including historical trading levels;
- appropriate price and volume benchmarks; and
- if needed, other parameters to be set individually according to the characteristics of the security.

Where an APA determines that a trade report it receives from an investment firm is incomplete or contains information that is likely to be erroneous, it must ensure it does not publish this information. It must alert the investment firm that the trade report is incomplete or contains information that is likely to be erroneous and has not been published.

An APA must review its systems periodically and adjust them when necessary.

Correction of trade information

An APA must have the ability to amend a trade report itself when a firm cannot do so for technical reasons in exceptional circumstances. The APA is not otherwise responsible for correcting information contained in trade reports. Where an APA determines a trade report is incomplete or contains information that is likely to be erroneous and therefore does not publish the trade, the investment firm must correct the trade report and publish a complete and accurate trade report as soon as the error is detected.

Monitoring

An APA must have the capability to monitor its own systems and controls to ensure with reasonable certainty that the trades it monitors have been successfully published.

Operational hours

An APA must be capable of monitoring trade reports throughout the normal trade publication hours of the investment firms submitting trade reports to it, irrespective of the time zones in which those investment firms operate. This must include providing for trades published under MiFID's deferred publication regime.

Resources and contact arrangements

An APA must have appropriate numbers of staff overseeing the APA service who are competent to perform their duties and meet the requirements for APAs.

An APA must have a nominated individual responsible on a day-to-day basis for the performance of the APA's functions and its compliance with these standards. An APA must provide its clients with contact details for this person.

An APA must provide a facility for market participants to query the accuracy of the trade publications it disseminates and must have procedures in place for market participants to raise complaints regarding the APA's services and activities. The facility must be operational throughout the normal trade publication hours of the investment firms submitting trade reports to the APA so that queries can be addressed promptly.

Recovery provisions

An APA must provide adequately for possible disruptions to its operations in order to enable the timely resumption of publication in the case of system failure. It must have arrangements to ensure IT systems are not prone to failure and must ensure business continuity if a system or systems failed. This must include system "fail-over" arrangements to minimise the risk of disruption to the APA's service.

An APA must regularly review these provisions and ensure they remain sufficient to ensure there is minimum disruption to the continuous operation of its service. An APA must inform its clients without delay if its operations are disrupted.

Conflicts of interest

APAs must have appropriate arrangements for managing conflicts of interest. In particular, appropriate control and governance structures must be in place to ensure that staff in the APA's surveillance function do not come under undue pressure or influence from the APA's commercial functions.

Outsourcing

Where an APA arranges for functions to be performed on its behalf by third parties, the APA must be satisfied that the person performing the function is fit, able and willing to perform the function. An appropriate contract must be in place to cover the outsourced functions, with accompanying service level agreements. In addition, the APA must satisfy itself that such a third party has recovery provisions in place akin to those outlined above.

Regulatory reporting responsibilities

Periodic report

The information that an APA must provide on a periodic basis to the competent authority of each investment firm using the facilities of the APA must include (but may not be limited to) the proportion of information to be made public received by the APA from the investment firm that:

- The APA did not publish because the information was incomplete;
- The APA did not publish because the information was likely to be erroneous;
- Were later cancelled by the investment firm;
- Were later amended by the investment firm; and
- Were not received by the APA within the time required under Article 29(5) of the MiFID Implementing Regulation or the delays allowed under Article 28 of the MiFID Implementing Regulation.
- Were flagged as being either incomplete or likely to be erroneous that were resubmitted and the resubmitted trade was then subsequently cancelled or amended

Each APA must provide to the competent authority of each investment firm:

- A measure of average time taken to resubmit corrected trades that the APA flagged to the investment firm as being either incomplete or likely to be erroneous; and
- a measure of the average time between a trade first being published and it later being either cancelled or amended

Ad hoc reports

Where an APA considers that an investment firm is consistently providing poor quality data, it must in the first instance inform the investment firm of its concerns. If the submission of poor quality data continues, the APA must report its concerns to the investment firm's competent authority.

COMMITTEE OF EUROPEAN SECURITIES REGULATORS

Date: 29 July 2010
Ref.: CESR/10-799

TECHNICAL ADVICE

CESR Technical Advice to the European Commission in the Context of the MiFID Review: Non-equity Markets Transparency

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ANNEX 1: Non-confidential responses to the Consultation Paper.

Executive Summary

The Markets in Financial Instruments Directive (MiFID) came into force on 1 November 2007. It introduced significant changes to the European regulatory framework for equity secondary markets, leaving open to Member States the possibility to extend transparency requirements to financial instruments other than shares according to Recital 46.

CESR analysed the eventual extension of MiFID transparency requirements to non-equity financial instruments in CESR's response to the Commission on non-equity transparency (Ref. CESR/07-284b) in August 2007 and CESR's report on transparency of corporate bonds, structured finance products and credit derivatives markets (Ref. CESR/09-348) of July 2009.

CESR concluded in CESR/07-284b that at that time there was no evident market failure in respect of market transparency in corporate bond markets and that there was no need for a mandatory pre- or post-trade transparency regime. When CESR re-examined the need for additional transparency in the wake of the financial crisis (Ref. CESR/09-348), it focused solely on post-trade transparency. In that report, CESR concluded that additional post-trade information would be beneficial to the market.

This report presents possible ways of developing the recommendations in the July 2009 report in the context of the upcoming MiFID Review to be launched by the European Commission in the course of 2010. Since derivatives were not analysed in the past, CESR is also exploring the possibility of a post-trade transparency regime for the most significant subset of these financial instruments: interest rate derivatives, equity derivatives, foreign exchange (FOREX) derivatives and commodity derivatives.

At the request of the European Commission, CESR is also reconsidering whether there is a need for pre-trade transparency for corporate bonds, ABS, CDOs, CDS and the derivatives mentioned above.

The main outcomes of this exercise can be found below. CESR has given considerable thought to the issue of transparency of non-equity markets. As outlined in CESR's previous advice to the Commission the transparency of these markets should be enhanced and, in CESR's view, the most appropriate way of doing so is through the introduction of a harmonised pan-European mandatory post-trade transparency regime.

The review of MiFID now presents the ideal opportunity to introduce far-reaching measures designed to improve the transparency of a broad range of asset classes and CESR strongly recommends to the Commission to take forward the recommendations as outlined in this report.

Post-implementation review

Introducing these requirements will obviously mean significant changes to the markets in question. A recurring theme from a broad range of market participants is the scope for an adverse impact on liquidity.

CESR is of the view that the calibration of thresholds and time delays for the proposed regime should ideally be based on the liquidity of the asset in question. However, due to the largely OTC nature of these markets there is currently an absence of trading data which can reliably be used to robustly calibrate a regime. CESR therefore recommends at this stage that calibration should be based on the average trading size of each of the markets in question.

However, once the regime is implemented this information will quickly become available. Therefore at the core of CESR's recommendations to the Commission is the need to undertake a post-implementation review (for all asset classes) with a view to reaching conclusions one year after introducing the new transparency obligations. CESR stands ready to assist the Commission in collecting and analysing the available data and to amend the regime if deemed necessary.

It is important to stress that the purpose of this review would not be to alter the scope of the regime. However, alterations to take into consideration the liquidity of the instrument and/or to increase or decrease the size thresholds and time delays may be considered necessary.

Post-trade transparency

In relation to the calibration of a post-trade transparency regime CESR recommends the following approach:

Corporate bonds

Transaction size (net value)	Information to be published	Timing of publication
To be further refined but the upper threshold should be in the region of €500,000 to €1 million	Price and volume of transaction	As close to real time as possible
Between €500,000/€1 million and €5 million	Price and volume of transaction	End of trading day
Above €5 million	Price but no volume (but with an indication that the transaction has exceeded the €5 million threshold)	End of trading day

Public bonds

Transaction size (net value)	Information to be published	Timing of publication
Below €1 million	Price and volume of transaction	As close to real time as possible
Between €1 million and €5 million	Price and volume of transaction	End of trading day
Above €5 million	Price but no volume (but with an indication that the transaction has exceeded the €5 million threshold)	End of trading day

Structured finance products covered by the first phase

Transaction size (net value)	Information to be published	Timing of publication
Below €5 million	Price and volume of transaction	End of trading day
Above €5 million	Price but no volume (but with an indication that the transaction has exceeded the €5 million threshold)	End of trading day

Clearing eligible single name and sovereign CDS

Transaction size (net value)	Information to be published	Timing of publication
Below €5 million	Price and volume of transaction	As close to real time as possible
Between €5 million and €10 million	Price and volume of transaction	End of trading day
Above €10 million	Price but no volume (but with an indication that the transaction has exceeded the	End of trading day

	€10 million threshold)	

Clearing eligible index CDS

Transaction size (net value)	Information to be published	Timing of publication
Below €10 million	Price and volume of transaction	As close to real time as possible
Between €10 million and €25 million	Price and volume of transaction	End of trading day
Above €25 million	Price but no volume (but with an indication that the transaction has exceeded the €25 million threshold)	End of trading day

Phased approach for a post-trade transparency regime in structured finance products

CESR recommends that the transparency regime should cover all ABS and CDOs for which a prospectus has been published (i.e. including all ABS and CDOs admitted to trading on EEA regulated markets) or which are admitted to trading on a MTF. Due to the perceived illiquidity of these markets CESR recommends that the transparency requirements should be introduced in a two step approach:

1. In the first phase all the instruments rated as AAA, AA or A[1] (or any equivalent terminology used by other credit rating agencies) should be covered.

2. In the second phase, the rest of the universe of SFP as outlined above should be covered.

Post-trade transparency for other types of derivatives

CESR recognises that the current stage of the analysis, given the heterogeneity of all the OTC derivative segments included in the consultation paper, is still in an early phase. Nevertheless CESR is strongly of the view that enhancing post-trade transparency for derivatives other than CDS will assist market participants in making investment decisions as well as in supporting more resilient and transparent markets in general.

CESR therefore recommends to the Commission that a harmonised post-trade transparency regime for these assets should be further developed. CESR stands ready to assist the Commission in calibrating a regime for these assets which, takes into consideration the different features of the markets in question.

Pre-trade transparency for bonds, structured finance products, credit default swaps and derivatives

CESR is of the view that there is currently an unlevel playing field in the EEA with respect to the provision of pre-trade transparency for instruments other than shares. CESR therefore recommends that current voluntary arrangements are put on a formal footing and that a compulsory harmonised pre-trade transparency regime be introduced. The regime should apply to organised trading platforms (RMs and MTFs) with respect to the non-equity instruments traded on these platforms. Similar to the pre-trade transparency regime for equity, this regime needs to be refined to provide appropriate pre-trade transparency standards for various market structures and trading models, taking into account the various instruments and asset classes traded. As for equity, this may also involve the provision of appropriate waivers.

[1] At the time of implementation of the regime for existing instruments, or at the time of issuance for instruments issued after implementation of the regime.

Given the different characteristics of the wide range of products concerned, each with its respective market microstructure and the varying degree of liquidity exhibited in these markets CESR does not, at this stage, propose to introduce mandatory pre-trade transparency requirements to the OTC space. Nevertheless CESR would welcome that any future regime allows Member States to introduce local requirements if they deem them to be necessary given the specificities of their markets in question.

I. Introduction

1. The Markets in Financial Instruments Directive (MiFID) came into force on 1 November 2007. It introduced significant changes to the European regulatory framework for equity secondary markets, leaving open to Member States the possibility to extend transparency requirements to financial instruments other than shares according to Recital 46.

2. CESR has analysed the eventual extension of MiFID transparency requirements to non-equity financial instruments in CESR's response to the Commission on non-equities transparency (Ref. CESR/07-284b) in August 2007 and CESR's report on transparency of corporate bonds, structured finance products and credit derivatives markets (Ref. CESR/09-348) as of July 2009.

3. CESR concluded in CESR/07-284b that at that time there was no evident market failure in respect of market transparency on corporate bond markets and that there was no need for a mandatory pre or post-trade transparency regime. When CESR re-examined the need for additional transparency in the wake of the financial crisis in CESR/09-348, it focused solely on post-trade transparency. In this report CESR concluded that additional post-trade information would be beneficial to the market.

4. In respect of corporate bonds, CESR recommended that a post-trade transparency regime should have the following characteristics:

   i) The scope should cover all corporate bonds for which a prospectus has been published (i.e. including all corporate bonds admitted to trading on a regulated market) or which are admitted to trading on an MTF;
   ii) In terms of the relevant information to be made public, the content of post-trade transparency data should at least include the description of the bond, the price/yield at which the transaction has been concluded, the volume of the executed trade and date and time when the trade was concluded

5. Regarding ABS and CDOs, CESR proposed that a phased approach should be used so that the regime would gradually apply to all those instruments commonly considered as standardised. The initial issuance size of ABS and CDOs was one criteria which could form a basis for the approach. It was agreed that the following information should be made public:

   i. Standardised format of identification;
   ii. Issuer name;
   iii. Price at which the transaction was concluded;
   iv. Volume of the executed trade;
   v. Date and time when the trade was concluded;
   vi. Currency;
   vii. Maturity; and
   viii. Rating.

6. In relation to CDS, CESR agreed that a post-trade transparency regime should cover all CDS contracts which are eligible for clearing by a CCP due to their level of standardisation, including single name CDS, although there may not yet be an offer for clearing of these CDS by a CCP. The following was seen as the most relevant information to be made public:

   i. Standardised format of identification;
   ii. Issuer name;
   iii. Price at which the transaction was concluded;
   iv. Volume of the executed trade;

v. Date and time at which the trade was concluded;
vi. Currency;
vii. Maturity;
viii. Rating; and
ix. Reference entity.

7. For the above mentioned instruments, and as with the transparency regime for equity markets under MiFID, CESR considered that specific attention should be paid to an approach that allows for delayed publication and/or the disclosure without specified volumes if the transaction exceeds a given threshold in order to minimise a potential adverse impact on liquidity.

8. In addition, CESR stated that trade information needs to be made available on a non-discriminatory commercial basis at a reasonable cost and in a manner which is easily accessible by all investors. It was also recommended – in alignment with the existing MiFID requirements- to apply the above approach for post-trade transparency to regulated markets (RMs) and MTFs as well as to investment firms trading outside RMs and MTFs.

9. As a follow-up to the recommendations included in CESR's report on non-equity transparency of July 2009 (Ref. CESR/09-348) and as part of its advice to the Commission on the MiFID Review, in April 2010 CESR published a consultation paper (CESR Technical Advice to the European Commission in the Context of the MiFID Review: Non-equity markets transparency; Ref. CESR/10-510; from now on, the consultation paper) to request views from the market on a proposal for a mandatory post-trade transparency regime (in terms of thresholds and delays) for corporate bonds, ABS, CDOs and CDS. In addition, that document consulted, on whether there is a need for greater pre-trade transparency for the above mentioned instruments and whether there is a need for greater pre and post-trade transparency for additional non-equity instruments (i.e. interest rate, equity, commodity and FOREX derivatives) in response to a request by the Commission for information (Ref. MARKTG3/SH/cr Ares). This built on CESR's decision in December 2009 to extend its work on analysing the need for post-trade transparency to derivatives markets.

10. In addition CESR held an Open Hearing to seek the views of market participants on these topics and their possible impact as well as hosted a Retail Investor Day where the proposals in the Consultation Paper were presented to representatives of retail investors. Further to that, and as part of CESR's regular processes, the Consultative Working Group of the Secondary Markets Standing Committee has provided its views on the topics under consultation.

11. At the Open Hearing CESR confirmed that in response to recent events in European financial markets CESR decided that the scope of this work should be broadened to include sovereign bonds[2].

12. The Open Hearing and the Retail Investor Day provided CESR with a wide variety of views from the full spectrum of interests which may be affected by any regulatory initiative undertaken in this area. It is noted that stakeholders offered differing views depending on their position in the market and the nature of their interests. However, it is also important to highlight that CESR's aim in relation to the topics analysed below is not only to provide benefits for market participants but also to achieve improvements to the market as a whole.

13. Forty eight submissions (including eight confidential responses) were received in response to the Consultation Paper from a wide range of interested parties. Annex 1 provides a list of non-confidential responses to the Consultation Paper.

[2] See CESR press release on "CESR intensifies co-ordination in the light of recent market volatility in euro denominated debt instruments" (Ref. CESR/10-633).

14. This Report is organised as follows: Section II outlines CESR's view regarding pre-trade transparency for all the instruments covered by this exercise. Section III redefines the scope of the initial CESR proposal for post-trade transparency on bonds in light of the responses to the Consultation Paper and the latest evolution of financial environment, whereby not only corporate bonds but also public bonds are analysed. This section then outlines CESR advice on the calibration of a post-trade transparency regime for the bonds in question. Section IV develops the phased implementation approach for structured finance products that was presented in CESR/09-348 and proposes a calibration of a post-trade transparency regime for these instruments. Section V sets out CESR's advice on a post-trade transparency regime for credit default swaps and section VI provides general advice on post-trade transparency for other derivatives. Section VII summaries the conclusions and recommendations made by CESR.

II. PRE-TRADE TRANSPARENCY FOR BONDS, STRUCTURED FINANCE PRODUCTS, CREDIT DEFAULT SWAPS AND DERIVATIVES

Background

15. MiFID does not mandate pre-trade transparency for instruments other than shares admitted to trading on EEA Regulated Markets (RMs). Whilst operators of organised trading platforms (i.e. RMs and Multilateral Trading Facilities (MTFs)) are not subject to MiFID pre-trade transparency obligations, they must ensure that there is fair and orderly trading on their platforms. In order to fulfil this obligation they publish information about buying and selling interests on financial instruments traded on their platforms.

16. Furthermore, few Member States have exercised the option to extend the MiFID transparency regime to other financial instruments under Recital 46 of MiFID. Nevertheless, most organised platforms (i.e. RMs and MTFs) are pre-trade transparent on a voluntary basis.

17. When CESR examined the need for additional transparency in the wake of the financial crisis in 2008/2009, it focused solely on post-trade transparency. However, in the consultation paper *CESR Technical Advice to the European Commission in the Context of the MiFID Review: Non-equity markets transparency* (CESR/10-799) CESR asked market participants for views as to whether there was an absence of pre-trade transparency information for the following financial instruments:

    a. Corporate Bonds (CB);
    b. Structure Finance Products (SFP);
    c. Credit Default Swaps (CDS);
    d. Interest Rate Derivatives, Equity Derivatives, Commodity Derivatives and FOREX Derivatives.

Summary of feedback

18. Regardless of the differences between these financial instruments the majority of consultation respondents stated that there was no lack of pre-trade transparency. Furthermore given the fact that most transactions are made OTC and that there is a varying degree of liquidity amongst instruments, most respondents expressed that a mandatory pre-trade transparency regime would be very difficult to implement and would be unlikely to deliver benefits.

19. Overall wholesale participants generally seemed content with the way in which these markets worked and their access to pre-trade transparency information. However, pre-trade transparency information for small participants, including retail investors, was considered to be less accessible. Nonetheless, these are markets typically dominated by professional

investors and retail investment in the financial instruments stated above is residual[3].

20. However CESR recognises that pre-trade transparency is needed for investors to be able to compare prices and evaluate their trading opportunities and to assist intermediaries in obtaining trading information, thereby helping them to deliver best execution to their clients.

21. The transparency regime set up by MiFID for shares admitted to trading on RMs takes into account the fact that the business, mechanisms and regulation of organised trading platforms are fundamentally different from those of investment firms trading OTC. MiFID promotes the disclosure of as much trading information as possible, taking into account that the same degree of transparency may not be suitable for all business models. MiFID transparency requirements also recognise the different and specific trading needs of market participants.

Recommendation

22. CESR is of the view that there is currently an unlevel playing field in the EEA with respect to the provision of pre-trade transparency for instruments other than shares. CESR therefore recommends that current voluntary arrangements are put on a formal footing and that a compulsory harmonised pre-trade transparency regime be introduced. The regime should apply to organised trading platforms (RMs and MTFs) with respect to the non-equity instruments traded on these platforms. Similar to the pre-trade transparency regime for equity, this regime needs to be refined to provide appropriate pre-trade transparency standards for various market structures and trading models, taking into account the various instruments and asset classes traded. As for equity, this may also involve the provision of appropriate waivers.

23. CESR stands ready to assist the Commission in devising the detail of this regime, noting the parallels which could be drawn from the MiFID regime for equities and specifically the use of appropriate waivers.

24. Given the different characteristics of the wide range of products concerned, each with its respective market microstructure and the varying degree of liquidity exhibited in these markets CESR does not, at this stage, propose to introduce mandatory pre-trade transparency requirements to the OTC space. Nevertheless CESR would welcome that any future regime allows Member States to introduce local requirements if they deem them to be necessary given the specificities of their markets in question.

III. POST-TRADE TRANSPARENCY FOR CORPORATE BONDS

1. Background - Scope of corporate bonds transparency regime

1.1. Corporate bonds

25. As noted by CESR in its July 2009 Report to the Commission (CESR/09-348), the proposed scope of a transparency regime for corporate bonds covers those corporate bonds for which a prospectus has been published (i.e. including all corporate bonds admitted to trading on EEA RMs) or which are admitted to trading on an MTF.

26. In the consultation paper, the term 'corporate bond' was defined as a transferable debt security issued by a private corporation to raise capital with a maturity of at least 12 months. In this paper CESR clarified that corporate bonds issued by banks and secured by

[3] Except for a limited number of Member States, where relevant retail participation is observed, both in terms of number of trades and traded volume.

certain assets (generally mortgages or public sector loans) i.e. 'covered bonds'[4] should be covered by this review. CESR also sought input from market participants on whether the inclusion of these instruments within the corporate bond transparency regime or the structured finance transparency regime was more appropriate.

Summary of feedback

27. The consultation paper did not explicitly ask for views regarding the proposed definition of a corporate bond.

28. In relation to the appropriate regime for covered bonds, responses received were evenly split between the corporate bonds and structured finance regime. A minority of respondents supported a specific regime for covered bonds.

Recommendation

29. After further consideration CESR proposes to amend the definition of a corporate bond to make clear that bonds issued by both privately and publically owned companies are included. Therefore, CESR recommends that for the purposes of the transparency regime corporate bonds should be defined as "transferable debt securities issued by a corporation (either privately or publicly owned) to raise capital with a maturity of at least 12 months". For these purposes, the concept of "publicly owned" encompasses not only public corporations but also unincorporated enterprises that function as if they were corporations (the so-called quasi-corporations).

30. In relation to covered bonds CESR remains of the view that bonds issued by banks and secured by certain assets (generally mortgages or public sector loans), i.e. "covered bonds" should be considered within the scope of the concept of "corporate bonds".

1.2. Public bonds

Background

31. Sovereign bonds are an important type of non-equity instrument in terms of number of trades and volume traded in the EU secondary markets trading on regulated markets, MTFs and OTC markets. Recently, several concerns regarding the pre and post-trade transparency of, sovereign bonds but also their corresponding CDS have arisen.

32. Whilst not covered in the consultation paper, CESR has decided to go beyond sovereign CDS and include public bond markets within the scope of this proposal with a two-fold aim: to address certain concerns raised in light of recent market events and to provide a fully consistent approach to post-trade transparency in instruments related to the public sector.

33. CESR made these intentions clear in the course of the Open Hearing held on 25 May 2010 and during CESR's Retail Investor Day on 27 May. It was also announced on CESR's press release on "CESR intensifies co-ordination in the light of recent market volatility in euro denominated debt instruments" (Ref. CESR/10-633).

Summary of feedback

34. Neither at the Open Hearing nor at the Retail Investor Day, did CESR receive any objections to these proposals. More significantly in the written submissions received on this issue, there was broad support for including these assets within scope.

4 For example German "Pfandbriefe" and Spanish "cedulas hipotecarias" and "cedulas territoriales".

35. However, in their responses, a variety of terminology was used, for example sovereign bonds, government bonds, agencies bonds, supranational bonds and regional authorities bonds.

Recommendation

36. Therefore, in order to provide greater clarity on this issue, CESR recommends that the following definition should be used in order to determine which bonds will fall under the public bond post-trade transparency regime:
"Public bonds are transferable debt securities excluding those with a maturity below 12 months and treasury bills issued by:

a) Member State's general government. For these purposes, the concept of 'general government' should be construed as including public authorities and the agencies of:
   i. Government units that exist at each level - central, state, or local - of government within the national economy;
   ii. All social security funds operated at each level of government; and
   iii. All non-market non-profit institutions that are controlled and mainly financed by government units.
b) Monetary authorities of one of the Member States;
c) International bodies of which one or more Member States are members; and
d) The European Central Bank ,

37. It is important to highlight that bonds issued by privately owned companies which are unconditionally and irrevocably guaranteed (directly or indirectly) by a Member State or a Member State's regional or local authorities should not be included within the 'public bond' regime.

38. It is also worth noting that similarly to corporate bonds, the public bonds subject to this regime should be those for which a prospectus has been published and/or which are admitted to trading either on an EEA RM or on an EEA MTF.

1.3. Other instruments to be considered within the scope of the corporate bonds regime

Background

39. In order to ensure that CESR's recommendation to the Commission captures all relevant instruments within scope CESR asked for views as to whether other assets should be considered as a corporate bond for the purpose of future transparency requirements.

Summary of feedback

40. A limited number of respondents addressed this issue. However, two respondents proposed that Spanish "participaciones preferentes" should be included within the corporate bond regime. Two respondents suggested that convertible and exchangeable bonds should fall under the equity transparency regime.

Recommendation

41. After taking into account the responses from market participants CESR is of the view that the following instruments should be considered as 'corporate bonds' for the purpose of future transparency requirements under MiFID:

- Convertible and exchangeable bonds should fall under the definition of corporate bonds due to their similarities in their secondary market trading (platforms where they are traded, frequency, and information available).

- Spanish "participaciones preferentes", for their special structure and secondary trading in Spain.

2. Post-trade transparency for corporate bonds

Background - Calibration of the post-trade transparency regime for corporate bonds

42. In its previous report (Ref. CESR/09-348) CESR concluded that it would be desirable and beneficial to the market to have a harmonised and mandatory post-trade transparency regime for corporate bonds.

43. In terms of the calibration of this regime, CESR has given consideration to a granular approach (similar to the one for equities) which would take into account the liquidity of a particular instrument by measuring criteria such as average daily turnover, initial issuance size or other relevant factors. However, after taking into account the complexity of this approach, which would demand careful calibration and would have to be accompanied by heavy infrastructure investments from the regulators (e.g. expansion of the MiFID database for shares) and the industry, this approach was not chosen, at least not at this initial stage.

44. Instead the proposal that was put forward was based solely on the size of transactions and differentiated information to be published and timing of publication according to the transaction size. The parameters of this regime are set out in the following table:

Transaction size (net value)	Information to be published	Timing of publication
Below €1 million	Price and volume of transaction	As close to real time as possible
Between €1 million and €5 million	Price and volume of transaction	End of trading day
Above €5 million	Price but no volume (but with an indication that the transaction has exceeded the €5 million threshold)	End of trading day

45. In terms of rationale for this approach, transactions below €1 million are viewed as covering smaller market participants, including retail investors. Therefore in order to assist with price formation the price and volume of each transaction must be published as close to real time as possible.

46. Transactions of a size greater than €5m are viewed to be 'large' transactions. For transactions of this size it is important to carefully balance the need for price transparency against the desire not to negatively impact liquidity by causing market participants to withdraw liquidity form the market.

Summary of feedback

47. A considerable number of respondents expressed doubts over the proposal to differentiate solely according to the size of the transaction and not to take liquidity or other criteria serving as liquidity proxies into account. This view was also shared by attendees at the Open Hearing and by some members of the Consultative Working Group.

48. On the other hand there was also some support to the regime proposed, although a very wide spectrum of proposals for adjusting the parameters of the post-trade transparency regime were put forward:

    a. A considerable number of market participants from both the buy and sell-side supported lowering the threshold for smaller trades. A few firms also argued for

lowering the threshold for large in size trades whereas others supported an increase of the threshold.

b. Generally, there was concern among the sell-side about the publication of the volume and the timing of publication, particularly for large and also medium size trades. The importance of not publishing the exact volumes was stressed and instead an aggregation of volume was suggested.

c. Also, a number of respondents among the sell-side were in favour of having longer publication delays for large trades – a position however not shared by other market participants.

Recommendation - liquidity

49. CESR acknowledges the value of the proposals tabled and agrees with the concept of calibrating the thresholds and timings of the regime against the liquidity of the instrument. However, in the absence of data it is not possible to collect supporting evidence and assess each one of those proposals independently and in a robust manner.

50. CESR therefore recommends to the Commission that the most appropriate approach at this stage is a regime which is based on average transaction size. The data which CESR has collected from EEA regulators as part of this consultation process should prove helpful in this regard. CESR stands ready to provide the Commission with assistance in the refinement of these proposals in the upcoming months, where appropriate.

51. In order to balance market concerns on liquidity with the recommendation of a mandatory regime for post-trade transparency on corporate bonds, CESR agrees that further analysis will need to be undertaken once the regime is in place and if necessary to calibrate more accurately its thresholds and timings.

Recommendation – post-implementation review

52. CESR recognises the importance of monitoring the implementation of the post-trade transparency regime for corporate bonds, considering a lack of information is the main impediment to conduct any empirical assessment of the impact of an eventual transparency regime on the market for corporate bonds. Once the regime is in place however, ESMA will be well placed to collect this data and reconsider this approach as necessary.

53. CESR therefore recommends that a joint ESMA/Commission assessment is conducted at the end of the first year of implementation of the post-trade transparency regime for corporate bonds in order to assess the appropriateness of the thresholds and delays implemented. To that end, the data collected in the course of the first year after implementation should enable ESMA and the Commission to take into consideration, where appropriate, other parameters, and in particular, liquidity.

54. The timing for that assessment should follow the schedule below:

	When	Scope in terms of CBs covered	Thresholds & delays	Liquidity proxy	
Assessment	T + 12 months starting at T+9 months	Not affected	Potential recalibration	Potential recalibration	

55. In that work, ESMA would provide the Commission with assistance to collect and make a first assessment of the outcome in light of the different proposals received from market participants to the consultation paper (Ref. CESR/10-510) basing this advice.

56. Such an assessment, although not affecting the scope of the post-trade transparency regime (i.e. corporate bonds for which a prospectus has been published, including all corporate bonds admitted to trading on EEA RMs or which are admitted to trading on an MTF), would make it possible, if deemed necessary, to adjust and recalibrate thresholds and delays, either by increasing or decreasing them, to properly take into account liquidity and other parameters where appropriate.

57. More generally, CESR recommends the European Commission follows the same approach for equity markets as for non-equity markets transparency in order to achieve the highest standards of quality of post-trade data and consolidation of information in the context of MiFID review.

Recommendation – calibration

58. The introduction of a post-trade transparency regime for corporate bonds will lead to significant change in this market. It is therefore essential that the calibration of the regime does not lead to unintended consequences which ultimately have an impact on the real economy.

59. CESR is mindful of the concerns, particularly from buy-side participants, which have been raised in relation to the proposed requirements for real time reporting for all trades up to €1m. CESR is of the view that a proportion of trading must be reported in real time in order to assist with the price formation process in a meaningful way.

60. The data collected as part of this consultation process needs further refinement in order for CESR to recommend the exact calibration for trades which must be reported in real time. At this stage CESR therefore recommends to the Commission that further work should be undertaken in this area. CESR stands ready to assist with this work but in the first instance recommends that calibration for real time reporting would be in the region of €500,000 to €1 million.

61. CESR recommends the adoption of a mandatory post-trade transparency regime for corporate bonds be structured as follows:

Transaction size (net value)	Information to be published	Timing of publication
To be confirmed but the upper threshold should be in the region of €500,000 to €1 million	Price and volume of transaction	As close to real time as possible but no later than 15 minutes
Between €500,000/€1 million and €5 million	Price and volume of transaction	End of trading day
Above €5 million	Price but no volume (but with an indication that the transaction has exceeded the €5 million threshold)	End of trading day

Background- Interpretation of the requirement "as close to real-time as possible"

62. The current concept of real-time publication under MiFID for transactions in shares allows for making use of a 3 minute deadline in exceptional circumstances in which a more timely publication is not possible. CESR considered an adjustment of this interpretation for corporate bonds due to the different market structure and invited views of market participants.

Summary of feedback

63. There was a wide spectrum of answers ranging from 2-3 minutes or very short time frame to overnight reporting or even until settlement. However, the majority of respondents supported 15 minutes as the most practical option.

Recommendation

64. Taking into account that trading in corporate bonds is mostly less frequent and less automated than in shares, CESR recommends 15 minutes as the appropriate benchmark for real-time publication for post-trade transparency information of corporate bonds, i.e. that all trades should be reported as close to real time as possible but no later than 15 minutes after execution of the trade.

65. As clarified in the Consultation Paper on CESR Technical Advice to the European Commission in the Context of the MiFID Review: Equity Markets (CESR/10-394)[5], the 15-minute delay should only be used in exceptional circumstances where the systems available do not allow for a publication in a shorter period of time.

Background - Inclusion of notional value or other information

66. In addition to the information set out in its previous report (CESR/09-348), CESR consulted on whether it would be useful to include information about the notional value of the bond or any other information in the post-trade information to be published.

Summary of feedback

67. A number of respondents argued strongly to include notional value within the transparency regime, whereas the majority of market participants did not consider this piece of information very useful, but were – with very few exceptions - not strongly against its inclusion in the post-trade information to be published.

68. In terms of the information to disclose a number of respondents preferred the inclusion of parameters such as high, low and average prices instead of publishing individual trade information.

Recommendation

69. In line with the overall goal to enhance transparency CESR recommends that the transparency regime should be transactional based and should therefore focus on the specific data of the transaction rather than aggregate or high, low and average prices.

70. CESR recommends that the notional value of the bond should also be made public in addition to the fields that were recommended in the former report on this topic (Ref. CESR/09-348).

3. Post-trade transparency for public bonds

Background

71. As outlined above, CESR is of the view that public bonds should be included within scope of the proposed enhanced MiFID post-trade transparency regime. This will ensure information is available and efficiently disseminated to all market participants on equal grounds. A harmonised expansion of the MiFID transparency regime for these instruments should

[5] http://www.cesr.eu/popup2.php?id=6548

improve price formation and assist intermediaries in fulfilling their best execution obligations.

72. CESR has given careful consideration as to whether the proposed framework and the suggested calibration parameters for the corporate bonds regime should also be applied to public bonds. In order to inform opinion CESR undertook an assessment of transaction reports collected by Competent Authorities for public bonds, to the extent possible.

Summary of findings

73. Those respondents who explicitly mentioned sovereign bonds generally supported the adoption of the proposed corporate bonds regime. In particular respondents noted that these instruments are viewed as liquid and so the concerns expressed for corporate bonds are not necessarily applicable here. Furthermore, the data collected by CESR confirms that the suggested calibration is appropriate.

Recommendation

74. CESR recommends to the Commission that for trades in public bonds the following calibration should apply:

Transaction size (net value)	Information to be published	Timing of publication
Below €1 million	Price and volume of transaction	As close to real time as possible
Between €1 million and €5 million	Price and volume of transaction	End of trading day
Above €5 million	Price but no volume (but with an indication that the transaction has exceeded the €5 million threshold)	End of trading day

75. CESR also recommends to the Commission that public bonds should be included within scope of the proposed post-implementation review as outlined in section 2 above.

76. CESR also recommends that the transparency regime should be transactional based and should therefore focus on the specific data of the transaction rather than aggregate or high, low and average prices.

IV. POST-TRADE TRANSPARENCY FOR STRUCTURED FINANCE PRODUCTS (ABS AND CDOS)

1. Phased approach for a post-trade transparency regime in structured finance products (SFPs)

77. CESR's view as expressed in its previous report (CESR/09-348) is still valid. According to the former report,

    "CESR is mindful of the current uncertainties surrounding the ABS market and is of the view that a transparency regime should be calibrated to ensure that market liquidity does not retreat further as a result of introducing increased post-trade transparency. CESR acknowledges the potential benefits arising from an increased level of post-trade transparency as well as concerns from market participants regarding potential cost and considers that post-trade transparency should be delivered in the most cost-effective way".

78. As a consequence, CESR recommended a phased approach for implementing a post-trade transparency regime for structured finance products.

79. In the consultation paper, CESR proposed that for the purposes of a transparency regime standardised should be considered as all ABS and CDOs for which a prospectus has been published (i.e. including all ABS and CDOs admitted to trading on EEA regulated markets) or which are admitted to trading on a MTF. On that basis, CESR consulted on the possible criteria for the determination of the phased approach for ABS and CDOs, such as:

    a. Rating of the instrument;
    b. Issuance size; and
    c. Frequency of secondary trading.

Summary of feedback

80. The feedback received by CESR from market participants, and in particular in the responses to the consultation paper, expressed the need to take liquidity into account in the implementation of a post-trade transparency regime and supported the phased approach proposed by CESR. However, a number of respondents questioned the appropriateness of including these assets in a post-trade transparency regime given their bespoke nature and the perceived illiquidity of this market.

81. Many respondents favoured the criteria proposed. Most find the "frequency of secondary trading" (i.e. liquidity) as a key criterion to take into account; one respondent however highlights the difficulty of measuring this. Liquidity proxies mentioned by market participants are tranche issuance size, rating, asset class, maturity. Responses also highlighted that these criteria can be altered during the asset life.

82. However, a number of concerns regarding the proposed criteria were expressed. These included reservations about the role of credit rating agencies and difficulties in using frequency of secondary trading as a measurable and observable criterion.

Recommendations

83. CESR recommends that for the purposes of a transparency regime 'standardised' should be considered as all ABS and CDOs for which a prospectus has been published (i.e. including all ABS and CDOs admitted to trading on EEA regulated markets) or which are admitted to trading on a MTF. As a consequence, the scope of the post-trade transparency regime once fully implemented should include all these assets.

84. Whilst all proposals for determining phases are subject to limitations CESR reached the conclusion that the most practicable criterion to determine a "phased approach" to implement a post-trade transparency regime for structured finance products will be the rating of the instrument at the time of implementation of the regime for existing instruments, or at the time of issuance for instruments issued after implementation of the regime.

85. CESR recommends a two-step approach to introducing post-trade transparency for structured finance products:

    a. CESR recommends that the first phase of the post-trade transparency regime encompasses all the instruments rated as AAA, AA or A[6] (or any equivalent terminology used by other credit rating agencies).

[6] At the time of implementation of the regime for existing instruments, or at the time of issuance for instruments issued after implementation of the regime.

b. In the second phase, the rest of the universe of 'standardised' SFP (as outlined above) should fall under the post-trade transparency regime.

86. As with the approach for corporate bonds and in order to achieve a fully informed assessment, CESR is of the view that the same ESMA/Commission revision should be carried out once the information of one year's trading is available in order to:

a. Assess the appropriateness of the thresholds and delays implemented in the first phase for adjustment. To that end, the data collected should enable ESMA and the Commission to take into consideration, where appropriate, other parameters, and in particular, liquidity; and

b. Adjust the thresholds and delays, either in an upwards or downwards direction, for the instruments covered by the second phase and where appropriate, other parameters, and in particular, liquidity. However, the scope of the regime should not be altered.

87. The schedule for the phasing approach should follow the schedule below:

Phasing	Timing	Action
1^ phase: *AAA,AA and A rated instruments*	Starting at T	Implementation of the thresholds and delays for the SFP covered by the first phase of the exercise
	T + 9 months	Start collection of data and assessment of the impact of the first phase.
2^ phase: The rest of SFP for which a prospectus has been published (i.e. including all SFP admitted to trading on EEA RM) or admitted to trading on a MTF	T + 12 months	Implementation of the refined thresholds and delays for the instruments covered by the first phase + implementation of the post-trade transparency regime for the instruments covered by the second phase determined on the basis of the information collected

2. Calibration of the post-trade transparency regime for structured finance products covered by the first phase

Background

88. In order to determine the proper calibration of the post-trade transparency regime for structured finance products, CESR consulted on the desirability of applying the framework proposed for corporate bonds to structured finance products, whereby transactions would be broken down in three different size bands, each being subject to different obligations in terms of information to be published and timing of publication.

89. CESR also consulted on whether the proposed calibration parameters for corporate bonds (i.e. transaction size thresholds, information to the published and timing of publication) would be appropriate for structured finance products. In parallel, CESR collected

information from the transaction reports submitted to Competent Authorities for trading activity of structured finance products during 2009.

Summary of feedback

90. Opinions from respondents to CESR's consultation were fairly split. Whereas some stated that corporate bonds and structured finance products were similar enough for the same calibration parameters to be applied to both types of products, many others highlighted that it is not appropriate to use the same framework, due to very illiquid nature of structured finance products and of their investor base that is generally represented by sophisticated institutional investors.

91. In relation to the degree of secondary trading for these instruments, the information gathered by CESR shows a different pattern of secondary trading for structured finance products than for corporate bonds.

Recommendations

92. CESR recognises the benefits of a framework split in different transaction size bands, which allows the thresholds and the related time delay to be set in a way which provides adequate consideration both to the risks incurred by wholesale market participants when committing capital to provide liquidity to the market and the need to ensure that the market benefits from greater post-trade transparency.

93. In line with the approach for corporate bonds CESR recommends that the transparency regime should be transactional based in order to deliver maximum benefit to the market. The regime should therefore focus on the specific data of the transaction rather than aggregate or high, low and average prices.

94. Due to the specific nature and level of liquidity of structured finance products CESR does not recommend a real time reporting requirement for these instruments. Instead, CESR recommends the following framework and publication parameters:

    a. Transactions up to €5M: publication of price and volume at the end of the trading day
    b. Transactions above €5M: publication of price but no volume at the end of the trading day, with an indication that the threshold of €5 million has been exceeded

95. More generally, CESR recommends the European Commission follows the same approach for equity markets as for non-equity markets transparency in order to achieve the highest standards of quality of post-trade data and consolidation of information in the context of MiFID review.

V. POST-TRADE TRANSPARENCY FOR CREDIT DEFAULT SWAPS (CDS)

1. Post-trade transparency for CDS

Background

96. As outlined in its previous report (Ref. CESR/09-348), CESR is of the view that a post-trade transparency regime should cover all CDS contracts which are eligible for clearing by a Central Counterparty (CCP) due to their level of standardisation. In terms of content of post-trade transparency for CDS, CESR concluded in 2009 that the following is the most relevant information to be made public:

    i) Standardised format of identification;
    ii) Issuer name;
    iii) Price at which the transaction was concluded;

iv) Volume of the executed trade;
v) Date and time when the trade was concluded;
vi) Currency;
vii) Maturity;
viii) Rating; and
ix) Reference entity.

97. At the moment, the universe of CDS eligible for clearing includes index and some single name (corporate) CDS. Going forward, the CDS universe is expected to expand to include a broader range of single name CDS, as well as sovereign CDS.

98. In the consultation paper, CESR proposed a CDS post-trade transparency regime broken down in 3 different size bands, each of which with different obligations in terms of the information to be published and the timing of publication. CESR also sought views regarding the specific calibration parameters to apply to CDS and whether the calibration proposed for corporate bonds would be appropriate for CDS.

99. CESR also sought views from market participants on whether this same approach should be adopted for index CDS and also for sovereign CDS once they become clearing eligible.

Summary of findings – single name CDS

100. Respondents expressed a variety of views on both the inclusion of single name CDS within the post-trade transparency regime and to the proposed calibration parameters, but overall the tone was positive. In particular a number of respondents thought that the CESR agreed scope of clearing eligible CDS was appropriate. A minority of respondents pointed out that whilst an instrument will need to be liquid to be considered clearing eligible this does not necessarily guarantee the liquidity of the instrument for the duration of the contract. This should therefore be reflected in the calibration process. A minority of respondents also supported a different calibration of the regime for different maturities.

101. In terms of the proposed calibration parameters the majority of respondents considered that it is appropriate for single name CDS to follow the same approach as for corporate bonds. A minority of respondents expressed concern at the proposal for real time reporting and were of the view that the proposed €1m threshold was too high. At the other end of the spectrum two respondents supported more onerous reporting requirements for these instruments.

Recommendation

102. In line with the feedback received in consultation CESR is of the view that the framework for the proposed regime is appropriate for single-name CDS. However, CESR's analysis of average trading size shows that the proposed thresholds are insufficient and would not capture a sufficient degree of trading. CESR is therefore of the view that both the thresholds for real time reporting and for 'large' trades should be increased. This will ensure a greater degree of price transparency is provided to the market.

103. In line with the desire to deliver the greatest degree of transparency CESR also recommends that the regime should be transactional based and should therefore focus on the specific data of the transaction rather than aggregate or high, low and average prices.

104. CESR recommends to the Commission that the post-trade transparency regime for clearing eligible single name CDS, regardless of maturity, be calibrated in the following way:

- For trades up to €5m, the price and volume should be published in real time
- For all trades from €5m to €10m the price and volume should be published at the end of the trading day

- For all trades above €10m the price should be published at the end of the trading day with an indication that the transaction has exceeded the €10m threshold.

105. CESR recognises the concerns expressed regarding the changing profile of liquidity of clearing eligible single name CDS. However, CESR is of the view that the daily publication of an end of day settlement price by the relevant clearing house (and the associated auction process) will ensure that a sufficient degree of price transparency continues to exist in the market for all clearing eligible CDS. This should sufficiently mitigate the concerns raised by some respondents.

106. More generally, CESR recommends the European Commission follows the same approach for equity markets as for non-equity markets transparency in order to achieve the highest standards of quality of post-trade data and consolidation of information in the context of MiFID review.

Summary of findings – index CDS

107. Only a limited number of respondents addressed this issue but those that did supported the use of higher thresholds for index CDS compared to single name CDS to reflect the higher average trading size for these instruments. This is confirmed by an analysis of data available through DTCC (the trade repository for CDS).

108. In determining the thresholds a number of respondents supported differentiating the approach for 'on-the-run' indices and 'off-the-run' indices due to the differing liquidity profiles.

Recommendation

109. CESR agrees that the calibration of the regime for single name CDS is not appropriate for index CDS given their larger average trade size. CESR's analysis confirms that the average trading size for the Itraxx Europe index is in the region of €25m. However CESR acknowledges that this differs between maturity and by index with the average trade size for other indices in the region of €10m.

110. In order to provide the appropriate degree of transparency to the market, CESR recommends to the Commission that the calibration parameters for index CDS should be set at a higher threshold than for single name CDS. CESR recommends the following approach for CDS indices:

- For trades up to €10m the price and volume should be disclosed in real time.
- For trades between €10m and €25m the price and volume should be published at the end of the trading day.
- For trades above €25m the price but not the volume should be published at the end of the trading day with an indication that the transaction has exceeded the €25m threshold.

111. CESR also recommends that the transparency regime should be transactional based and should therefore focus on the specific data of the transaction rather than aggregate or high, low and average prices.

112. CESR acknowledges that the liquidity profile for on-the-run and off-the-run CDS indices differs significantly. In order to address this point CESR recommends to the Commission that the proposals for single name CDS (as outlined above) should apply to off-the-run CDS index trades.

Summary of findings – sovereign CDS

113. Overall the majority of respondents were in favour of including sovereign CDS within the post-trade transparency regime once they become eligible for clearing. Half of the respondents supported adopting the same calibration approach as for single name CDS. However, a number of respondents had reservations. These ranged from inclusion within the regime outright to the need to undertake further work to make sure that the calibration parameters for sovereign CDS are appropriate in order to reflect the specificities of this market.

Recommendation

114. CESR fully supports enhancing the transparency of the CDS market. In order to reflect the anticipated move of sovereign CDS to central clearing, CESR is of the view that it is appropriate now to put forward recommendations in this space. CESR therefore recommends to the Commission that the regime be calibrated as for single name:

- For trades up to €5m the price and volume should be disclosed in real time.
- For trades between €5m and €10m the price and volume should be published at the end of the trading day.
- For trades above €10m the price but not the volume should be published at the end of the trading day with an indication that the transaction has exceeded the €10m threshold.

115. As with the approach for other asset classes, CESR also recommends that the transparency regime should be transactional based and should therefore focus on the specific data of the transaction rather than aggregate or high, low and average prices.

Summary of findings – Other issues

116. A number of respondents provided technical observations regarding the proposed information to be made public. Specifically the publication of a standardised format of identification, issuer name and rating were not thought to be relevant information to publish.

Recommendation

117. CESR agrees that in the context of CDS the issuer name and the rating are not relevant information to publish. However CESR does see value in the publication of a standardised format of identification. CESR therefore recommends to the Commission that any post-trade transparency regime for any type of CDS should ensure that the following information is made public:

I. Standardised format of identification;
II. Price at which the transaction was concluded;
III. Volume of the executed trade;
IV. Date and time when the trade was concluded;
V. Currency;
VI. Maturity; and
VII. Reference entity.

Recommendation – post implementation review

118. As with the approach for corporate/public bonds and structured finance products CESR recommends that a joint ESMA/Commission assessment is conducted at the end of the first year of implementation of the post-trade transparency regime for CDS in order to assess the appropriateness of the thresholds and delays implemented. To that end, the data collected in the course of the first year after implementation should enable ESMA and the Commission to verify the appropriateness of the thresholds and timings and if appropriate

modify them accordingly, either by increasing or reducing them. This review should also where appropriate, consider other parameters, and in particular, liquidity.

119. The timing for that assessment should follow the schedule below:

	When	Scope in terms of CBs covered	Thresholds & delays	Liquidity proxy	
Assessment	T + 12 months starting at T+9 months	Not affected	Potential recalibration	Potential recalibration	

VI. POST-TRADE TRANSPARENCY FOR DERIVATIVES (Interest rate derivatives, Equity derivatives, Commodity derivatives and FOREX derivatives)

Background

120. Derivative contracts can either be traded in a public venue, i.e. a derivatives exchange, or privately over-the-counter (OTC), i.e. off-exchange. OTC derivatives markets have been characterised by flexibility and tailor-made products. This satisfies the demand for bespoke contracts tailored to the specific risks that a user wants to hedge. Exchange-traded derivative contracts, on the other hand, are by definition standardised contracts.

121. Derivatives traded on a RM or MTF are subject to transparency requirements as set out by national legislation, regulations or exchange rules. However, there are no harmonised rules in EU dealing with a post-transparency regime as MIFID requirements only apply to equities markets. Moreover, there are no such requirements for trading which takes place OTC. Consequently, and in response to the Commission Communication on enhancing the resilience of OTC derivative markets (COM (2009) 332 final), CESR has preliminarily analysed whether greater price transparency for OTC derivatives might improve the resilience of the financial system and improve market efficiency.

Summary of findings

122. CESR received a variety of responses reflecting different views on the perception of a potential lack of post-trade transparency in terms of access to the relevant information. The majority of respondents seem satisfied with the current level of post-transparency. This was largely seen as a result of the often bespoke nature of OTC derivatives which in turn leads to limited secondary trading for some instruments and as a consequence less information on traded prices and volumes. As with other asset classes covered in the consultation paper concerns regarding introducing greater transparency focus on the scope for a negative impact on liquidity.

123. Others respondents, by contrast, are supportive of an strengthening of the current level of post-transparency as they perceive that there is a lack of data in OTC derivatives markets. The responders vary their opinion on the current level of information available to all potential markets participants.

124. In terms of benefits and drawbacks of increasing post-trade transparency for these assets, drawbacks focused on a possible decline in liquidity, eventual difficulties for hedging and loss of anonymity. Benefits noted were an increase in the credibility of the market, restoration of market confidence, higher comfort for small players and a more efficient price formation process.

Recommendation

125. CESR recognises that the current stage of the analysis undertaken, given the heterogeneity of all the OTC derivative segments included in the consultation paper, is still in an early phase. Nevertheless CESR is strongly of the view that enhancing post-trade transparency for these assets will assist market participants in making investment decisions as well as in supporting more resilient and transparent markets in general.

126. CESR therefore recommends to the Commission that a harmonised post-trade transparency regime for these assets should be further developed. CESR stands ready to assist the Commission in calibrating a regime for these assets which, takes into consideration the different features of the markets in question.

Annex 1. NON-CONFIDENTIAL RESPONSES TO THE CONSULTATION PAPER

ABI (Association of British Insurers)
ACI (The Financial Markets Association)
Af2i(Association Française des Investisseurs Institutionnels)
AFME (Association for Financial Markets in Europe), BBA (British Bankers' Association) and ISDA (International Swaps and Derivatives Association)
APCIMS (Association of Private Client of Investment Managers and Stockbrokers))
AXA INVESTMENT MANAGEMENT
BDEW (Bundesverband der Energie- und Wasserwirtschaft e.V.)
Bloomberg L.P.
BME (Bolsas y Mercados Espanoles)
Bundesverband Investment und Asset Management e.V.
BVR
CFA Institute
CNMV Advisory Board
Danish Mortgage Bank Association
Deutsche Börse
EACB (European Association of Co-operative Banks)
EBF (European Banking Federation)
EFAMA (European Fund Management Association)
ESBG (European Savings Banks Group)
Euroclear
EuroInvestors (European Federation of Investors)
FBF (French Banking Federation)
FESE FEDERATION OF EUROPEAN SECURITIES EXCHANGES (Federation of European Securities Exchanges)
FOA (Futures and Options Association)
ICMA (International Capital Market Association)
IMA (Investment Management Association)
Interactive Data
Legal and General Group, plc.
London Stock Exchange Group
Markit
NASDAQ OMX
NBIM
NYSE EURONEXT
Schroders Investment Management
SWEDISH SECURITIES DEALERS ASSOCIATION
Thomson Reuters
Tradeweb
Wholesale Market Brokers' Association (WMBA) & London Energy Brokers' Association (LEBA)
Zentraler Kreditausschuss

COMMITTEE OF EUROPEAN SECURITIES REGULATORS

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TECHNICAL ADVICE

CESR Technical Advice to the European Commission in the context of the MiFID Review – Transaction Reporting

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Executive summary

In the light of the ongoing MiFID Review of the European Commission, CESR provides its advice to to the Commission on possible amendments to MiFID and its Implementing Regulation on transaction reporting.

This paper sets out CESR's proposal for amending the transaction reporting regime under MiFID. The key purpose behind the suggested amendments is to improve market supervision.

The proposed main amendments focus on the following areas:

- Introduction of a third trading capacity (client facilitation);
- Collection of client and meaningful counterparty identifiers – CESR suggests to the European Commission that the collection of client IDs and meaningful identifiers for all counterparties and its submission to competent authorities would be made mandatory in all Member States
- Standards for client and counterparty identifiers – CESR elaborates on possible guidance and future standards for client and counterparty identifiers;
- Client ID collection when orders are transmitted for execution - CESR suggests amending MiFID to enable Member States to require that, when orders are transmitted for execution, the transmitting firm either provides the client ID to the receiving firm or reports the trade, including full client ID, to the Competent Authority; and
- Transaction reporting by market members operating under the Article 2(1)(d) exemption - CESR suggests amending MiFID by introducing a transaction reporting obligation to those persons that are members of a regulated market or MTF or, alternatively, by introducing a similar obligation on regulated markets or MTFs that admit these undertakings as members.

1 INTRODUCTION

1. In the course of the ongoing MiFID Review by the European Commission, CESR would like to provide its advice on possible amendments to MiFID and its Implementing Regulation regarding transaction reporting provisions.

2. Within the overall MiFID framework and with regard to CESR members' obligation to monitor the activities of investment firms to ensure that they act honestly, fairly and professionally and in a manner which promotes the integrity of the market, Article 25(3) of MiFID obliges investment firms to report executed transactions to their competent authorities.

3. Transaction reporting data is needed to enable supervisors to detect and pursue suspected instances of market abuse, client abuse or other breaches of relevant MiFID provisions.

4. MiFID transaction reporting regime is based on reporting of executed transactions and not on information on individual orders. In that regard, Article 5 of the MiFID Implementing Regulation clarifies that for these purposes 'transaction' is a reference only to the purchase and sale of a financial instrument, excluding securities financing transactions, the exercise of options or of covered warrants, primary market transactions (such as issuance, allotment or subscription) in financial instruments falling within Article 4(1)(18)(a) and (b) of MiFID.

5. Article 13 of the MiFID Implementing Regulation and its Annex I set out the content of the transaction reports that investment firms that execute transactions in financial instruments admitted to trading on a regulated market have to report to their competent authorities.

6. Since the drafting of the MiFID Implementing Regulation CESR members have been aware of the difficulties in achieving an entirely homogeneous transaction reporting system across Europe. As the transaction reporting systems and market structures were considerably different, CESR proposed in its advice to the European Commission not to impose a single system to investment firms, but to build on the existing systems in order to avoid unnecessary costs for investment firms. The exchange of transaction reports would therefore be organised only between securities regulators, each regulator having the responsibility to collect necessary transaction reporting data from the firms it supervises, according to its specific arrangements.

7. To address the technical impact on market participants that the lack of a more convergent approach could cause, CESR published the CESR Level 3 Guidelines on MiFID Transaction Reporting (Ref. CESR/07-301) in May 2007. The guidelines covered non-technical issues where there was a need for a harmonised approach by CESR members: transaction reporting by branches; scope of the transaction reporting obligation (i.e. what constitutes 'execution of a transaction' for transaction reporting purposes); and approval of reporting channels.

8. In that document, after considering necessary to separate execution of a transaction from reception and transmission of orders, it was also acknowledged that there are many different circumstances in which transactions take place, being impossible at that stage to reach a total agreement on the concept of 'execution of a transaction' consistently applicable across Member States. Moreover, it was recognised that competent authorities have a justifiable need to specify under which circumstances transactions are executed and hence need to be reported.

9. However, in order to establish a minimum level playing field and facilitate the implementation of MiFID, CESR members agreed to exchange the information in points (a) and (b) below and, if requested and when available, the information in point (c):

   a) *information relating to transactions conducted by the investment firms transacting directly with an execution venue (immediate market facing firm);*

   b) *information relating to transactions not covered by (a) above but where the investment firm is undertaking the transaction on its own accounts (regardless whether the transaction is executed on an RM or MTF or outside them); and*

c) *information which is necessary to identify the ultimate client on whose behalf the transaction is undertaken or information which is necessary to establish the identity of the investment firm which is dealing with the ultimate client where the competent authority is not already in possession of such information or where it could not obtain such information in a sufficiently timely manner.*

10. Item c) above was included since CESR members agreed that in addition to transaction reports, competent authorities need other information on the different steps of executing a transaction. Due to the different practices from member to member, further information (including the identity of the originator of the order) may be collected as part of the transaction report or it may be acquired by other means (for example ad hoc requests that can take place ex post).

11. These guidelines were considered an interim solution. Regarding the scope of the transaction reporting obligation, CESR committed to launch a review of them after there had been a year's experience of full operation of the MiFID transaction reporting regime with a view to producing definitive guidance in this area which aims at converging practices between CESR members.

12. To this end, CESR launched a Call for Evidence on 3 November 2008 (Ref. CESR/08-873), inviting all interested parties to submit their views as to what CESR should consider when conducting the review of the scope of the MiFID transaction reporting obligation.

13. In the responses received, a need for greater consistency of approach to the interpretation and implementation of MiFID was made clear. Respondents to the Call for Evidence requested CESR to include into its review such elements as the harmonisation of the standards for the use of client and counterparty identifiers within a transaction report, the regulatory uncertainty regarding the firms falling under the transaction reporting regime or the need to clarify which transactions on non-EEA exchanges should be reportable.

14. From the responses and internal discussions held within CESR, the existence of significantly different interpretations of some key terminology relating to transaction reporting also became evident.

15. Another issue identified at this stage was the possibility to analyse whether information helping to identify the beneficiary of a transaction should be included in the transaction reporting requirements (the so called 'client-side' reports described in category c) of the Level 3 Guidelines).

16. Jointly with the consideration of the benefits and drawbacks of including such client-side information in transaction reports in order to meet the market monitoring obligations of competent authorities described in Article 25(1) of MiFID, the eventual harmonisation of the standards for the use of client and counterparty identifiers within a transaction report were analysed.

17. On the basis of the work conducted and following the public consultation on Technical Advice to the European Commission in the context of MiFID review – Transaction Reporting (Ref. CESR/10-292), CESR submits its proposal to the European Commission on the following issues

    - Key terminology supporting the concept of transaction reporting – trading capacity and distinction between clients and counterparties;
    - Factors impacting the collection of client and meaningful counterparty identifiers;
    - Possible standards for client and counterparty identifiers; and
    - Client ID collection when orders are transmitted for execution

CESR

2 KEY TERMINOLOGY ON TRANSACTION REPORTING

18. In order to progress towards harmonising transaction reporting requirements, this section focuses on some of the basic terminology. This includes trading capacity (i.e. the distinction between principal and agency trading and the eventual 'grey' areas) and client and counterparty. These discussions are exclusive to transaction reporting.

2.1 Trading Capacity

19. When analysing the different transaction reporting schemes that may take place, the role played by the investment firm(s) involved is one of the key points that is necessary to understand. Field 5 in Table 1 of Annex I of the MiFID Implementing Regulation provides only two possibilities to identify the trading capacity of the reporting investment firm:

    1. on its own account (either on its own behalf or on behalf of a client);
    2. for the account, and on behalf, of a client.

20. This suggests that MiFID only intended to allow a single choice when the investment firm reports; i.e. either as principal ('P') or as agent ('A').

21. CESR considers that the key distinction between a principal transaction and an agency transaction envisaged in MiFID is that in a principal transaction the buying firm takes ownership of the instrument (no matter how briefly) whereas in an agency transaction the firm never takes ownership of the instrument (as it acts on behalf of the "client" who takes ownership of the instrument). So, in an agency transaction, an investment firm acts for the account, and on behalf, of a client.

22. However, some market participants do not agree that these two categories of principal and agency can adequately describe all the possible trading capacities a firm can operate in. Some argue that there remains a 'grey' area for those transactions executed by the investment firm on its own account and on behalf of the client and that these transactions do not fall into the category of either principal or agency. This latter category differs from a 'pure' agency trade in that the firm actually takes ownership of the instrument (sometimes momentarily) before a separate transaction is made to 'hand over' the financial instrument(s) to the "client". This second transaction is almost always an "off-market" transaction[1].

23. These principal transactions made by a firm on its own account and on behalf of the client may have different names across Europe (e.g. "riskless principal", "back to back transaction", "on account of client in firm's name" and "commissionaire"). Whilst these transactions do not appear as agency transactions, they are still executed on behalf of a client rather than compromising the proprietary capital of the executing firm. This scenario typically happens when two matching trades are entered at the same time and price with a single party interposed following a client's order.

24. CESR therefore identifies three possible scenarios where an investment firm executes a transaction:

    – It acts on its own account and on its own behalf (pure principal transaction – i.e. on the decision of the firm);
    – It acts for the account and on behalf of a client (pure agency transaction); and
    – It acts on its own account and on behalf of a client – i.e. on the order of the client.

25. The third scenario makes supervision of these trades difficult, since they are currently reported in many countries (and exchanged through TREM) as principal trades while their nature is

[1] CESR also understands that some derivative markets operate on a "principal-to-principal" capacity whereby a client order will generate two contracts and two principal transactions, both of which are deemed to have traded on the exchange.

closer to an agency trade, since the initiative to trade and the corresponding order come from a client of the firm.

26. It is worth noting the difficulty in reaching harmonisation on the treatment of transactions covered in the third scenario above as different legislation or practices across Member States result in some CESR members defining such transactions as two separate transactions whilst other members define them as a single transaction. CESR considers that there are three possible practical solutions to reporting transactions falling in the third scenario described above in a transaction report.

27. Firstly, they can be treated as two separate principal transactions with the counterparty field populated but the client field left empty in both transaction reports.

28. Secondly, these transactions can be represented in a single principal transaction report with both the counterparty and client fields populated. The originator of the transaction should be entered into the client field. It should be noted that with this option, the client field would have to be populated in all Member States. Under the existing legal framework, for those Member States collecting the client ID, a meaningful code must be entered. For those Member States currently not collecting a client ID, the client field could, for instance, be populated with the word "client". (Please note the discussion later in this document on the use of client ID).

29. A third option is to create an additional trading capacity as these transactions cannot be classified simply as agency or principal. However, a change of the MiFID Implementing Regulation (Annex I, Table 1, Field 5: Trading capacity) is required for this. Like option two above, the "riskless principal" transactions would be represented in a single transaction report with the originator of the transaction being identified in the client field if populated. (Please note the discussion later in this document on the use of client ID).

30. Another topic, different from the trading capacity debate, is the one on trades done through a market-making arrangement. The current possibilities provided for in MiFID do not allow for identifying transactions performed by market makers (liquidity providers, specialists, etc.). Transactions carried out by them have features that may justify marking such transactions in order to differentiate them from ordinary transactions for supervisory purposes. They respond to a commitment by an investment firm to operate in the market with the goal of providing liquidity to a particular security. The market maker or liquidity provider may channel client orders or even operate on own account on the same financial instrument in a particular trading session. There is some interest, from a supervisory point of view, to be able to differentiate trades done in the capacity of liquidity provider and the rest.

31. However, the definition of the activity of market making or liquidity provision should be carefully considered. The aim would be to capture only transactions that respond to a stable and publicly known arrangement by an investment firm that is committed vis-a-vis an issuer or a trading venue, to provide liquidity in a predefined manner. Therefore, transactions identified as such would not include "discretionary" market making, in the line of the definition included in Article 4(8) of MiFID, but a more stable, public and precise activity regulated by some kind of market rule or practice.

32. Despite the above, taking into account that the number of this kind of arrangements is normally small in each market and that, due to the public nature of those arrangements, supervisors are normally aware of the role that a particular investment firm plays on certain financial instruments, CESR is of the view that the addition of some kind of a harmonised flag or indicator by all market makers and liquidity providers at EU level, while useful in some cases, is not essential and could be left to the discretion already available for competent authorities.

Conclusions

33. CESR considered in its consultation paper on Transaction Reporting (Ref. CESR/10-292) the introduction of a third trading capacity (riskless principal) to be the best and most robust way forward and that the MiFID Implementing Regulation should be amended accordingly. However, there was significant opposition to this proposal from some firms and industry bodies

principally due to the extreme difficulty firms might face in matching the market side transactions of the "riskless principal" transactions with the client side transactions. Firms also noted that CER had not provided a clear definition of the new trading capacity and, as a result, this might increase the number of transaction reporting errors and inconsistencies across the EEA. CESR acknowledges the merit in both these arguments and has decided to modify and clarify its proposal as follows:

Trading capacity must be populated with one of the following three values:

1. Principal for own account (P)
2. Principal as part of a client facilitation (F)
3. Agency (A)

34. The definition for agency capacity remains unaltered, but principal has been split into those transactions that the firm undertook as a result of its own trading decisions and those that it undertook as a result of a client order. Typically, two transaction reports should be submitted by an investment firm for the client facilitation trades – one showing the 'market side' transaction and a second showing the 'client side' transaction. In each of these transactions, the counterparty field should be populated (with client's ID in the counterparty field when reporting the "client leg"), but **not** the client field. CESR believes this solves the difficulties for firms needing to link the market side and client side transactions in a single report whilst enabling regulators to note that the reporting firms were not the initiators of a transaction. The following scenarios demonstrate this client facilitation:

35. Scenario 1 – Investment firm 'X' receives an order from client 'A' to buy 10,000 shares in stock 'Z'. The investment firm satisfies the order by making a principal transaction on the market and a principal transaction to the client.[2] The investment firm should submit the following transaction reports to its local regulator:[3]

Reporting Firm	BIC for X
Time	10:05:26
Trading Capacity	F
Buy/Sell Indicator	B
Counterparty	BIC of CCP or MIC
Client	
Quantity	10000

Reporting Firm	BIC for X
Time	10:05:26
Trading Capacity	F
Buy/Sell Indicator	S
Counterparty	Code of the client
Client	
Quantity	10000

NB: client field is blank in both transaction reports

36. Scenario 2 – Investment firm 'X' receives three orders to buy 10,000, 15,000 and 30,000 shares from clients 'A', 'B' and 'C'. Investment firm 'X' satisfies these orders by buying 50,000 shares from London Stock Exchange CCP and 5,000 from investment firm 'Y'.

Reporting Firm	BIC for X
Time	11:21:00
Trading Capacity	F
Buy/Sell Indicator	B
Counterparty	BIC of LSE CCP
Client	

[2] It is noted that the investment firm might choose to represent this scenario in a single agency transaction report **if** the transaction was conducted on an agency basis.

[3] Only the key features of the transaction reports are shown in these examples – not all the required fields.

Quantity	50,000

Reporting Firm	BIC for X
Time	11:23:42
Trading Capacity	F
Buy/Sell Indicator	B
Counterparty	BIC of Y
Client	
Quantity	5000

Reporting Firm	BIC for X
Time	11:24:05
Trading Capacity	F
Buy/Sell Indicator	S
Counterparty	Code of client A
Client	
Quantity	10000

Reporting Firm	BIC for X
Time	11:24:05
Trading Capacity	F
Buy/Sell Indicator	S
Counterparty	Code of client B
Client	
Quantity	15000

Reporting Firm	BIC for X
Time	11:25:05
Trading Capacity	F
Buy/Sell Indicator	S
Counterparty	Code of client C
Client	
Quantity	30000

NB: Client field is empty in all examples. Time does not have to be identical in all transaction reports.

Proposal

37. CESR suggests amending the MiFID Implementing Regulation by introducing a third trading capacity – client facilitation.

2.2 Client and Counterparties

38. Under the existing EEA transaction reporting framework, the terms "client" and "counterparty" and how they are distinguished are particularly important, as there are two separate fields in a transaction report for these elements and any confusion may result in competent authorities (CA) misunderstanding whether the parties have bought or sold. This is because the buy/sell indicator in a transaction report (i.e. Field 4 in Table 1 of Annex I) indicates the action of the entity in the client field – the entity in the counterparty field (i.e. Field 20 of Table I) has actually taken the opposite action to that indicated by the buy/sell field.

39. Article 4(10) of MiFID provides a definition of client for the provision of investment services ("client means any natural or legal person to whom an investment firm provides investment and/or ancillary services"). However, from a transaction reporting perspective, a client can be identified in two ways in a transaction report:

 - In the counterparty field (Field 20), where the investment firm is operating in a principal capacity; or

– In the client field, if required locally, where the investment firm is operating in an agency capacity.

40. So, it is essential to distinguish counterparties from clients for the following reasons:

  – CESR members are obliged under MiFID to collect counterparty identifiers (Field 20), at least for investment firms, regulated markets, MTFs or CCPs, but currently have the option to collect or not to collect client identifiers.

  – The meaning of the buy/sell indicator (Field 4) is the opposite for the entity in a counterparty field (Field 20) to that for the entity in the client field.

  – Client fields are populated at least for agency transactions (indicated by an 'A' in Field 5) (if required by national regulations), but the counterparty field (Field 20) is populated in all transaction reports.

41. This is illustrated in the following examples:

Example 1. – Individual D instructs his broker, investment firm N to buy stock Z. N would act as agent for D and buy stock from the market. The investment firm would submit a single transaction report with an agency trading capacity, the market CCP, for instance, as counterparty and a client identifier in the client field (if required by the CA). The buy/sell indicator is "B" since the investment firm is acting as an agent of the client, who is buying stock from the market.

Example 2. Company C is a client of Investment Firm Y and wants to buy stock Z. Investment Firm Y sells to C as principal. Company C will then be the counterparty for transaction reporting purposes. In this example, the buy/sell indicator is S because Investment Firm Y acted as principal and thus should report from its own perspective.

Conclusions

42. On the basis of responses received by CESR to the consultation paper on Transaction Reporting (CESR/10-292) it became evident that respondents were generally supportive of CESR's analysis on distinguishing the terms "client" and "counterparty" for transactions reporting purposes. CESR, therefore, does not see any need for suggesting amendments to MiFID in this regard to the European Commission.

3 COLLECTION OF THE CLIENT IDENTIFIER/MEANINGFUL COUNTERPARTY IDENTIFIERS

43. This section looks at the collection of client identifiers and its pros and cons.

3.1 Legal framework

44. Article 13 of the MiFID Implementing Regulation and its Annex I set out the content of the transaction reports that investment firms which execute transactions in financial instruments admitted to trading on a regulated market have to report to their competent authorities.

45. In addition to the data set out in Table 1 of Annex I, Article 13(3) of the MiFID Implementing Regulation permits Member States to require additional information than that specified in Table 1 of Annex I. Moreover, Article 13(4) of the MiFID Implementing Regulation gives Member States the possibility to require transaction reports to identify the clients on whose behalf the investment firm has executed the transaction. Reporting of client identifiers is not compulsory under Article 25(4) of MiFID.

46. This legal flexibility allows Member States to perform their market monitoring and supervision in different ways: either by requiring a systematic reporting of additional information including the client ID or acquiring it on an ad hoc basis, when a trade deems to be suspicious. It takes into account the different practices, structures and sizes of the markets of the Member States.

3.2 Competent Authorities' policies on collecting client identifiers

47. The different rules adopted with respect to client ID collection in the EEA Member States can be summarised as follows: in 19 out of 29 Member States, client information is required in transaction reporting. Therefore a broad majority (more than 65% of CESR members) already request client information in transaction reporting.

48. Of the 10 CESR members which do not currently require client information, some are considering whether to request client information in the near future.

49. Where the client is an investment firm/credit institution, most CESR members that request client information require a BIC code. If a BIC code does not exist, the reporting firm should, in most Member States, use a unique and consistent internal reference code. In two Member States (Germany and Austria), the investment firm/credit institution can choose between certain options such as a BIC code, a unique code for the firm determined by CA/National Bank or other types of local identification codes, for example stock exchange ID or banking routing number.

50. Where the client is not an investment firm/credit institution, most CESR members that request client information require a unique (format free) client code (together with the BIC code of the reporting firm) on the level of the investment firm (e.g. UK). Three Member States (Germany, Austria and Sweden) request a unique (format free) client code on the level of a securities account. In that case, a client with more than one securities account will have different client IDs. Some Member States (Norway, Spain, Portugal, Czech Republic and Malta) use a unique identification number, for example: taxpayer number, personal identity number, business enterprise organisation number, identification number assigned by the National Bank or name of the party entering into the transaction.

51. Three different levels of uniformity are currently used for clients who are not an investment firm/credit institution:

    a. Unique identification number independent of the investment firm/credit institution (for example taxpayer number);

    b. Unique identification number on the level of the investment firm/credit institution; and

    c. Unique identification number on the level of a securities account (for example the bank/securities account number)

52. Most Member States currently request the second option.

3.3 Advantages and disadvantages of collecting client identifiers

53. Many of the arguments for collecting, or not collecting, client identifiers can equally be applied to collecting identifiers for counterparties that are not investment firms, regulated markets, MTFs or central counterparties. So references to client identifiers in section 3.3 and 3.4 should be taken to include entities that might otherwise be identified in the counterparty field as "customer/client".

54. CESR identified a number of benefits provided by the collection of client/counterparty identifiers. These benefits are further explored in paragraphs 55 to 66.

55. All the competent authorities that collect client IDs currently place great value on the input they provide for market surveillance purposes and rate the usefulness of client IDs as very high.

56. The main purpose of collecting transaction reports is to help CAs meet the obligations of MAD. To meet these obligations, many CAs consider that it is essential to identify the initiator or beneficiary of a trade within the transaction report to enable the detection of market abuse and to protect the integrity of the markets. For many markets, this cannot be done simply by collecting reports on transactions made by investment firms transacting directly with an execution venue. Supervisory signals at firm's level have proved much less precise and much less useful for supervisory purposes than those based on client data.

57. Member States where client ID is regularly collected have seen a decrease in the likelihood of false positives (considering suspicious at firm's level what would be a non-suspicious set of trades at client's level) and false negatives (considering as non-suspicious certain trades that, when attached to a particular client, were clearly suspicious). Without a client identifier, it would be impossible for the CA to deduce certain information from the transaction reports without ad hoc requests, which, in turn, increases compliance costs for firms and CAs. Therefore, client IDs can improve the efficiency of supervision.

58. Category c) in the current CESR Level 3 Guidelines essentially offers CAs the choice to collect client identifiers as part of the transaction reports or collect them on an ad hoc basis. For many markets it is not practical to collect client information on an ad hoc basis as the CA may collect up to seven million transaction reports a day. The CA might end up sending huge and onerous requests to firms for information when further client information would have clearly shown that nothing suspicious had transpired. This burden comes as a cost to the firms and can be upsetting for them if they have already provided client identifiers to help CAs detect truly suspicious transactions.

59. It is important to note that this process can slow down the speed and efficiency of any investigation. Additionally, the ability to immediately identify suspicious client transactions or, just as importantly, to identify certain transactions as non-suspicious, significantly reduces the burden on the CAs, as well as the firms from which information is being sought. Increasingly, transactions are being carried cross-border. In such an instance, suspicious transactions of a firm based in another EEA Member State which does not contain client-identifying information may lead to a request by the investigating CA (the requesting CA) for assistance to the CA in another country (the assisting CA). This will then, dependent on the procedures of the requesting CA, lead to a request by the assisting CA for information from the relevant firm, to be provided within a specified period of time, typically 10 to 15 days. The request will then be answered and the response provided to the assisting CA who will in turn pass the information along to the requesting CA. This process typically takes between three and four weeks and often results in the firm identifying yet another firm as the client for whom the transaction was carried out when in fact the true beneficial owner of the securities is a client of the second firm. This can lead to an additional request for assistance in an effort to pinpoint the true beneficial owner. With the client-identifying information readily available, this initial step or steps can be rendered unnecessary and can thus result in substantial savings of both time and resources for the requesting CA as well as for the firm and the assisting CA. Due to the large number of market moving events, it is particularly valuable to pinpoint the suspicious accounts of interest as soon as possible.

60. Client identifiers are also useful as they enable profiles of clients' behaviour to be developed in an automatic way. For example, we might find that a seemingly suspicious client actually trades thousands of times a year and loses money as often as he profits. Conversely, we might find that a client always profits from his transactions or always makes profitable transactions ahead of events involving a certain party. This advanced intelligence is totally dependent upon client and counterparty identifiers.

61. Since CAs are obliged to collect counterparty identifiers (at least for investment firms) it may appear inconsistent that they do not collect client identifiers for agency transactions as well. Many CAs view agency transaction reports received from other CAs without a client identifier, or principal transaction reports with the counterparty identified as "customer/client", as additional "noise" that actually detracts from their ability to focus on truly suspicious transactions.

62. Short selling has become an increasingly important topic and many CAs have implemented new regulations to limit or force disclosure of this activity. CESR has also recommended measures relating to short selling in its Report on CESR model for a pan-European short selling disclosure regime (CESR/10-088) and Report on technical details of the pan-European short selling disclosure regime (CESR/10-453). It is impossible to police such regulation through the identification of investment firms alone and many CAs have noted that many of the parties involved in short selling are hedge funds outside the EEA. The use of client identifiers in

transaction reports would undoubtedly help CAs police their short selling rules in the analysis by the regulators of the short positions notified to regulators or published.

63. Many firms and CAs have undertaken considerable expense in providing these identifiers and building systems to take full advantage of the information provided. If the harmonisation of standards resulted in an agreement not to collect these identifiers, it would result in significant wasted costs to firms and regulators that currently require them.

64. Costs of ad hoc requests by CAs to firms to gather information about their clients' IDs would shrink significantly if these IDs were routinely collected and reported as the regulators could better filter out the cases to investigate further.

65. Requiring the collection of client ID may also assist investment firms to comply with other regulatory obligations which involve the management of client data (e.g. large exposures, liquidity risk reporting, anti-money laundering and credit exposures reporting).

66. Summarising, the collection of client-side information in transaction reports is extremely valuable as a large element of suspicious market behaviour can be detected based on client trading patterns (as well as reporting firm trading patterns). It undoubtedly allows authorities to reduce the amount of additional requests sent to firms, though not eliminating them completely. Without client identifiers, the transaction reports may offer little additional value to trade reports for market monitoring. It should also be noted that attempts to spot suspicious transactions only by the reporting firms is seriously compromised by the fact that it is unclear from a principal transaction whether it was conducted by the firm as a proprietary account or as part of client facilitation.

67. However, CESR acknowledges that collecting client identifiers might also have several disadvantages. They are further elaborated in paragraphs 68 to 74.

68. It should first be noted that the collection of client identifiers is not a prerequisite for effective market supervision, as some CESR members have in place surveillance systems and methods with proven records in terms of market abuse investigations and sanctions whereby the client identification is obtained in an ad hoc way, when needed.

69. The present variety among CESR members in requirements to collect client identifiers leads to the following problems, which were also identified by some respondents to the Call for Evidence.

70. In situations where multiple legs in a chain of transactions have to be reported in order to provide the information on client ID, it results in additional records in the TREM system that can (in some cases) be deemed redundant.

71. The introduction of systematic collection of the client ID would mean additional costs (mostly one-off, both for firms and CAs) in the 10 Member States that are currently not collecting it. In fact they would have to adapt their reporting systems accordingly, bear additional administrative workload linked to the input of the client ID and, in some cases, extract the correspondent legs in order to reconcile the information related to the same transaction (for example, as mentioned above, when multiple legs in a chain of transactions have to be reported in order to provide the information on client ID).

72. Moreover, these new costs could be passed on to investment firms' clients, typically with a relevant share of retail investors in those Member States that at present time are not collecting client IDs.

73. In case information on the ultimate client is required to be included in transaction reports on a general basis, attention will have to be paid to investment firms outsourcing transaction reporting to a third party or relying on the waivers provided for in MiFID because this information is not available to the latter or is subject to other conditions.

74. Finally, it should be noted that the introduction of a mandatory and meaningful client ID for natural persons in the context of transaction reporting will need to be articulated with existing legislation on data protection; attention needs to be paid that the regime, including the exchange of data between competent authorities through TREM, is fully compatible with Directive 95/46/EC.

Conclusion

75. Based on the above analysis CESR believes that the anticipated advantages of collecting client identifiers overweigh the disadvantages identified. The provision of client identifiers and meaningful counterparty identifiers could lead to greater efficiencies in market surveillance and the detection of market abuse. The vast majority of CESR members aim, from a surveillance perspective, at increasing the accuracy of the information on clients and exchanging it on a regular basis, since their experience proves this information to be extremely useful for surveillance activities.

Proposal

76. There is a consensus[4] among CESR members to request the European Commission to amend MiFID and its Implementing Regulation in order to make the collection of client ID and (thus) meaningful identifiers for all counterparties by competent authorities mandatory within the framework of the upcoming review of MiFID[5].

77. As the introduction of a mandatory and meaningful client ID in the context of transaction reporting (article 25 of MiFID) implies the collection of data that could be of a personal nature, depending on the standard for client identification in each Member State, CESR believes the matter will have to be considered further by the European Commission to ensure full compatibility between client ID data collection under MiFID and Directive 95/46/EC.

4 STANDARDS FOR CLIENT AND COUNTERPARTY IDENTIFIERS

78. CESR consulted on the standards for many of the fields identified in Annex I, Table 1 of the MiFID Implementing Regulation in 2006 (Ref. CESR/06-648b), on the basis of which it was decided that the BIC should be used to identify investment firms in the counterparty field and the client fields (if available and if required by the CA). Decisions on identification codes for regulated markets, MTFs and entities acting as central counterparty were made as well (it was decided to use MIC codes for regulated markets and MTFs and BIC codes for central counterparties).

79. However, BICs are not available for all entities and there is no universally agreed standard identifier to be used for entities such as legal or business entities and natural persons.

80. Undoubtedly, a universal code to identify all entities and persons would be preferable to firm specific client codes as parties can have multiple accounts across many firms, either within the same Member State or in different ones. Unfortunately, such a code does not currently exist and many organisations have discovered the futility in trying to implement such a coding scheme. Indeed, when drafting its Level 2 advice in 2005, CESR already identified this issue for client/customer identification. CESR considered that it was not in a position to propose the use of a unique, European-wide code for a client/customer identification by every investment firm reporting a transaction, considering, first, the technical and cost-related aspects of building from scratch such a pan-European identification code and, second, the political sensitivity of this issue.

81. As already described above in the previous section, when implementing the MiFID reporting obligations, some CESR members that request a client identifier required in their local reporting a unique identification number independent of the investment firm/credit institution to be used. For example, such codes can be existing national standards like the taxpayer number, the personal identity number or the business enterprise organisation number. Some other CAs have also tried to go beyond the firm level by requiring the client name in addition to an internal code set by the investment firm or a national ID code.

82. From a technical point of view, using such coding schemes may not be a major issue for the regulators as most of the Member States requiring the client identifiers use a format free field

[4] Consensus being defined as unanimity minus one.

[5] LU objects the proposal in paragraph 76.

in the local reporting system. Similarly, for the exchange of this information between regulators, the current structure of the TREM file is most likely to remain appropriate (a 40 alphanumeric characters field). However, many firms claim that their internal systems will be impacted resulting in implementation costs.

83. Even though the use of a national code for legal or business entities does not raise any data protection issues, the matter may be different for the identification of natural persons. In at least one Member State the collection of national client identification codes within the transaction reports and their processing is subject to national Data Protection Agency approval. Even if such information could be freely exchanged through TREM with regulators from European Union Member States, the possible legal and procedural problems related to data protection to their exchange with CESR members that are not members of the European Union would need to be analysed.

84. Furthermore, some practical solutions would have to be found if personal identification numbers were used at national level, in particular for dual-nationals or in case of joint accounts.

85. The use of the actual name of the persons or entities alone (without combining it with a code) for client identification purposes is not being considered reliable enough due to risks associated with homonymy and the existence of several possible names (commercial, legal, etc.) for the same entity. However, in those Member States where the names together with codes are collected this has proved to be valuable information. This could be kept even if names were not exchanged through TREM (for data protection reasons) and remained at the local CA, in case the investigating CA requested the former more detailed information (names) about particular suspicious transactions.

86. Implementing a code type as universal as possible, and at least beyond the investment firm level, would enable CAs to operate more efficiently, but would have significant cost implications for reporting firms. There might also be legal restrictions for some Member States. However, such a change would have long-term benefits to firms as they would potentially receive fewer information requests from competent authorities.

87. In the view of CESR a possible solution to step from national to pan-European level, at least for natural and legal persons, might be the use of nationality as the leading element[6]. In this case, each Member State could make use of the national code that fits the most its own preferences.

88. Example: Member State A chooses social security number, while Member States B chooses tax payer number. Client Mr. Paul White, of Member State A, has an account both in Member State A and B. Since his nationality is A, he will be identified with his social security number from A, either when executing a transaction via his account in Member State A or via his account in Member State B.

89. Furthermore, European Securities and Markets Authority (ESMA) could play a role in data exchange on client IDs collected through transaction reports in the future provided that European legislation on data protection is complied with.

90. In order to address both the advantages and disadvantages, CESR is investigating the use of a single unique and meaningful identifier for each client or counterparty. Without prejudice of Annex I Table 1 of the MiFID Implementing Regulation and the coding structure already agreed by CESR for investment firms, regulated markets, MTFs and central counterparties, CESR is considering the following guidelines in order to harmonise the standards for the collection of counterparty and client identifiers:

   a. If a BIC has been assigned to the counterparty (irrespective of whether it is an EEA investment firm or not) or to the client (assuming client identifiers were collected), then it must be used as the identifier in the transaction report when exchanged through TREM.

[6] CESR is aware that few cases, such as dual-nationals and joint accounts, would not be covered. Although, a possible solution for the first case of dual-nationals could be assuring that each person uses always the same nationality among the ones he has, irrespectively of where the transaction is concluded.

b. In those cases were a BIC code has not been/could not be assigned, an alternative standard should be used to identify the counterparty or the client.

91. For incorporated entities that are not regulated and to which a BIC code is not assigned, the business enterprise organization number/companies register number seems a suitable solution as a meaningful code for client or counterparty identification, in particular as there is no related data protection issue.

92. The specific case of discretionary or fund portfolio management should also be properly addressed as it is the investment manager who is the initiator of the trade (whether the transaction is eventually carried out for a fund or for a discretionary mandate). Thus, for market surveillance purposes, transaction reports by the intermediary dealing for (or with) the investment manager should identify the investment manager in the client (or counterparty) field.

93. If an investment manager executes a transaction that it reports (e.g when it is member of a regulated market or an MTF - cf. section 6), it may be considered to use as client identifier the ISIN code for the investment fund (thus avoiding any issue in relation whether or not the fund is legally incorporated) and a unique code for the client under discretionary mandate[7], though the issue of grouped orders should not be neglected.

94. In the case of 'bulk transactions' carried out in the context of a Dividend Reinvestment Plan, which may have tens of thousands of clients for one transaction, an exemption to the reporting of the client ID could be considered given the passive nature of these types of transaction.

95. In other cases, in particular for natural persons, CESR believes that the alternative standard should be chosen between one of those described below, which have been ranked from the "widest" one - at pan-European level - down to the "narrowest" one - at a securities account level.

96. The standards selected by CESR are the following ones:

a. Unique identifier at pan-European level, should that code exist at some point in the future, based possibly on any of the following codes:

- personal identity number;
- tax payer number (for natural and legal persons);
- social security number

b. Unique identifier at national level, such as any of the following codes:

- personal identity number;
- tax payer number (for natural and legal persons);
- social security number;
- name of the client (as a complement, not substitute, of the above codes)

c. Unique identifier at investment firm level, such as any of the following codes:

- internal number assigned by the firm;
- bank/securities account number (provided there is one account per client)

d. Unique identifier at securities account level, such as any of the following codes:

- securities account number;
- bank account number

97. Each of the standard levels suggested involves different advantages and disadvantages, which are summarised below:

[7] This unique code should be the same as defined/decided for the general situation.

Pros	Cons
Unique identifier at pan-European level	
i) maximal benefit in terms of surveillance for spotting suspicious clients ii) consistency in the reporting model, improving the integrated financial market iii) minimise the complexity of the reporting and the associated costs for crossborder firms (in the long run) iv) facilitate the exchanges through TREM v) easier to monitor in the detection system	i) need to ensure data protection ii) problematic implementation (incl. time needed – seen by some as a medium to long term solution) iii) how to deal with non EEA natural persons iv) risk of disclosing the client identity along the chain (depending of the nature of the code)
Unique identifier at national level	
i) In principle, unique identifier for any client who is an EEA national ii) Supervisory signals would be at the client level, not the firm's level iii) already used by some Members iv) almost equivalent to the pan-European code in terms of benefits for the surveillance	i) need to ensure data protection ii) anticipated different quality standards of the code in different Member States and difficulties in achieving homogeneous approach due to lack of consistency of available data in different jurisdictions iii) how to deal with non EEA natural persons iv) for groups operating cross border, multiple reporting to the various CAs. v) risk of disclosing the client identity along the chain (depending of the nature of the code)
Unique identifier at investment firm level	
i) easier to implement ii) avoid disclosing a client ID to competitors along the chain iii) already used by some Members iv) improving the implementation of the Know Your Customer requirements by investment firms, to properly identify their clients.	i) differences in specific codes used by firms resulting in aggregation problems for the regulators and ad hoc requests addressed to firms, ii) need to assign only one code to each client across trading activities. iii) not effective as one client can spread its trading activity over a number of different investment firms, iv) wayback for the CAs already collecting at national level
Unique identifier at securities account level	
i) easier to implement ii) avoid disclosing a client ID to competitors along the chain iii) already used by some Members	i) not effective as one client can have several accounts ii) no clear benefit for market surveillance. iii) wayback for the CAs already collecting at firm or national level vi) differences in specific codes resulting in aggregation problems for the regulators and ad hoc requests addressed to firms v) no strong incentive for regulators to invest in automated detection system targeting the client level

98. Any of these solutions is expected to entail costs related to the introduction, maintenance and operation.

99. In principle, CESR considers that the ideal solution would be a unique pan-European code for each person (natural or legal) used for transaction reporting. However, due to the inherent

technical difficulties arising from the creation of such a code, CESR is of the opinion that unique client codes at a national level could reach the same effect, enabling competent authorities to identify the final investors for market surveillance purposes. That would also be consistent with previous proposals put forward in this document. CESR also considers that each competent authority should be free to decide which code should be used for these purposes, taking into account national regulations and practices, as long as they fulfill the aforementioned requirements.

100. If the solution retained is to decide upon the national level for the codes to be used, one should be aware that it is not always possible to allow just one type of code in a certain country for reporting purposes since some persons that can be clients may not have such code (children under age, foreign nationals, certain types of trusts, etc.). Therefore, each competent authority would provide clear rules for populating the client ID field, including a list of acceptable codes with a clear preference order attached to it, an alternative standard being acceptable only if the previous one is unavailable. This design would strike a balance between maximum harmonisation of coding rules and their compatibility with laws and available codes in each country. However, one should be aware that the multiplicity of possible codes at national level implies complicated information management within firms to pass on that information for transaction reporting purposes and prevent any consistency check to be conducted. Additionally, it should be mentioned that a single field for the identification of the client may not be enough to reflect both the client ID and the standard retained. When technical details are defined, there may be a need to identify the type of code and the country of origin of that code, to ensure that transactions exchanged through TREM will be meaningful for the receiving authority.

101. Depending on the type of client code selected at national level, there appears to be merit in some jurisdictions in establishing a central national register containing data which would enable competent authorities, without reverting to investment firms, to establish the identity of a client using the client code entered on a transaction report. Such a register could play a significant role in assisting competent authorities in conducting market surveillance and should reduce the number of queries addressed to investment firms in some countries.

102. The question of whether to collect directly the actual name of the client would be left to national discretion, as long as it complements a certain specific code and is not the sole client ID information collected.

Proposal

103. CESR considers that the ideal solution would be a unique pan-European code for each person (natural or legal) used for transaction reporting. However, due to the inherent technical difficulties arising from the creation of such a code and the lack of harmonised national codes in all Member States, CESR is of the opinion that each Member State should be free to decide which codes should be used for these purposes, taking into account national regulations and practices, as long as they fulfill the aforementioned requirements. Nonetheless, for the purpose of exchanging transaction reports between CESR Members, CESR relies on the use of BIC codes for counterparties and clients (whenever such codes exist) and strongly encourages their use at national level.

5 CLIENT ID COLLECTION WHEN ORDERS ARE TRANSMITTED FOR EXECUTION

104. According to Article 25(3) of MiFID, investment firms shall report executed transactions to their competent authorities. Article 5 of the MiFID Implementing Regulation specifies that for these purposes transaction means the purchase and sale of a financial instrument and specifically excludes securities financing transactions, exercise of options or of covered warrants as well as primary markets transactions.

105. The MiFID regime has proven controversial when addressing the supervisory need to monitor client orders that are transmitted by an investment firm to another one for execution. In cases

where these orders do not carry along the full client ID, the receiving firm cannot populate the final client ID when reporting to its regulator, since it only knows the identity of the transmitting firm. This may lead to a situation where the competent authority receives reports that provide an incomplete picture of the origin of the transaction, since the transmitting firm may not be obliged to report at all. In these cases, the identity of the real client that initiated the trade is lost for supervisory purposes.

106. The importance of this loss of client IDs must not be underestimated: it means a weaker base for market supervision, more costs for firms due to further ad hoc requests by CAs, misleading supervisory signals (as the transmitting firm appears, unduly, as client) and a general loss of precision in the information exchanges through TREM.

107. Some CESR members have already addressed this issue when interpreting the reporting rules and CESR guidelines. CESR is of the view that it is not acceptable to consolidate a reporting regime without trying to make it as accurate and efficient as possible while maintaining the maximum possible harmonisation to facilitate compliance by trans-national firms. Therefore, CESR is of the view that some changes should be considered to the MiFID regime with that purpose.

108. The goal of the changes would be to ensure that client IDs collected are as accurate and meaningful as possible and that they are not lost for supervisory purposes while orders are transmitted from one firm to another.

109. This issue can be looked at as a legal interpretation debate of the term 'execution' versus 'transmission'. However, since solving this problem would require amending MiFID, CESR has focused the discussion, alternatively, to directly analysing specific changes on obligations of reporting firms to ensure that the information reported is accurate and meaningful for the supervisors.

110. CESR envisages two workable ways of reaching the above mentioned goal:

- Requiring transmitting firms to disclose to the receiving firm the client ID information which is required in the transaction report that the executing firm should send to its competent authority.
- Requiring firms that do not transmit the necessary client ID information to the receiving firm to report the trade to their competent authority, including the client ID and specifying that the report is on an order transmitted to the respective firm.

111. The first option would have the advantage of not creating new reporting obligations for any firm or Member State. On the downside, it is unlikely that firms in certain Member States would agree to pass on client details due to legitimate commercial interests. Client codes can be almost anonymous (internal codes at firm's level) in some reporting regimes but could allow for clear identification of the client in others (tax payer number, name/surname). It is noted also that where the client ID is assigned at investment firm level, it may be necessary for the transmitting firm to pass an additional identifier to the executing firm to ensure that the competent authority can identify the investment firm that assigned the code to the client.

112. The second option carries the merit of protecting the client information from the receiving firm but has the disadvantage that it would require new reporting obligations for those firms (the transmitting firms) in most countries. This could entail some reporting duplication since execution of those orders would also be reported by the executing firm (for instance, the firm that faces the market or platform). However, as long as the reporting of these transmissions is clearly marked as such, there should be workable solutions to avoid double counting and distinguish these reports at the supervisor level.

113. Since both solutions would reach the same goal from a supervisory point of view, it could be left to the choice of the firms to either pass on the client ID information or assume the obligation to report the trade to the CA themselves (or through the other methods allowed by MiFID). This would accommodate different reporting rules existing across the EU, taking into account that client ID codes, as long as there is no single pan-European one, can contain more sensitive information in some jurisdictions than in others. It would also have the advantage of allowing

firms to decide depending on the nature of the receiving firm and their commercial interests (for instance, firms that pass an order for execution to another firm in the same group may want to pass the client information onwards for the executing firm to do the reporting to the supervisor).

114. Since the decision to require to transmit the client ID to the receiving firm or to report the trade to the CA would depend on the final coding structure of client identifiers to be adopted at national level, each Member State could be given the ability to allow the options described above for the firms in its jurisdiction or just one of the alternatives, in case the structure of client identifiers makes the other one not advisable or not workable. While CESR considers that the firms could have the choice, there may be cases where due to national circumstances, one alternative is preferable.

Proposal

115. CESR suggests amending MiFID to require that Member States ensure that, when orders are transmitted for execution, the transmitting firm either:

- Transmits the client ID to the receiving firm; or
- Reports the trade to the Competent Authority with a mark that differentiates it from ordinary executions, including full client ID, to the CA

6 TRANSACTION REPORTING BY MARKET MEMBERS NOT AUTHORISED AS INVESTMENT FIRMS

116. Article 2(1)(d) of MiFID provides that the Directive does not apply to persons who do not provide any investment services or activities other than dealing on own account unless they are market makers or deal on own account outside a regulated market or an MTF on an organised, frequent and systematic basis by providing a system accessible to third parties in order to engage in dealings with them.

117. The above exemption could potentially create a situation where firms not authorised as investment firms under MiFID fall outside the obligation to report transactions to the competent authority as provided under Article 25(3) of MiFID while trading in financial instruments admitted to trading on regulated markets also when such firms are members of regulated markets or MTFs.

118. Trades conducted by such firms on the regulated market's or MTF's order book contribute to the price formation process for the regulated market or MTF involved. The lack of reporting obligation raises serious concerns in such circumstances as it undermines the general concept of market monitoring and supervision system based on transaction reporting.

119. Reporting of those trades could be done by the members who conducted them but since these are firms exempted from the application of the directive as a whole, this could turn problematic. First, applying MiFID as a whole to such firms is not an option, since it would be disproportionate. Second, lifting partially the MiFID exemption for those companies, by making them subject to only certain aspects of the MiFID regime (Article 25, Article 57, relevant articles of Regulation 1287/2006, articles related to supervision and enforcement capabilites by supervisors, etc.) could prove a complex exercise.

120. Alternatively, the trades could be reported to the competent authorities by the regulated markets and MTFs where those trades were finalised. Of course, trading venues that assume that obligation should incorporate in their rules such a provision and could charge these firms the internal cost of reporting to supervisors. In this case, a specific provision should be added in MiFID. Trading venues should have a clear distinction of which of their members are investment firms and which are operating under the exemption provided in Article 2(1)(d), to be able to report on behalf of these.

Proposal

121. CESR suggests amending MiFID by introducing a transaction reporting obligation in Article 25(3) applicable to regulated markets and MTFs that admit as members undertakings currently falling under the Article 2(1)(d) exemption for all the transactions carried out by those members on the respective regulated market or MTF.

COMMITTEE OF EUROPEAN SECURITIES REGULATORS

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TECHNICAL ADVICE

CESR Technical Advice to the European Commission in the context of the MiFID Review - Investor Protection and Intermediaries

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Executive Summary

The Markets in Financial Instruments Directive (MiFID) entered into force in November 2007. Embedded in MiFID is a process for reviewing certain provisions in the Directive. This paper contains CESR's technical advice on investor protection and intermediaries issues for the European Commission (EC) as part of MiFID Review, so that the EC can report to the European Parliament and Council on possible changes to MiFID.

In providing its advice, CESR has reviewed and consulted on the continued appropriateness of certain provisions of MiFID.

The main points are under the following six headings:

Requirements relating to the recording of telephone conversations and electronic communications: In Part 1 of the paper, CESR proposes a common EEA regime for the recording of orders received/transmitted over the telephone or through electronic communications. The vast majority of CESR members believe that the existing discretion in Article 51(4) of the MiFID Level 2 Directive should be replaced by a minimum harmonisation EEA recording obligation. These CESR members consider that such a regime would be an important step forward in terms of certainty, consumer protection, and surveillance of markets to achieve a credible deterrence in EEA markets.

Execution quality data (Article 44(5) of the MiFID Level 2 Directive): In Part 2, CESR proposes to require execution venues to produce regular reports on execution quality in shares.

MiFID complex vs. non-complex financial instruments for the purposes of the Directive's appropriateness requirements: In Part 3 of the paper CESR proposes amendments to clarify and to deliver a more graduated risk-based approach to the distinction between complex and non-complex financial instruments for the purposes of the Directive's appropriateness requirements.

Definition of personal recommendation: Part 4 of the paper covers CESR's concerns on the current wording of Article 52 of the MiFID Level 2 Directive, with regards to the provision by intermediaries of personal recommendations through distribution channels. CESR proposes an amendment to the Directive to clarify that investment advice can be provided through distribution channels.

Supervision of tied agents and related issues: In Part 5 of the paper CESR proposes amendments to the MiFID tied agents regime focusing on three broad areas: (i) further harmonising the national rules on the use of tied agents; (ii) enhancing transparency concerning the identity of tied agents; and (iii) enhancing investor protection through clarifying the passport regime for firms using tied agents (Articles 31 and 32 of MiFID).

MiFID options and discretions: In the last part of the paper CESR proposes areas for further convergence with respect to the options and discretions in MiFID and its implementing measures.

Introduction

1. In November 2007, the Markets in Financial Instruments Directive 2004/39/EC (MiFID) and its implementing measures (MiFID Level 2 Directive 2006/73/EC and Regulation 1287/2006) entered into force.

2. MiFID extended the coverage of the former Investment Services Directive (ISD) and introduced new and more extensive requirements for firms, in particular for their conduct of business and internal organisation. It also harmonised certain conditions governing the operation of execution venues.

3. MiFID was a major part of the European Union's Financial Services Action Plan (FSAP), which was designed to help integrate Europe's financial markets. MiFID comprises two levels of European legislation. 'Level 1', the Directive itself, was adopted in April 2004. The requirements were supplemented by 'technical implementing measures', so-called 'Level 2' legislation. The EC's Level 2 measures were developed on the basis of advice provided by the Committee of European Securities Regulators (CESR) and were the subject of negotiation at European level in the European Securities Committee (ESC). They were formally adopted by the EC and published in the Official Journal of the European Union on 2 September 2006.

4. Since the implementation of MiFID, European financial markets have seen a number of changes. For instance there has been greater competition/pan-European trading, consolidation between exchanges, improved technology and innovation e.g. smart order routing, algorithmic trading and new clearing arrangements. In addition, there have been issues with post-trade transparency data including the fragmentation /consolidation of such data, delays, and costs. Furthermore, with the global financial crisis in the background, regulators have focused on selling practices regarding certain financial instruments to try and limit instances of investor detriment.

5. As part of the process embedded in MiFID for reviewing certain provisions in the Directive, CESR is providing advice to the EC in the context of the MiFID Review – Investor Protection and Intermediaries, so that the EC can report to the European Parliament and Council on possible changes to MiFID in early 2011.

6. As a part of CESR's Advice to the EC in the context of the MiFID Review, in April 2010 CESR undertook a public consultation.[1] CESR's general policy for the consultation, with a few exceptions, was to limit the issues under consultation to those issues related to investor protection and intermediaries that incorporate a review clause in the MiFID legislative texts. These were:

- Article 51(5) of the MiFID Level 2 Directive, which requires the EC to report on the continued appropriateness of the discretion on recording requirements in Article 51(4) in the MiFID Level 2 Directive on the retention of records under the record-keeping obligations in MIFID.

- Article 44(5) of the MiFID Level 2 Directive on best execution, which requires the EC to report on the availability, comparability and consolidation of information concerning the quality of execution of various execution venues. As part of this review the EC has to decide whether or not a regulatory intervention is required to ensure that investment firms have the necessary information to select appropriate execution venues to include in their execution policies. Given that the EEA trading landscape is changing very rapidly CESR has considered that it is preferable to limit the work to execution quality data on shares. CESR is conducting Level 3 work on the overall operation of the execution regime with a view to publish Level 3 material on this topic later on during 2010.

- Article 65(3)(c) of MIFID which requires the EC to report on "the appropriateness of rules concerning the appointment of tied agents in performing investment services and/or activities, in particular with respect to the supervision of them".

- MiFID options and discretions. This was included in the Consultation Paper in light of the Ecofin Council conclusions of December 2007 which stated that Member States should keep

[1] CESR Consultation Paper CESR/10-417.

under review the options and discretions implemented in their national legislation and limit their use wherever possible. The Ecofin Council conclusions of May 2008 and June 2009 more generally called for enhanced European supervisory convergence.

7. In its Consultation Paper, CESR also included two areas that have arisen from Level 3 work, these are:

- Complex/non complex financial instruments. This was included in the Consultation Paper as a result of a CESR consultation in May 2009[2] on MiFID complex and non-complex financial instruments, where the industry requested CESR and its members to provide further clarification on the types of MiFID products that might be categorised as complex or non-complex products for the purposes of the appropriateness requirements.

- Definition of personal recommendation. This was included in the Consultation Paper as a result of a CESR consultation in July 2009[3] on investment advice, where CESR considered that the current definition in Article 52 of the MiFID Level 2 Directive needed greater clarity.

8. CESR did not provide further technical advice on the MiFID exemptions regarding specialist commodity derivative firms contained in Articles 2(1)(i) and (k) of MiFID. Therefore CESR's technical advice on the MiFID exemptions for commodity derivatives business (CESR/08-752) published on 15 October 2008 remains valid.

Status of this paper

9. This paper is CESR's technical advice to the EC in the context of the investor protection and intermediaries area of the MiFID Review. In some cases, CESR has identified and proposed drafting for legislative changes. In other cases, CESR has provided technical advice to the EC without spelling out specific drafting proposals for legislative changes, but merely sets out CESR's view on the policy approach that should be adopted.

[2] CESR Consultation Paper CESR/09-295.
[3] CESR Consultation Paper CESR/09-665.

Part 1: Requirements relating to the recording of telephone conversations and electronic communications

CESR's advice

CESR members (except for BaFin and FMA) believe that it is appropriate for the EEA to adopt a minimum harmonising recording requirement. They believe that such a recording requirement should have the following scope and following record-keeping standards.

Scope of obligation

The obligation should apply to investment firms who provide and/or perform the following investment services and activities: reception and transmission of orders in relation to one or more financial instruments, execution of orders on behalf of a client, portfolio management and dealing on own account.

The investment firms mentioned above should be required to record telephone conversations in a format which allows the conversation to be replayed and electronic communications where one of their employees:

- receives from a client an order to be transmitted to another entity for execution or an order to be executed on behalf of a client;
- transmits an order to an entity not subject to the MiFID recording requirement when providing the service of the reception and transmission of client orders and the service of portfolio management;
- concludes a transaction with an execution venue when executing an order on behalf of a client or on their own account;
- concludes a transaction when trading on own account on behalf of the investment firm, regardless of whether or not a client is involved in the transaction.

This obligation would apply to orders and transactions relating to all financial instruments covered by MiFID. It would also apply to all forms of telephone conversation and electronic communication. Employees of investment firms would only be allowed to undertake conversations and communications of the sort set out above on equipment belonging to the investment firm.

Investment advice

CESR considers that work should be done to clarify the record keeping obligation regarding investment advice.

Record retention

The record made under the obligation above should be kept in accordance with the standards set out in Article 51(4) of the MiFID Level 2 Directive. This means investment firms would need to keep the records for at least 5 years and that they should be stored in a way that makes them accessible by regulators and that prevents them from being altered.

In addition to this advice on recordkeeping for orders and transactions, CESR believes it is necessary to undertaking work on recordkeeping for the provision of investment advice.
One member believes it would be cost-effective to require investment firms to keep for 5 years all electronic communications with clients. This would facilitate supervision of compliance with rules on investment advice and information to clients, since such records are easily searchable, at little additional cost to investment firms.

Introduction and background

10. In its advice to the EC in 2005 on the MiFID implementing measures (Level 2 Directive 2006/73/EC)[4], CESR said that the MiFID Level 2 Directive should include a requirement on investment firms to record telephone conversations where firms received client orders. Such a proposal was discussed by the European Securities Committee (ESC)[5] but was not included in the final MiFID implementing measures.

11. The MiFID Level 2 Directive does, however, contain two provisions that are relevant to this issue. Article 51(4) of the MiFID Level 2 Directive says *"Record-keeping obligations under Directive 2004/39/EC and in this Directive are without prejudice to the right of Member States to impose obligations on investment firms relating to the recording of telephone conversations or electronic communications involving client orders."*

12. This provision provides Member States with a discretion to set their own national rules about the recording of telephone conversations and electronic communications (which are described in the rest of this chapter as 'recording requirements') or to have no such rules. Article 51(5) of the MiFID Level 2 Directive required the EC to report on the continued appropriateness of Article 51(4) of the MiFID Level 2 Directive by 31 December 2009. This paper sets out CESR's advice to the EC for the purposes of that review.

Issues under discussion

Use of the discretion for a recording requirement

13. CESR asked its members for details of what use, if any, they make of the discretion in Article 51(4) of the MiFID Level 2 Directive in their Member State. In responding, CESR members were asked to consider whether their recording requirements (if any) fall within the categories of:

    (i) Broker to broker order;
    (ii) execution of client orders at the hub (trading desk) level only; or
    (iii) extended execution of client orders including receiving and transmitting orders from the client.

    The responses have been incorporated into the table in Annex 1.

14. The table in Annex 1 shows that of the 26 Member States whose CESR member responded, 16 have a recording requirement which is incorporated in legislation or rules whilst 10 do not (although investment firms in these jurisdictions may be subject to recording requirements imposed by regulated markets). In the countries with recording requirements incorporated in legislation or rules, the obligations mainly appeared to cover the categories of (ii) and (iii) set out in the previous paragraph. Of these two categories, the vast majority of Member States fall into the category that require investment firms to record all client orders received by telephone. France, Germany and Sweden appear to require, inter alia, the telephone lines of traders/trading desks to be recorded.

Rationale for a recording requirement

15. From the point of view of competent authorities there are three main rationales for imposing recording requirements:

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[4] See Box 5 in CESR/05-024c. http://www.cesr.eu/index.php?page=document_details&from_title=Documents&id=2965

[5] See Article 13 in ESC/17/2005: http://ec.europa.eu/internal_market/securities/docs/isd/dir-2004-39-implement/esc-17-2005_en.pdf

- to ensure that there is evidence to resolve disputes between an investment firm and its clients over the terms of transactions;
- to assist with supervisory work in relation to conduct of business rules; and
- to help deter and detect market abuse and to facilitate enforcement in this area.

16. In some Member States there appears to be little evidence that there is a large number of disputes between investment firms and their clients over the terms of transactions where the receipt of the order involves a telephone conversation or electronic communication. In particular, some CESR members are unaware of any significant problem concerning the orders of retail clients.

17. Records made as a result of recording obligations are not the sole material that any competent authority uses to assess investment firms' ongoing compliance with conduct of business obligations. But they can help to assist a competent authority to check compliance with, for example:

    - the requirements in MiFID and in the MiFID Level 2 Directive on information to clients and potential clients;
    - the requirements in MiFID on best execution; and
    - the requirements in MiFID and the MiFID level 2 Directive on client order handling.

18. Where firms are not complying with their conduct of business obligations recordings of telephone conversations and electronic communications have been used as part of the evidence in enforcement cases.

19. The prosecution of market abuse presents significant challenges. Evidence collected through recording obligations can provide additional material for discovering the facts of a case. It can also provide evidence that may not be available through other sources such as documents and oral testimony. In particular, recordings more often help to show the intention behind trading and the knowledge of the person at the point at which they trade which are matters which are often not easily established but may be crucial in a successful enforcement case.

20. A small minority of CESR members (BaFin[6] and the FMA[7]), do not think that records held as a result of a recording obligation are of significant assistance in supervisory and market abuse monitoring work. They believe that most of the material kept as a result of a recording requirement is unlikely to be of interest to competent authorities and raises a significant issue of proportionality, especially in view of the costs arising out of such new requirements. These CESR members also feel that due to already existing documentation requirements, there is plenty of other information available to competent authorities to enable them to check an investment firm's compliance with its conduct of business obligations. They point to the fact that the record keeping obligation in Article 13(6) of MiFID requires firms to keep records of their business "*…which shall be sufficient to enable the competent authority to monitor compliance with the requirements under this Directive, and in particular to ascertain that the investment firm has complied with all obligations with respect to clients or potential clients*" as indicating that a recording requirement is not necessary for conduct of business purposes.

21. The discussion about a recording requirement in the context of the negotiation of the MiFID Level 2 Directive mainly focused on the rationale of dealing with resolving disputes between investment firms and their clients. At one point the proposals for a recording requirement in the papers discussed by the ESC included a requirement that recordings would be the sole evidence to be relied on in the event of a dispute. The discussion above shows that competent authorities in jurisdictions with a recording requirement believe that the requirements serve a wider purpose. CESR believes that it is important that in considering a possible EEA recording requirement, the EC takes account of this. CESR believes that the EC needs to consider the

[6] BaFin expressed a dissenting view on this part of the advice.
[7] The FMA abstained from expressing a view on this part of the advice.

wider context, in particular the use of recording requirements in relation to tackling market abuse.

Nature of a recording requirement

22. The EU's Economic and Financial Affairs Council conclusions in June 2009[8] included the following statement:

> *"… the Council invites the Commission and all other relevant parties to take the appropriate initiatives, which i.a. should aim at:*
>
> *Moving towards the realisation of a single rulebook, with a core set of EU-wide rules and standards directly applicable to all financial institutions active in the Single Market, so that key differences in national legislations are identified and removed."*

23. CESR has borne this context in mind in discussing the continued appropriateness of the discretion in Article 51(4) of the MiFID Level 2 Directive. However, in the light of the specific context of this issue, CESR believes that it is not possible to recommend a maximum harmonising approach to a possible EEA recording requirement to the EC.

24. As illustrated previously, the current position across Member States in relation to the discretion is varied. A single common approach would inevitably mean that new obligations would have to be introduced in some Member States, whilst in others existing obligations would have to be removed. Competent authorities in the Member States who potentially would need to reduce the scope of their existing obligations attach importance to these obligations in their supervisory and enforcement work. They believe that losing existing obligations would do damage to investor protection and efforts to prevent and detect market abuse. CESR does not therefore believe it is appropriate to recommend to the EC that a maximum harmonising recording requirement is included in EEA legislation.

25. Most CESR members believe that it is sensible for the existing discretion in Article 51(4) of the MiFID Level 2 Directive to be replaced by a minimum harmonising obligation. This would avoid competent authorities losing any recordings to which they currently have access whilst at the same time making progress towards harmonisation and a single rulebook. CESR's views on the substance of an EEA rule on the recording of telephone conversations and electronic communications included in this advice are therefore predicated on the assumption that such a rule will be minimum harmonising. It should not be assumed that CESR members would hold the same views about the substance of the proposal if a maximum harmonising rule was proposed.

26. Support from CESR members for a minimum harmonising EEA rule on the recording of telephone conversations and electronic communications is not unanimous. A small minority of CESR members (BaFin and the FMA) does not believe that the benefits of recording telephone conversations and electronic communications are proportionate to the costs which would be imposed on firms. They believe therefore that the existing discretion in Article 51(4) of the MiFID Level 2 Directive should be retained. In the responses to the consultation this was a position supported by several national and European trade associations representing banks.

Policy arguments

Scope of a recording requirement

27. CESR decided that the best way to define the scope of a possible recording requirement was in two stages. First, to decide which investment firms would be subject to the requirement by reference to investment services and activities to be covered. Second, to define what telephone

[8] http://www.consilium.europa.eu/ueDocs/cms_Data/docs/pressData/en/ecofin/108392.pdf

conversations and electronic communications in relation to those services and activities would have to be recorded.

28. CESR considered five main investment services and activities as potentially being relevant to a recording obligation. These were: reception and transmission of orders, execution of orders on behalf of clients, dealing on own account, portfolio management and investment advice.

29. Reception and transmission and the execution of client orders obviously involve the receipt of client orders which is relevant both in the context of conduct of business supervision and detecting market abuse. CESR believes that conversations and communications relating to these services should therefore be inside the scope of a recording requirement. Covering conversations and communications relating to the transmission of orders raises the issue of duplication. CESR believes this should be taken into account in framing a recording requirement. This issue is explained in more detail in the next section of this paper.

30. Including the execution of client orders within the scope of a recording requirement will inevitably capture some investment firms who deal on own account. This is because some investment firms execute client orders by dealing on own account. But where investment firms dealing on own account are not executing orders on behalf of clients this proprietary trading activity is potentially of interest from a market abuse perspective. CESR therefore believes that communications and conversations relating to dealing on own account should be inside a recording requirement.

31. When providing the service of portfolio management, investment firms act on behalf of clients but do not transmit or execute orders that have come directly from clients. This trading activity is potentially of interest from both a conduct of business and a market abuse perspective.

32. The quality of investment advice is obviously a crucial factor in consumer protection. CESR is aware that several consumer groups believe that this makes it important to tape conversations involving the provision of investment advice (and one CESR member is shortly to introduce such an obligation). However, a lot of advice will be given on a face-to-face basis and other record-keeping obligations around this service should provide competent authorities with a significant amount of information with which to judge the quality of investment advice (although it is notable on this point that Member States have differing national requirements governing the information that investment firms have to provide to clients about the suitability of investment advice). CESR does not therefore think it is appropriate to include investment advice in the scope of a recording requirement.

33. The specific conversations and communications that CESR believes should be recorded in relation to the services outlined above are:

- the receipt of an order from a client (both where the investment firm will transmit the order and where it will execute it);
- the transmission of an order; the conclusion of a transaction which executes a client order;
- the conclusion of a transaction when dealing on own account; and
- the transmission to another entity of a decision to deal by a portfolio manager.

It is not intended that this would capture internal conversations and communications within investment firms (although it would capture conversations and communications between two investment firms in the same group).

In the responses to CESR's consultation, several respondents supported the scope of conversations to be covered but believed the obligation should only apply where the person in the firm having a conversation was a professional trader. It was argued that this scope would provide a proportionate implementation of the obligation by covering a relatively concentrated and easy to identify set of phone lines within investment firms.

Duplication

34. The scope of a recording requirement raises issues of potential duplication (i.e. a situation where both parties to a conversation or communication are under an obligation to record that conversation or communication). There are several ways in which this can occur:

- transmission of an order from an investment firm with authorisation to receive and transmit orders to an investment firm with authorisation to execute orders on behalf of clients;
- transmission of an order from an investment firm with authorisation to undertake portfolio management to an investment firm with authorisation to execute orders on behalf of clients;
- conclusion of a transaction between two investment firms with authorisation to deal on own account.

35. Duplication will not occur 100% of the time because EEA investment firms will not always be dealing with other EEA investment firms in the situations set out above. Orders might be transmitted to or transactions concluded with entities based outside of the EEA.

36. From a supervisory perspective there is an advantage to such duplication. It more easily enables supervisors to review recordings relating to any individual firm. Elimination of some part of the duplication means that it will be more difficult for supervisors to collect information on individual firms.

37. Conscious of the need for any recording requirement to be proportionate, CESR believes that some of the duplication should be eliminated. It believes that investment firms with authorisation to receive and transmit orders or to undertake portfolio management should not have to record the transmission of orders when those orders are sent to other MiFID investment firms subject to the recording requirement. They should be required to record the transmission of an order where it is sent to an entity which is not a MiFID investment firm.

38. CESR believes that portfolio managers should be exempt from the taping obligations on the grounds of proportionality where they transmit a decision to deal to an entity under an obligation to record that conversation. The exemption will not apply where an investment firm that performs the service of portfolio management receives an order from a client and executes or transmits that order. However, the recording obligations are not intended to cover situations where an investment firm is discussing the portfolio management agreement with a client.

Financial instruments to be recorded

39. CESR has considered whether a recording requirement as described above should apply to orders and transactions related to all financial instruments covered by MiFID. MiFID conduct of business protections extend to transactions in all instruments covered by the definition of a financial instrument in Annex 1 of MiFID. There is also a requirement for investment firms under Article 25 of MiFID to uphold market integrity which implicitly applies to all financial instruments covered by the directive. However, the Market Abuse Directive (MAD – Directive 2003/6/EC) currently only applies to a subset of MiFID financial instruments.

40. One notable difference between the current scope of financial instruments between MiFID and MAD is that all UCITS are financial instruments under MiFID but only those admitted to trading on regulated markets are financial instruments under MAD. In some responses to CESR's consultation it was argued that including UCITS within the scope of financial instruments covered by a recording requirement was unnecessary because they cannot be used for market abuse purposes.

41. In order to ensure full investor protection and in the interest of simplicity it is proposed that a recording requirement should apply to conversations relating to all financial instruments covered by MiFID.

Mobiles and electronic communications

42. The recording requirements currently imposed by Member States with regard to recording mobile conversations appear to fall into two broad categories (Annex 1). Firstly, the majority of Member States who currently impose the broadest level of telephone recording obligations also require that mobile phones be recorded where client orders are received this way. Secondly, a number of Member States either; require traders to apply for special authorisation to trade via a mobile phone; prohibit the reception by traders of orders via mobile phone outside of a company mobile phone; or allow a special recording exemption to client orders received on a mobile phone. In Germany, most investment firms prohibit traders to trade via mobile phone. The UK FSA has recently consulted on removing its current exemption for conversations on mobile phones.[9] CESR believes that a recording requirement should be technology neutral and apply to all ways of making/receiving telephone calls and electronic communications.

43. It is envisaged that electronic communications would, for example, include email, chat/instant messaging, text messages/SMS and FIX Protocol communications.

Privacy

44. European legislation provides a framework to protect the privacy of the communications and of data held about individuals (in several EEA Member States there are also constitutional provisions which touch on these issues). Of most relevance here are the E-Privacy Directive 2002/58/EC and the Data Protection Directive 95/46/EC. This legislation does not prevent the recording of telephone conversations and electronic communications, but it does limit the circumstances in which recordings can be made and places safeguards around the handling of the recordings.

45. The scope of a recording requirement is likely to impact on the ability of firms to comply with it whilst also complying with their obligations under the above legislation. Firms are likely to face particular difficulties where conversations which are subject to the recording requirement take place on equipment, such as mobile phones, which are not the property of the investment firm. This suggests that a recording requirement should therefore only apply to conversations and communications which involve equipment provided by an investment firm to its employees. However, this risks creating a loophole whereby conversations and communications can take place on equipment which is not provided by the firm. This loophole could be closed by requiring firms to ensure that conversations and communications which fall within the scope of the recording requirement only take place on equipment provided by the investment firm to its employees.

Proportionality

46. A recording requirement which covers the receipt of client orders (either for transmission or execution) will cover a wide diversity of investment firms and offices of investment firms or credit institutions offering investment services. Some of the investment firms covered will be small firms, including possibly firms which are operated by a single natural person. Some of the offices of investment firms covered will largely undertake other business (such as banking business).

47. CESR has therefore considered the issue of whether or not there should be an exemption from a recording obligation on the grounds of proportionality for smaller investment firms or offices providing investment services which receive few telephone orders. In its advice to the

[9] CP10/07 http://www.fsa.gov.uk/pubs/cp/cp10_07.pdf

Commission on the MiFID implementing measures CESR included the following proposal to deal with concerns about proportionality:

Where, in view of the low frequency of orders given and/or received by an investment firm on a global basis or on any of its telephone lines, the requirement in the previous subparagraph would not be proportionate, the competent authority may exempt that investment firm from that requirement on a global basis, or as applicable, in respect of that telephone line."

48. CESR members in favour of a minimum harmonising taping obligation do not believe that it is appropriate to have an exemption of the sort suggested above. In relation to consumer protection they believe that there are no grounds for providing the protection of telephone recording only for the clients using certain phone lines or certain firms. In relation to market abuse they are concerned that this exemption creates a loophole to enable those seeking to commit market abuse to be certain that their conversations with an investment firm will not be recorded.

Retention of records

49. In analysing the current retention periods that investment firms are required to maintain telephone records for, a varied timeframe emerges (see Annex 1). The retention periods currently stipulated by Member States range from 3 months to 10 years. The most common period of retention is 5 years with four Member States imposing this timeframe on investment firms. In choosing 5 years, Member States are securing consistency with MiFID. However, it is likely that most issues requiring access to previous telephone conversations/electronic communications will arise in a shorter time period. In introducing requirements in this area, it must be considered whether the period of retention will strengthen or make obsolete the rationale behind these obligations e.g. there is no benefit in introducing recording requirements if investment firms can delete them before any related issue come to light. A period of retention of less than 1 year would seem inadequate in meeting the rationale behind these minimum requirements especially in meeting the purposes of investor protection.

50. Respondents to CESR's Consultation Paper made two main points about retention periods. The first was that the longer the retention period the more difficult it would be to find information in response to requests. The second was that there would undoubtedly be additional significant costs for a longer retention period. The figures given by various respondents are not easily comparable. However, from the figures given it did not appear that there was a straight line relationship between the retention period and costs of storage. For example, a 60 month storage period was not 10 times as expensive as a 6 month storage period.

51. CESR believes that there is no specific justification for records created under a recording requirement to be kept for a period of time that is different to the general MiFID record keeping requirement of at least 5 years. This is because in part the recording obligation is aimed at protecting investors in the same way as the general record keeping requirement. On its own, tackling market abuse would not provide a justification for keeping the documents for such a length of time as most market abuse investigations start well within 5 years after the events to which they relate.

52. Whatever the current length of the retention period in each individual Member State, it is the practice of competent authorities to require investment firms to hold recordings for longer where the recordings may be relevant for an investigation. If there is a harmonised EEA recording requirement competent authorities must retain this flexibility to request that firms should not destroy recordings. Alongside this flexibility it is also obviously important that competent authorities try to target requests to hold on to recordings, and when decisions are made that the recording is no longer needed that this is quickly communicated to the relevant investment firms.

53. Article 51(2) of the MiFID Level 2 Directive sets out conditions applying to the records kept by investment firms. These require, amongst other things, that records need to be accessible by

competent authorities and in a way that means they cannot be manipulated. CESR can see no reason why the same standard should not apply to records created by a recording requirement.

Impact assessment

Benefits

54. The mechanism for economic benefits to flow from a recording requirement is as follows:

- recorded communications may increase the probability of successful enforcement of conduct of business and market abuse rules;
- this reduces the expected value to be gained from violating conduct of business and market abuse rules; and
- this, in principle, leads to improved consumer and market outcomes.

55. Improved consumer and market outcomes deliver benefits not only to consumers but also to investment firms by encouraging greater investor participation. Whilst the mechanism to deliver benefits is clear, the extent of the benefits that will be delivered is less clear. Most CESR members believe, largely based on their supervisory experience, that the benefits are significant. The BaFin and FMA believe that because of other information that is available the benefits are modest.

Costs

56. The incremental impacts of the proposals depend on a number of factors which vary across Member States. In that context, CESR is mindful of the broadness of the cost involved. Some respondents to the consultation noted that the figures given below are, in some cases, dated, and do not present an in-depth look at costs across the EEA.

Current recording and retention requirements

57. The proposals will lead to additional costs e.g. capture and retention of conversations and associated data protection costs for investment firms in those Member States which have to adapt their regime in order to reach the proposed minimum requirements. See Annex 1 for an overview of the current recording requirements. The incremental cost for firms also depends on whether or not firms are recording (and/or keeping the records) over and above the current regulatory requirements for their internal purposes.

Structure of the financial services sector

58. To a large portion, the cost impact depends on the additional number of telephone lines which have to be captured due to the proposals and the fact that some Member States do not yet have such requirements at all and their investment firms will have to set up such telephone recording systems. The number of lines (relative to the size of the market) which need to be recorded depends on the structure of the financial services industry in Member States. Therefore the cost impact on the industry relative to the size of the market will be higher in some Member States than in others. The impact will be particularly high in Member States such as Germany where the market is highly fragmented and not dominated by a few large firms. Indications for the costs per line are given below.

Cost of fixed-line recording

59. In its Policy Statement 08/01[10] the UK's FSA provided estimates of the costs of recording fixed-line telephones. The analysis dates from 2008 and costs may be different today due to

[10] http://www.fsa.gov.uk/pubs/policy/ps08_01.pdf

technological progress. The UK per-line estimates for fixed line telephone recording are summarised in Table 1.

Table 1: UK cost estimates for fixed-line telephone recording

		Small Company		Medium Company		Large Trader	
		Design/ Install/ Commission Per User (£)	Annual Operational Cost per User (£)	Design/ Install/ Commission Per User (£)	Annual Operational Cost per User (£)	Design/ Install/ Commission Per User (£)	Annual Operational Cost per User (£)
Fixed telephone							
Recording	Low cost	79*	0	200**	20	160***	16
	High cost	2,610	644	414	145	216	74
Storage for 1 year & Retrieval	Low cost	N/A	N/A	N/A	N/A	N/A	N/A
	High cost	Included in the cost of recording	Included in the cost of recording	Included in the cost of recording	Included in the cost of recording	Included in the cost of recording	Included in the cost of recording
Storage for 3 years & Retrieval	Low cost	N/A	N/A	N/A	N/A	N/A	N/A
	High cost	Included in the cost of recording	Included in the cost of recording	Included in the cost of recording	Included in the cost of recording	Included in the cost of recording	Included in the cost of recording

* For the Small Company, the provider teams up with a third party supplier for providing fixed line recording systems.

** For the Medium Company the provider supplies a fixed line call recording system (from a third party supplier) purchased by the customer with an annual maintenance fee.

*** For the Large Company the fixed line prices are based on the incremental cost per 100 additional users to upgrade the call recording system from 400 to 500 users.

60. The German Banking Federation (Bundesverband Deutscher Banken - BDB) produced its own estimates of the costs of recording telephone lines in 2008 which the BaFin considers to be credible estimates of the likely costs of a recording requirement in Germany. The BDB, based on a survey of its members, put the one-off cost per telephone line at €3,528 and the ongoing annual costs at €1,500 per line. Because of the structure of the German banking industry the BDB said that these costs per line implied one-off acquisition costs for the German banking industry of €632 million.

Mobile phones

61. Annex 1 shows that a majority of Member States currently imposing taping requirements include mobile phones in these obligations.

62. The UK FSA commissioned a study by Europe Economics to estimate the costs of mobile phone recording (published in CP 10/7[11]). Table 2 provides estimates of the UK one-off costs per line for different forms of mobile phone recording. Table 3 provides estimates for the annual ongoing costs. These estimates are provided separately for small, medium, and large firms. Again, it has to be considered, that costs in other Member States may vary.

[11] See www.fsa.gov.uk

Table 2: UK cost estimates for mobile phone recording – one-off cost per user

	Small firm (low cost) £	Small firm (high cost) £	Medium firm (low cost) £	Medium firm (high cost) £	Large firm (low cost) £	Large firm (high cost) £
Voice from mobile	95	1094	85	208	170	80
SMS	0	40	0	40	0	40
MMS	65	65	60	60	50	50
IM	65	40	60	60	50	60
Video	95	95	85	85	75	75
Email	65	65	60	60	50	50
Pin to pin	65	65	60	60	50	50

Table 3: UK cost estimates for mobile phone recording – ongoing cost per user

	Small firm (low cost) £	Small firm (high cost) £	Medium firm (low cost) £	Medium firm (high cost) £	Large firm (low cost) £	Large firm (high cost) £
Voice from mobile	160	835	150	283	83	383
SMS	60	492	60	235	60	182
MMS	100	100	90	90	80	80
IM	50	442	45	421	45	362
Video	300	300	260	260	240	240
Email	80	80	75	75	75	75
Pin to pin	50	50	45	45	45	45

63. Ultimately, investment firms will decide whether they wish to use mobile phones to take client orders. Some firms, who currently permit the use of mobile phones but do not currently record relevant conversations, may well choose to ban their use in order to avoid compliance costs. If an exemption for mobile phones is included it will weaken the rationale behind the imposition of minimum requirements.

Retention period

64. The required retention period does have an impact on storage and retrieval costs for firms. This impact will depend on the systems used by firms. The UK cost estimates for fixed-line telephone recording provided in Table 1 included storage costs and are based on a retention period of 1 year.

Part 2: Execution quality data (Article 44(5) of the MiFID Level 2 Directive)

CESR's advice

There is a need to clarify through Level 3 guidance the obligations on investment firms executing orders in shares to collect information to enable them to assess which execution venues should be included in their execution policies, in particular in regard to investment firms executing client orders on behalf of retail clients. This should be backed up by a general obligation in the Level 1 text for executing venues to produce data on execution quality. The Directive could give to ESMA the discretion to introduce binding technical standards and requirements for execution venues to produce regular reports on execution quality in shares. If these reports are prescribed the metrics should at least cover price, speed of execution and likelihood of execution for individual shares.[12]

Introduction and background

65. The MiFID best execution obligation[13] requires firms to 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 (execution factors). The execution arrangements by which the firm achieves the 'best possible result' should be set out in an order execution policy and should include details of the venues used to achieve the best possible result on a consistent basis.

66. Firms are required to review, on a regular basis, the execution venues used to deliver the best possible result for the client and to consider whether they need to make changes to these execution arrangements. This assessment should require data on execution performance, for each of the venues, over a period of time.

67. During the negotiations on the MiFID Level 2 Directive, there was a debate about whether a regulatory requirement was needed to ensure that investment firms had adequate information to assess the relative merits of execution venues. During the negotiations the EC proposed that an obligation be imposed on execution venues to provide information on execution quality for all financial instruments. The proposal was as follows[14]:

"*In order to enable investment firms to identify those execution venues that will [or are likely to] deliver the best possible result for their clients for the purposes of Article 21(1), execution venues shall make available to the public on a reasonable commercial basis data relating to the quality of execution of transactions on that venue on at least an annual basis. The Committee of European Securities Regulators shall establish the content and the format of the data to be made available in accordance with the previous sentence with the view of their comparability by [31 October 2006].*"

68. During the course of those negotiations, it was considered that it was premature to impose such an obligation and that the market should be given a chance to show that it could deliver adequate information. The obligation therefore turned into a review clause in Article 44(5) of the MiFID Level 2 Directive:

[12] CMVM suggests requiring execution venues in the EU to link and route orders to one another, similar to the regime imposed by the Order Protection Rule (Rule 611 under Regulation NMS) established in the United States. CMVM considers that the current MiFID rules do not strike the right balance between two forms of competition: on one hand, competition between individual orders and, on the other hand, competition between execution venues; and that requiring an ex-ante approach to ensuring best execution is preferable to the current ex-post demonstration of execution quality.
[13] Article 21 of MiFID and Articles 44 to 46 of the MiFID Level 2 Directive.
[14] ESC/23/2005 – REV1.

"Before 1 November 2008 the EC shall present a report to the European Parliament and to the Council on the availability, comparability and consolidation of information concerning the quality of execution of various execution venues."

Issues under discussion

Venue selection

69. The starting point for a review of the issues related to the data that investment firms need in order to select execution venues has to be an assessment of what information firms need to assess execution venues. As set out in MiFID, an investment firm's obligation when executing client orders is to obtain the best possible result taking into account a range of execution factors (although total consideration – price plus costs directly related to the execution – prevails for retail clients). Therefore adequate data on all execution factors relevant to the firm's execution policy is required to assess which venues may deliver best execution.

70. The simplest execution factor, price, requires data on prices offered or achieved. For the other factors, different data is required – for example data on volumes may be used to evaluate a venue's market share and liquidity. However, it should be appreciated that for some factors, aggregate or objective data may not be easily available– for example assessments of counterparty risk or information leakage. At a minimum, it seems reasonable that data on prices, costs, volumes, likelihood of execution and speed should be available. However, it is acknowledged that many firms may require other data in order to make assessments of particular other factors.

71. Many firms use market share data to filter out venues which have insufficient liquidity before making an assessment on factors such as price. In this case they will not need data from all the venues. Conversely, firms that slice orders into smaller portions may not want to apply any filter at all. Therefore, while for firms individually data on all venues may not be required, for the market as a whole data on all venues is necessary.

72. Finally, there is the issue of how frequently investment firms need data. Given that the best execution policy review should take place at least annually the data is needed on at least an annual basis. However, given that firms have to monitor the effectiveness of their order execution arrangements and policy, such information may be needed on a more frequent basis.

73. To assist with its work on best execution, CESR circulated a questionnaire to investment firms, regulated markets, Multilateral Trading Facilities (MTFs) and CESR members. This focused mainly on best execution and share trading and the following description of the availability of data relating to share trading draws on the responses to the questionnaire as well as on the responses to CESR's Consultation Paper (Ref. CESR/10-417).

Share trading

74. Under MiFID there are requirements relating to trading in shares for certain information to be made publicly available about pre and post-trade transparency. The pre-trade transparency obligations apply to individual regulated markets, MTFs and systematic internalisers. The post-trade transparency obligations apply to regulated markets, MTFs and investment firms.

75. Despite the public availability of pre and post-trade information on shares, CESR has not seen since the implementation of MiFID the emergence of data sets showing aspects of execution quality by execution venue based on commonly accepted statistical definitions. There are at least four main reasons why CESR has not seen such data emerge:

- First, as several respondents pointed out in their responses to the questionnaire, market structure differs significantly across the EEA. In some Member States most share trading is still heavily concentrated on a single regulated market with, at most, limited Over the Counter (OTC) trading. In other Member States, however, there are a plethora of

regulated markets and MTFs and a significant amount of trading is conducted on an OTC basis. For the time being, there is significant competition between trading venues only in relation to the minority of shares traded across Europe. A review of execution venues for a firm executing client orders is obviously a very different proposition in the former type of market structure as opposed to the latter.[15]

- Second, the needs of investment firms are not uniform when it comes to information about execution. Large firms are in a position to develop their own IT infrastructure to warehouse data from live feeds and to analyse execution, or to buy large amounts of data and analytical tools from data vendors. Smaller investment firms will likely have access to less data and fewer analytical tools.

- Third, there is significant competition between providers of data and analytical tools whether they are regulated markets, MTFs or data vendors. This competition inevitably involves efforts to differentiate products.

- Fourth, MiFID itself did not set any standards for benchmarks relating to execution quality.

76. Investment firms currently have three main sources of information about execution:

- Regulated markets, MTFs and third parties disseminating trade reports. All regulated markets and MTFs provide live data feeds which enable market participants to look at pre and post-trade information. They also provide varying amounts of pre and post-trade historical data. The biggest demand for data from regulated markets and MTFs is for the live feeds, although responses to the questionnaire suggested the demand for historical data has risen since the introduction of MiFID. Some investment firms will warehouse information provided through live feeds from execution venues in order to help them analyse execution. In some cases the live feeds from regulated markets are provided not directly by the regulated market but by third parties licensed by the regulated market to onsell their data. Third parties disseminating trade reports of OTC transactions also provide data feeds.

- Data vendors. There are a range of information companies (and regulated markets and MTFs) who take pre and post-trade data from the original sources and then aggregate the data and sell it to investment firms in various packages.

- Record keeping. MiFID has various record keeping obligations in relation to client orders and transactions which mean that investment firms themselves hold a lot of information about their own trading activities.

77. Both the data vendors and some of the regulated markets and MTFs offer analytical tools to enable investment firms to analyse their trading activity. This includes transaction cost analysis (TCA), something which developed first in the US and involves looking at trading performance against a variety of possible benchmarks.

78. Most firms executing client orders who responded to the CESR questionnaire were of the view that they did not have significant problems obtaining and analysing data for their review of their execution policy and arrangements. They were also of the view that execution venues provided adequate data and assistance.

[15] CESR acknowledges that the full complexity of market structure should also be taken into account. For instance in the UK, most retail client orders are executed through market makers operating on the London Stock Exchange and PLUS whilst orders from professional clients and eligible counterparties are executed on order books or through OTC trades.

79. However, despite this high-level picture of contentment the responses identified several detailed areas of potential concern. Several respondents referred to the sorts of problems with the quality and consolidation of post-trade data. In addition, the respondents also said that the availability of data, particularly historical data, varies from venue to venue. They also said that venues use a variety of different ways of calculating concepts such as liquidity and Volume Weighted Average Price (VWAP).

80. The issue of inconsistencies in the calculation of key statistics also appears to extend beyond the regulated markets. Data vendors frequently offer transaction cost analysis services to help firms executing client orders and portfolio managers to assess their compliance with their best execution obligations. A recent report on such services[16] indicated that the same is also true for the transaction cost analysis tools that are being offered for the industry. It went on to suggest that data vendors should come together to agree a common methodology for calculating key statistics such as VWAP and Best Bid and Offer (BBO).

81. In their responses to the questionnaire portfolio managers and receivers and transmitters said they do not usually receive information about execution quality from the investment firms who execute their orders (although some is made available in response to a specific request). They said they got information from data vendors for the purposes of monitoring execution.

82. Regulated markets and MTFs said that the main data they provide to market users is real-time market data. Some regulated markets and MTFs provide historical data and there is tentative evidence of an increase in demand for historical data post MiFID. The regulated markets and MTFs were of the view that it was not difficult to compare the information that they provide using straightforward conversions between different formats used.

Trading in financial instruments other than shares

83. Whilst the CESR questionnaire did ask for information on the trading of classes of financial instruments other than shares, CESR received very little information on issues affecting venue selection for those classes of financial instrument. A bit more colour was provided in the responses to CESR's Consultation Paper (Ref. CESR/10-417).

84. There are some important differences between trading in shares and trading in other classes of financial instrument. One important difference is that MiFID does not currently require the publication of pre- and post-trade information for these financial instruments. This does not mean that no such information is available but the type of information available will differ depending on the nature of the instrument and the nature of the trading venue.

85. More trading in shares happens rather on regulated markets and MTFs than on an OTC basis (although OTC trading is still a significant component of share trading[17]). In some financial instruments other than shares, in some Member States, trading takes place largely OTC with liquidity providers operating on a 'request for quote' basis and therefore transactions may not involve investment firms executing orders on behalf of a client and thus may not have to provide best execution.[18] In response to CESR's Consultation Paper some execution venues said that they could see no reason for not including financial instruments other than shares within the scope of an obligation to produce execution quality data. They already produce relevant data on instruments other than shares which they admit to trading.

86. When trading financial instruments other than shares, investment firms will have available to them a variety of information sources which will help them to select execution venues. This will

[16] European Data Consolidation – White Paper, Thomson Reuters.

[17] Figures were provided in CESR's report on 'impact of MiFID on secondary markets functioning' (CESR/09-355).

[18] A copy of a letter from the EC setting out its view on how best execution applies in markets where trading takes place on a request for quote basis can be found in CESR/07-320: Best Execution under MiFID.

include information from regulated markets, MTFs, data vendors, price reporters and their own trading activity.

87. Respondents to the CESR Consultation Paper expressed contrasting views on whether financial instruments other than shares should be within the scope of any obligation on execution venues to produce information on execution quality. Some execution venues thought that there was no logical reason for excluding them and some intermediaries thought an obligation was even more important for these instruments. Other intermediaries thought that such information would not be useful.

Policy considerations

Other relevant policy developments

88. As noted above, several market participants and some competent authorities expressed concern in replies to the best execution questionnaire about the quality and availability of post-trade reporting. The EC is also obliged to review another issue related to information about trading. Article 65(4)[19] of MiFID states:

"*By 30 April 2008, the EC shall present the European Parliament and the Council with a report on the state of the removal of the obstacles which may prevent the consolidation at the European level of the information that trading venues are required to publish*."

89. This review is concerned with pre- and post-trade transparency information in shares that trading venues are required to make public under MiFID. As such it is related to but separate from the review under Article 44(5) of the Level 2 Directive. They are related because both reviews are concerned about data on transactions completed on trading venues but are separate because they have different focuses. Article 65(4) of MiFID is looking at data from the point of view of price formation whilst the review under Article 44(5) of the Level 2 Directive is looking at data from the point of view of venue selection.

90. CESR is separately providing the EC with advice in the context of the MiFID review which will also address the quality and ease of consolidation of post-trade data for shares.

91. There are also significant policy developments in train which will affect the availability of trade data for classes of financial instruments other than shares. In its October 2009 communication[20] on OTC derivatives the EC indicated that as part of the MiFID review it intends to bring forward comprehensive proposals dealing with pre and post-trade transparency for classes of financial instruments other than shares (which is also the subject of separate advice to the EC from CESR). The Commission is also due to bring forward shortly legislation on trade repositories.

US SEC Rule 605 reports

92. As reported in the previous section of this paper, some of the respondents to the best execution questionnaire raised the issue of a European Best Bid and Offer benchmark for trading in shares. These ideas are similar to features of the US market for share trading under its national markets system (NMS). Another feature of this system is the requirement for 'market centres' to make available on a monthly basis reports in a uniform, readily accessible and usable electronic format covering various dimensions of execution quality.

93. Rule 605 reports have to be categorised by security, order type and order size. They have to include information on:

- the number of orders cancelled prior to execution;

[19] As amended by Directive 2006/31/EC of the European Parliament and of the Council of 5 April 2006.
[20] COM(2009) 563 final: Ensuring efficient, safe and sound derivatives markets: Future policy actions

- the number of orders executed at the market centre;
- the speed, within set time bands, with which orders were executed;
- realised and effective spreads;
- the extent to which orders are executed with price improvement and the extent of the price improvement; and
- the extent to which orders are executed outside the quote and the extent of the price shortfall relative to the quote.

94. Obviously the entire range of price statistics that market centres are required to produce only makes sense in the context of the NMS. That is because the NMS incorporates a consolidated Best Bid and Offer tape across the participating market centres (and consolidated post-trade information). This provides a benchmark against which price information can be judged and harmonised statistics for spreads and price improvement can be produced. There is currently no such regulatory benchmark within the EEA.

95. Also under Regulation NMS firms executing client orders are required to produce quarterly reports on order routing, that is, they have to show the top ten market centres to which they sent orders over the latest quarter. The intention is to allow clients to judge the efficiency of the order routing practices of the firms executing their orders.

Best execution

96. There are three aspects of the best execution rule that are relevant to a debate about execution quality data. The first relates to the obligation itself. As set out in the introduction to this part of the advice, MiFID defines the best possible result in terms of a range of factors. Ideally execution quality data would encompass metrics relating to as many of these factors as possible. Some, however, are easier to measure than others.

97. Some respondents to CESR's consultation expressed a fear that execution quality data would distort the best execution obligation by prioritising some execution factors, principally price, above others. This is obviously not the intention, although CESR has previously said that investment firms are unlikely to be acting reasonably if they give a low relative importance to the net costs of a purchase or the net proceeds of a sale of financial instruments on behalf of a client.

98. The second aspect of the best execution rule that is relevant to the debate on execution quality data is the obligation on firms to monitor and review their execution policies. This should create a demand for statistics about execution quality and, as indicated above, larger firms obtain information about execution quality from a variety of sources. However, it is less clear what information smaller firms dealing with retail clients are currently using.

99. CESR's Q&A on best execution[21] included two questions (23, 24) on monitoring and review. The question on monitoring made some suggestions as to what information investment firms might like to look at. In the light of experience since MiFID was implemented there is a case for revisiting this issue to see whether more information can be provided about competent authorities' expectations of firms in this area. As a respondent to the Consultation Paper pointed out, the issue of execution quality data is in the end about the use investment firms make of the information to deliver more effective outcomes for their clients.

100. The third aspect of the best execution rules that are of relevance is the information that has to be provided to clients on execution policies. Unlike in the US, this does not involve an obligation to provide statistics about the routing of orders as opposed to a list of the venues relied on. Clients, including retail clients, might be interested in such information. To be of use, however, it would have to be presented in an easily digestible fashion.

[21] http://www.cesr.eu/index.php?docid=4606

Post-trade data

101. A key consideration for the review under Article 44(5) of the Level 2 Directive is whether an improved quality of post-trade reporting on shares is sufficient to be comfortable that investment firms have access to adequate information to enable them to make an effective selection of execution venues for the purpose of their execution policies. There are several issues that are not directly addressed by post-trade data. In particular it does not address the issue of a lack of a commonly agreed basis for measuring execution quality amongst execution venues and data vendors or the ease of consolidating the historical data sets currently available from execution venues.

Impact assessment

102. Best execution rules exist to correct potential market failures that result from an asymmetry of information between clients and investment firms with regard to the execution of client orders (i.e. execution quality is more directly observable by the firm than by the client). The issue of execution venues producing data on execution quality is linked to this issue but is also a bit more complex.

103. The production of data on execution quality by execution venues should help to reduce the information asymmetry between investment firms and their clients with regard to execution quality. In this sense it would therefore work with the obligation on the firm to help ensure that the interests of clients are protected when they rely on an investment firm to execute an order acting as the agent of the client.

104. In turn, however, the investment firm is also provided with additional information. This is not necessarily about dealing with an information asymmetry between the investment firm and an execution venue, but potentially about dealing with an externality. The benefits to the marketplace and investors of investment firms having comparable data on execution may exceed the private costs to the execution venues of producing the data. A regulatory obligation may therefore be necessary to ensure that the socially optimal amount of such data is available.

105. CESR has not, at this stage, done any specific work on the costs of an obligation on execution venues to produce reports on execution quality.

106. The SEC produced a cost-benefit analysis[22] (CBA) of Rule 605 when it published the final rule towards the end of 2000 (when the rule was called Rule 11Ac1-5) – the rule took effect in 2001. The validity of the CBA was contested by some of those who responded to a previous consultation on the draft of the rules but the SEC rejected the criticisms made by those arguing the costs would be substantial and the benefits minimal.

107. This CBA said that the SEC expected the rule would bring benefits to broker dealers and to investors. Broker-dealers would be better able to fulfil their best execution obligation, whilst investors would be better able to have meaningful input into how broker-dealers executed their orders. The SEC argued that the rule would not just reallocate income from broker-dealers to investors but would create additional income through ensuring the more efficient execution of orders. It mentioned the very significant savings available to investors for relatively small improvements in spreads. The CBA also pointed to academic studies which suggested that lower transaction costs would reduce the costs of capital.

108. The SEC put the annual cost of compliance with Rule 605 at $21.8 million a year (which was made up of labour costs at the market centres for data collection and the costs of services provided by data vendors to generate the required reports). It was expected that each market

[22] http://www.sec.gov/rules/final/34-43590.htm

centre would pay $2,500 a month to data vendors to generate the reports and that there were 627 market centres caught by the rules.

109. The benefits of an obligation on execution venues in Europe would be similar to those the SEC described in the US. It is very difficult to say whether the costs of an obligation in Europe would be similar to those in the US. Obviously it will depend on the number of execution venues who have to report, how much information they have to report, how frequently they have to report and how competitive is the market for providing services to execution venues to generate the reports.

110. In the responses to CESR's Consultation Paper there was useful information on costs. Some execution venues expressed the view that the costs of producing reports were manageable because they are already providing similar information. A data vendor who produces 605 reports in the US for market centres also said that the SEC figures quoted above were realistic, although it emphasised that costs might be lower in some cases. It was also pointed out that the costs of the reports are determined largely not by the periodicity of publication but the aggregate information that has to be collected. Therefore monthly reports would be little more expensive than annual reports for the same data set.

Part 3: MiFID complex vs non-complex financial instruments for the purposes of the Directive's appropriateness requirements

CESR's advice

CESR proposes that Article 19(6) of MiFID should be updated along the lines of the following:

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 all the following conditions are met:

(a) the above services relate to any of the following financial instruments:

(i) shares admitted to trading on a regulated market or on an equivalent third country market, where these are shares in companies, and excluding shares in non-UCITS collective investment undertakings and shares that embed a derivative;
(ii) bonds or other forms of securitised debt, admitted to trading on a regulated market or on an equivalent third country market, excluding those that embed a derivative or incorporate a structure which makes it difficult for the client to understand the risk involved;
(iii) money market instruments, excluding those that embed a derivative or incorporate a structure which makes it difficult for the client to understand the risk involved;
(iv) UCITS; or
(v) 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. This list shall be updated periodically;

(b) the service is provided at the initiative of the client or potential client;

(c) the service is not provided in conjunction with ancillary service (2) as specified in Section B of Annex 1;

(d) 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 or appropriateness 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;

(e) the investment firm complies with its obligations under Article 18.

Introduction and background

111. In 2009 CESR consulted on a proposed analysis and interpretation of MiFID's distinction between complex and non-complex financial instruments for the purposes of the Directive's appropriateness requirements. The first Consultation Paper was published in May 2009 (Ref. CESR/09-295), with a Feedback Statement (Ref. CESR/09-558) published in November 2009. During this time CESR also considered its policy approach on this topic in a set of Q&A (Ref. CESR/09-559).

112. In the Feedback Statement, CESR explained its view that, as drafted, MiFID did not deal adequately with certain categories of financial instruments for the purpose of the Directive's appropriateness requirements. CESR suggested that MiFID should therefore be amended in certain areas in the interests of clarity, and to deliver a more graduated risk-based approach. The amendments CESR is proposing to the EC are in the light of this work.

113. CESR considers that its advice to the EC on the proposals would improve legal certainty and give more clarity and transparency with regard to the categorisation of MiFID financial instruments for the purposes of the appropriateness test. However, CESR emphasises that these proposals do not reflect any changes that may be necessary in the future as a result of the outcome of discussions on a new EEA regime for Packaged Retail Investment Products.

Issues under discussion

114. The MiFID appropriateness requirements aim to increase the protection of clients (particularly retail clients) who are contemplating transactions in MiFID-scope financial instruments without receiving advice from the investment firm in question. They also aim to prevent complex products being sold on an 'execution-only' basis to retail clients who do not have the experience and/or knowledge to understand the risks of such products. In summary, where the appropriateness test applies, a firm must ask its clients to provide information about their knowledge and experience relevant to the specific type of product or service in question, so that the firm can assess whether the product or service is appropriate for the client. A firm is required to determine whether that client has the necessary experience and knowledge in order to understand the risks involved in relation to the product or investment service offered or demanded, and to warn the client if the firm determines that the product or service is not appropriate for them.

115. Essentially, therefore, MiFID lays down three sets of requirements in this area:

(i) where a MiFID firm is providing investment advice or discretionary portfolio management, it must do so in accordance with the suitability requirements set out in Article 19(4) of MiFID and Articles 35 and 37 of the MiFID Level 2 Directive;

(ii) where a MiFID firm is providing investment services other than investment advice or discretionary portfolio management, it must do so in accordance with the appropriateness requirements set out in Article 19(5) of MiFID and Articles 36 and 37 of the MiFID Level 2 Directive. These requirements are commonly referred to as the 'appropriateness test'; and

(iii) as an exception to (ii), in certain prescribed circumstances, a firm may provide some investment services - reception-transmission and execution of orders - involving some types of financial instruments on an 'execution-only' basis, without having to apply the appropriateness test. These prescribed circumstances are set out in Article 19(6) of MiFID (hereafter referred to as Article 19(6)) and Article 38 of the MiFID Level 2 Directive.

116. The risk-based way in which the requirement applies, and what it should involve in each case, depends particularly on the party taking the initiative of the transaction envisaged (i.e. whether the firm or the client) and on the type of MiFID financial instrument that is involved in the transaction. In terms of the type of instrument or financial product, the way in which the appropriateness requirements apply differs according to whether the instrument/product is deemed 'non-complex' or 'complex' for these purposes. In practical terms, this distinction matters because the appropriateness test must always have been undertaken by a MiFID firm where the service or transaction involves a 'complex' product. For 'non-complex' products, the test does not need to be undertaken in certain specified circumstances - meaning that the resulting transactions can be carried out in a way that can be described as 'execution-only'.

117. Article 19(6) lists specific types of instruments/products that can always be treated as non-complex for these purposes. Article 38 of the MiFID Level 2 Directive then provides a set of criteria for 'other non-complex' products not specifically listed. These provisions together also indicate some specific types of MiFID products that should always be treated as 'complex' for the purposes of the appropriateness requirements. However MiFID does not seek to provide definitive or complete lists of all types of products and how they should be categorised, and since MiFID was agreed, CESR and its members have received requests for clarification of how types of products might be categorised. This was one of the drivers for CESR's 2009 initiative on this topic.

Policy arguments and rationale

118. This section deals in turn with each category of financial instrument mentioned in Article 19(6), i.e. shares, money market instruments, bonds, other forms of securitised debt, UCITS and other non-complex financial instruments. It then presents two additional proposals, of which one is a minor drafting clarification.

Shares

119. With regard to shares, CESR expressed the view in its Feedback Statement and Q&A that, consistent with the definition of 'transferable securities' in Article 4(1)(18)(a) of MiFID, the reference to shares for the purposes of Article 19(6) should be interpreted as capturing shares in companies where those shares are admitted to trading on a regulated market or an equivalent third country market, but excluding other securities equivalent to shares in companies, partnerships or other entities, and depositary receipts in respect of shares. Instruments other than such shares in companies admitted to trading should be assessed against the criteria for "other non-complex financial instruments" set out in Article 38 of the MiFID Level 2 Directive (hereafter referred to as 'the Article 38 criteria'). CESR stated that shares admitted to trading on a third country market should also be assessed against the Article 38 criteria until such time as a list of equivalent third country markets is published by the EC.

120. Any type of share that embeds a derivative, including convertible and callable shares, should be treated as complex for the purposes of the appropriateness test. This would be the effect of applying the Article 38 criteria.

121. In addition, CESR believes that shares in a non-UCITS collective investment undertaking are first and foremost investments in a collective investment undertaking and that (for the purposes of the appropriateness requirements) this should prevail over the legal form they take (i.e. whether units or shares) in the interests of a consistent regulatory treatment of such investments for the purposes of the appropriateness requirements. CESR believes that shares in a non-UCITS undertaking should therefore be assessed against the Article 38 criteria, unless the final Directive on Alternative Investment Fund Managers prescribes a different treatment.

122. CESR believes that this approach should deliver reasonable outcomes for those shares not considered as automatically non-complex.

123. One particular issue that arose in CESR's work related to the treatment of subscription rights/nil paid rights. CESR stated in its Feedback Statement that where the exercise of the subscription rights involves the purchase of financial instruments which are different to the shares which gave rise to the subscription rights, then the exercise of such subscription rights should be regarded as complex or non-complex depending on the classification of the financial instrument being offered for purchase.

124. If the type of share itself is non-complex, the market acquisition (and exercise) of subscription rights/nil paid rights up to the number strictly necessary to round up the initial allotment, should also be classified as involving a non-complex instrument for the purposes of the appropriateness test.

125. If, on the other hand, the share is classified as complex, then the market acquisition and exercise of subscription rights/nil paid rights should also be classified as complex for the purposes of the appropriateness test. However, in the case of market acquisitions of subscription rights for non-complex shares beyond those strictly necessary to round up the initial allotment, these rights ought to be classified as falling within Article 4(1)(18)(c) of MiFID, and therefore are complex products for the purposes of the appropriateness test.

126. CESR felt that retail clients faced additional risks in non-advised secondary market acquisitions which warranted the application of the appropriateness test. On the other hand, market disposals of subscription rights by shareholders to whom these instruments have been granted, regardless of the classification of the underlying shares, can be regarded as necessary actions to obtain monies equivalent to dividends. Therefore the application of the appropriateness test to such transactions would be unnecessary and disproportionate in these circumstances.

127. In view of all the above, CESR therefore in this advice to the EC is proposing an amendment to the 'shares' reference in the first indent of Article 19(6), by clarifying that those shares that may be treated as automatically non-complex are shares admitted to trading on a regulated market or on an equivalent third country market, where these are shares in companies, and excluding shares in collective investment undertakings, convertible shares and other shares that embed a derivative. The proposed changes to the text of MiFID Article 19(6) in CESR's advice are intended to achieve this effect.

128. The treatment of subscription rights/nil paid rights in respect of shares will depend on the nature of the transaction including the nature of the particular share/right involved. However, CESR believes that this could better be clarified at MiFID Level 2 rather than MiFID Level 1.

Money market instruments, bonds and other forms of securitised debt

129. In its Feedback Statement and Q&A, CESR explained that Article 19(6) suggests that 'money market instruments, bonds and other forms of securitised debt' are non-complex instruments for the purposes of the appropriateness requirements, unless they embed a derivative. CESR stated that it sees the 'embed a derivative' consideration applying to all of these instruments since they are all forms of securitised debt. CESR considered that most asset-backed securities and structured products would also be considered complex for the purposes of the appropriateness test[23].

130. In its Feedback Statement, CESR also stated that it was of the opinion that the EC should consider the treatment of fixed income products in its forthcoming MiFID review. CESR had also previously stated in paragraph 65 of its May 2009 CP that '…the development of fixed income markets in the last decade on both volumes and complexity has been very significant, and it is doubtful that Article 19(6) as it currently stands is a helpful starting point to achieve an appropriate degree of investor protection. Particularly given recent developments in the financial markets, CESR believes that the risks associated with these instruments, and therefore the risks faced by retail clients considering a transaction without taking advice, are likely to warrant a more differentiated approach than the listing of money market instruments, bonds and other forms of securitised debt in Article 19(6).

131. Therefore CESR in its Advice to the EC proposes that MiFID be amended so that the categories of money market instruments, bonds or securitised debt in Article 19(6) are further differentiated. CESR believes that the current approach produces an oversimplified treatment of

[23] For the purpose of Article 19(6) CESR reads the term 'securitised debt' as meaning debt that is incorporated in a security, and not solely debt that has undergone a securitisation process (i.e. pooling contracts or assets and issuing new securities backed by the pool).

the instruments in that list that does not reflect their profile in terms of investor awareness of the associated risk.

132. Furthermore, CESR now believes that there are grounds to go further than it proposed in its first consultation on this issue in terms of the treatment of bonds under Article 19(6). It believes that the evolution of the markets and particular instances of consumer detriment that have been experienced in some markets justify an approach to bonds that is analogous to the treatment of shares that are eligible to be treated as automatically non-complex and so not requiring an appropriateness test to be satisfied. This means that only bonds admitted to trading on an EEA regulated market or equivalent third country market would be automatically non-complex, and even here excluding some types of bonds. Other types of bonds would need to be assessed against the Article 38 criteria to determine whether an appropriateness test needs to be carried out.

133. In addition, to ensure that Article 19(6) applies a consistent approach to MiFID debt instruments in the EEA, CESR is proposing revisions to the references in Article 19(6) to the types of debt instruments covered as non-complex instruments:

- bonds and other forms of securitised debt admitted to trading on a regulated market or on an equivalent third country market - excluding those that embed a derivative such as convertible bonds and exchangeable bonds, or incorporate a structure which makes it difficult for the client to understand the risk involved, such as structured covered bonds;

- money market instruments - excluding asset-backed securities and other structured instruments that embed a derivative or incorporate structures which make it difficult for the client to understand the risk involved.

134. In CESR's Advice to the EC, the proposed legal text is intended to achieve this effect.

135. CESR considers that the above categories would continue to be categories under Article 19(6) and these financial instruments should continue to be available on an execution only basis for the purposes of the appropriateness test. All the excluded instruments would on the other hand be considered as automatically complex.

136. CESR believes that the further breaking down of these categories in this way would provide more clarity and certainty regarding how certain financial instruments should be treated for purposes of the appropriateness test. It would also ensure that certain instruments are not brought back in as non-complex through the Article 38 criteria because Article 38 criteria are intended to be applied only to those instruments whose classification is not addressed by Article 19(6).

UCITS and other collective investment undertakings

137. In its Feedback Statement[24], CESR stated that nothing in Article 19(6) requires a person to look through to the underlying investments of a UCITS for the purposes of the appropriateness requirements. Therefore, as drafted, Article 19(6) treats all UCITS as automatically non-complex. In its Consultation Paper however, CESR raised the question as to whether this remains a correct approach. As CESR reported in its Feedback Statement[25], responses on this point were sharply divided, though some respondents felt that the treatment of the UCITS category for the purposes of the appropriateness requirements could better reflect the nature of the underlying investments.

138. CESR recognises that making any definitive proposals on the UCITS category at present is difficult. Any definitive proposal raises wider issues about the established and agreed EEA UCITS regime (which regulators deem suitable and which is a powerful global brand) that are

[24] Ref. CESR/09-558.
[25] Ref. CESR/09-558.

outside the scope of CESR's current exercise. CESR has not included any proposals as a part of its Advice to the EC. However, this issue is covered further in CESR's response to the additional questions the EC posed to CESR in its letter of March 2010.[26]

139. CESR also clarified in its 2009 Feedback Statement that shares and units in other (non-UCITS) types of collective investment undertakings within the scope of Annex I to the MiFID Level 1 Directive will need to be assessed against the Article 38 criteria.

Other non-complex financial instruments' under Article 38 of the MiFID Level 2 Directive

140. In its 2009 Consultation Paper, Feedback Statement and Q&A[27], CESR acknowledged the rationale for the criteria in Article 38 of the MiFID Level 2 Directive (i.e. that it is not practical for the MiFID Level 1 Directive to attempt to list all types of financial instruments that may, now or in the future, be treated as 'non-complex' for the purposes of the appropriateness requirements). CESR also noted that although there is scope for interpretation in applying some of the criteria, the high-level aim of Article 38 of the MiFID Level 2 Directive is to confine the scope of 'other' non-complex instruments to those products that are adequately transparent, liquid, and capable of being readily understood by retail clients. MiFID derivatives and certain similar instruments cannot qualify as 'non-complex' under the criteria. CESR does not propose any amendments to MiFID in this area.

141. In its Consultation Paper, Feedback Statement and Q&A, CESR briefly considered certain other instruments or products that had not been explicitly covered in previous sections of the Consultation Paper. CESR does not propose any changes to MiFID to accommodate explicitly any specific 'other products'. It cannot be expected that MiFID will explicitly cater for every combination or permutation of financial products that exists in the market, particularly as products are always evolving and changing. CESR believes that, if the other changes to MiFID that it recommends are pursued, the high-level Article 38 criteria for other non-complex instruments can continue to work effectively.

Additional proposals

142. Currently, Article 19(6) enables investment firms not to perform an appropriateness test "when providing investment services that only consist of execution and/or the reception and transmission of client orders with or without ancillary services." A strict application of the letter of this provision would permit a firm to provide the ancillary service of "granting credits or loans to an investor to allow him to carry out a transaction in one or more financial instruments, where the firm granting the credit or loan is involved in the transaction", in conjunction with the execution and/or the reception and transmission of client orders, without the need for an appropriateness test.

143. CESR questions whether this result is the correct one, since such granting of credits or loans will increase the client's leverage and risk exposure. CESR believes that if a firm is offering this ancillary service in conjunction with the execution and/or the reception and transmission of client orders, it should always be required to establish whether the client has the necessary knowledge and experience to understand the risks, regardless of whether the financial instrument concerned is complex or non-complex. CESR is aware of circumstances where firms have offered to provide loans to clients in order to incentivise them into a non-advised trade in a non-complex instrument.

144. Finally, one of the conditions under Article 19(6) is that "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 the client or potential client does not benefit from the corresponding protection of the relevant conduct of

[26] CESR reference: MARKT G3/SH/cr Ares (2009).

[27] Consultation Paper (Ref. CESR/09-295), Feedback Statement (Ref. CESR/09-558), Q&A (Ref. CESR/09-559.

business rules; this warning may be provided in a standardised format". It has been suggested that the reference in this condition to "suitability" but not to "appropriateness" seems strange, since the requirement in question is appropriateness rather than suitability. Therefore, CESR's Advice to the EC is that it would help avoid any confusion to include a reference to appropriateness in this condition, either instead of the reference to suitability or in addition.

Impact assessment

145. In the main, CESR's Advice to the EC is that its proposals to amend the text in Article 19(6) are points of clarification in respect of the existing text rather than fundamental changes to its meaning. CESR believes that such clarifications should help firms in implementing the requirements with greater confidence and certainty as to regulators' expectations. Generally, CESR believes that its views are consistent with market interpretations of the MiFID text; particularly where firms have hitherto erred on the side of caution in interpreting the appropriateness requirements (for example, concerning structured investment products).

146. The exception to this is CESR's proposal for the treatment of bonds, where the suggested change is more substantial. The change would narrow the range of bonds that could be treated automatically as non-complex instruments for the purposes of the appropriateness requirements and would mean that firms would need to assess other types of bonds against the Article 38 criteria in determining whether the appropriateness test needed to be carried out. However, CESR believes that any additional controls that firms may need to introduce are likely to be justified on client protection grounds. If a firm is contemplating transacting for a retail client on a non-advised basis involving bonds not admitted to trading on a regulated market (or equivalent), it seems reasonable that an assessment of the characteristics of the instrument and any inherent risks is undertaken. If an instrument then fails to satisfy the criteria for being treated as a non-complex instrument, because the market is not characterised by suitable levels of liquidity and transparency to provide prompt, objective benchmarks, it also seems correct that a firm should seek to determine whether the client has the knowledge/experience to understand the risks involved.

147. CESR believes that the same arguments are pertinent in the case of the impact of the proposed clarifications in respect of structured investment products, to the extent that firms may have interpreted MiFID differently. In the light of recent market events and regulatory findings[28], CESR does not believe that it is sustainable for all such instruments to be treated automatically as non-complex instruments when they are being transacted for retail clients on a non-advised basis.

[28] For example, the published findings of the UK FSA in respect of sales of structured investment products backed by Lehman Brothers.

Part 4: Definition of personal recommendation

> **CESR's advice**
>
> Article 52 of the MiFID Level 2 Directive amplifies the meaning of a "personal recommendation" for the purposes of the definition of "investment advice". The final sentence of this article "A recommendation is not a personal recommendation if it is issued exclusively through distribution channels or to the public" should be amended to delete "through distribution channels or" in order to protect clients against the growing number of intermediaries who now use distribution channels such as the internet and other similar means to provide personal recommendations.

Introduction and background

148. In July 2009, CESR commenced its consultation on the definition of advice, with the aim of clarifying the definition of 'investment advice' and providing illustrations of situations where firms are deemed, or not, to be providing investment advice. The Consultation Paper (Ref. CESR/09-665), asked the market participants to consider whether the current definition of 'investment advice' under Article 52 of the MiFID Level 2 Directive needs greater clarity.

Policy arguments and rationale

149. Currently, Article 52 of the MiFID Level 2 Directive states that where the recommendation is made available exclusively through a distribution channel or to the public, it can be considered as not constituting investment advice, therefore falling outside the scope of Article 4(1)(4) of MiFID.

150. CESR is concerned that the current wording of Article 52 of the MiFID Level 2 Directive, with regards to the issuance by intermediaries of recommendations exclusively through distribution channels, no longer adequately protects clients against the growing number of intermediaries who now use distribution channels such as the internet and other similar means to provide personal recommendations. Therefore CESR believes that clarification is needed that the provision of personal recommendations exclusively through distribution channels amounts to investment advice as defined under Article 4(1)(4) of MiFID.

151. CESR has made clear in its Level 3 work on investment advice that a personal recommendation can be provided through means such as the internet or mailings, and therefore suggests, that the words 'through distribution channels or' are removed from Article 52 of the MiFID Level 2 Directive in order to clarify that investment advice can be provided through distribution channels.

152. CESR's recommendation is not intended to represent a change in the substance of what constitutes investment advice. Information provided through distribution channels will only be investment advice where it meets the other criteria for information to be considered a personal recommendation in Article 52 of the MiFID Level 2 Directive.

CESR

Part 5: Supervision of tied agents and related issues

CESR's advice

Work on further harmonisation of the rules on the use of tied agents and on the reduction of differences resulting from the discretions in Article 23 of MiFID

- The discretion for Member States to prohibit investment firms from appointing tied agents under Article 23(1) of MiFID should be removed.
- The discretion for Member States to allow tied agents operating under MiFID to handle clients' money and financial instruments under the second paragraph of Article 23(2) of MiFID should be removed.

Work to enhance investor protection through enhanced transparency

- In Article 31 of MiFID the home competent authority should be obliged to transmit the identity of any tied agents acting cross border to the host authority, which should then disclose this information to the public.

Work on the passport regime for firms using tied agents (Articles 31 and 32 of MiFID)

- It should be clarified in Article 32 of MiFID that all tied agents established in a Member State other than the investment firm's home Member State are treated as if they were part of a branch regardless of whether the firm operates another place of business alongside the tied agents.
- The same notification procedures as those applying to tied agents of investment firms should apply to tied agents acting on behalf of credit institutions providing investment services.

Introduction and background

153. Pursuant to Article 65 (3)(c) of MiFID, the EC shall, on the basis of public consultations and in the light of discussions with competent authorities, report to the European Parliament and Council on "the appropriateness of rules concerning the appointment of tied agents in performing investment services and/or activities, in particular with respect to the supervision on them".

154. Article 4(1) (25) of MiFID defines tied agents. The regulatory framework governing the use of tied agents by investment firms, including specific organisational requirements for investment firms using tied agents, is spelled out in Article 23 of MiFID.

155. Overall CESR believes that the regime governing investment firms' use of tied agents has worked well since the implementation of MiFID. In particular, CESR does not believe that there is a need to change the rules governing tied agents' supervision and investment firms' oversight of their tied agents. This does not however, pre-empt any future work to provide guidance on how investment firms oversee tied agents through effective internal controls and other arrangements.

156. CESR's proposed advice to the EC is therefore confined to technical issues related to the operation of the regime in Article 23 of MiFID, including recommendations for greater harmonisation.

Issues under discussion

157. CESR's work on tied agents in the context of the MiFID review can be grouped under three main headings:

- work on further harmonisation of the rules on the use of tied agents and on the reductions of differences resulting from the discretions in Article 23 of MiFID;
- work to enhance investor protection through enhanced transparency, resulting from CESR members' supervisory experience; and
- work on the passport regime for firms using tied agents (Articles 31 and 32 of MiFID).

Policy arguments/rationale

Work on further harmonisation of the rules on the use of tied agents and on the reduction of differences resulting from the discretions in Article 23 of MiFID.

158. Article 23(1) of MiFID permits Member States to allow investment firms authorised in their jurisdiction to appoint tied agents. The vast majority of Member States allow firms to use tied agents. CESR believes that this discretion should be transformed into a rule in order to ensure a level playing field across the EEA.

159. CESR believes the discretion can be removed because on the basis of their practical supervision of investment firms using tied agents, CESR members have found the potential risks that this distribution channel poses can be appropriately managed. This requires that investment firms employ robust procedures to ensure that tied agents comply with high standards of integrity as well as legal requirements and internal guidelines. Requiring all Member States to allow investment firms for which they are the home Member State to use tied agents would also enhance investor protection as there would be a public register for tied agents in each EEA country.

160. The second paragraph of Article 23(2) of MiFID enables Member States to allow tied agents to handle client money and/or financial instruments in particular circumstances. The majority of Member States prohibit tied agents from handling client money/financial instruments. Even though investment firms remain fully and unconditionally responsible for any action or omission on the part of tied agents used by them, the fact remains that tied agents are not themselves authorised persons. Indeed, some investment firms employing tied agents are not authorised to handle clients' money and financial instruments because they are not subject to the full provisions of the Capital Requirements Directive. CESR therefore believes that it is appropriate to remove Member States' discretion to allow tied agents to handle client money and/or financial instruments. This suggested change is not intended to bring into question the ability of tied agents of credit institutions to handle client money and financial instruments.

Work to enhance investor protection through enhanced transparency

161. The current MiFID passporting provisions allow for, but do not prescribe, the transmission of the identity of tied agents from the home competent authority to the host competent authority. Therefore further room for increased transparency exists with regard to the passport for investment firms providing cross border services through tied agents (Article 31 of MiFID). The CESR Protocol on passport notifications[29] already contains a voluntary agreement between CESR members to share the identity of any tied agent that the firm is using in a Member State other than the home Member State of the investment firm. From an investor protection perspective, it is important that investors can check with their regulator whether the person/firm they are dealing with is truly a tied agent.

[29] http://www.cesr.eu/index.php?page=contenu_groups&id=53&docmore=1#doc

162. Therefore CESR considers that in Article 31 of MiFID, the home competent authority should be obliged to transmit the identity of any tied agents acting cross border to the host authority, which should then disclose this information to the public.

Work on the passport regime for firms using tied agents (Articles 31 and 32 of MiFID)

163. Article 32(2) subparagraph 2 of MiFID states that in cases where an investment firm uses a tied agent established in a Member State outside its home Member State, such tied agent shall be assimilated to the branch and shall be subject to the provisions of MiFID relating to branches. CESR proposes that it is clarified that all tied agents established in a Member State other than the investment firm's home Member State are treated as if they were part of a branch regardless of whether the firm operates another place of business alongside the tied agents. This is to facilitate convergence on passporting notifications and to facilitate a common interpretation of Article 32(2) (2) of MiFID, given that a small minority of competent authorities have reported legal problems in their jurisdictions with the current drafting of the aforementioned MiFID provision. Therefore all tied agents established in the host Member State should jointly be treated as one single branch.

164. For example, if a Belgian firm appoints a tied agent established in Germany and provides cross-border services in Austria using this tied agent, the firm will need to make a notification under Article 32 of MiFID to the BaFin and another one under Article 31 of MiFID to the FMA.

165. Finally, there are level-playing field issues relating to passporting between tied agents of investment firms and tied agents of credit institutions that CESR believes should be tackled by the EC. Tied agents acting on behalf of credit institutions are not subject to the notification procedures under Articles 31 or 32 of MiFID and the CRD does not contain specific provisions for the notification procedures to be followed by credit institutions providing investment services that use tied agents. This situation weakens investor protection because investors and competent authorities do not necessarily have full access to details of all tied agents operating in their Member State. Therefore CESR believes that these inconsistencies should be ironed out by requiring that the same notification procedures apply to tied agents acting on behalf of credit institutions providing investment services, as those applying to tied agents of investment firms.

Impact assessment

166. Allowing firms to use tied agents by amending Article 23(1) of MiFID would grant firms more flexibility in setting up an appropriate infrastructure for the distribution of their services and products. The increased flexibility in appointing and recalling tied agents would enable firms to respond more effectively to changing market conditions. In particular, the costs for exiting a market will be lower than when using own employees. Therefore, allowing tied agents could translate under favourable conditions into lower fixed costs for firms which should result in a better provision of investment services. The proposals would also result in all tied agents being registered in the Member State in which they are established, bringing along greater certainty and increased levels of investor protection in the EEA.

Proposals

167. Based on the above explanations, CESR proposes the following amendments to MiFID (amendments are underlined):

Amendments to Article 23 of MiFID

1. 'Member States ~~may decide to~~ shall allow an investment firm to appoint tied agents for the purposes of promoting the services of the investment firm, soliciting business or receiving orders from clients or potential clients and transmitting them, placing financial instruments and providing advice in respect of such financial instruments and services offered by that investment firm.

2. Member States shall require that where an investment firm decides to appoint a tied agent it remains fully and unconditionally responsible for any action or omission on the part of the tied agent when acting on behalf of the firm. Member States shall require the investment firm to ensure that a tied agent discloses the capacity in which he is acting and the firm which he is representing when contacting or before dealing with any client or potential client. Member States shall prohibit tied agents registered in their territory from handling clients' money and financial instruments.

Member States may allow, in accordance with Article 13(6), (7) and (8), tied agents registered in their territory to handle clients' money and/or financial instruments on behalf and under the full responsibility of the investment firm for which they are acting within their territory or, in the case of a cross-border operation, in the territory of a Member State which allows a tied agent to handle clients' money.

Member States shall require the investment firms to monitor the activities of their tied agents so as to ensure that they continue to comply with this Directive when acting through tied agents.

3. ~~Member States that decide to allow investment firms to appoint tied agents shall establish a public register.~~ Tied agents shall be registered in the public register in the Member State where they are established. Member States shall establish a public register for tied agents established in their territory.

~~Where the Member State in which the tied agent is established has decided, in accordance with paragraph 1, not to allow the investment firms authorised by their competent authorities to appoint tied agents, those tied agents shall be registered with the competent authority of the home Member State of the investment firm on whose behalf it acts.~~

Member States shall ensure that tied agents are only admitted to the public register if it has been established that they are of sufficiently good repute and that they possess appropriate general, commercial and professional knowledge so as to be able to communicate accurately all relevant information regarding the proposed service to the client or potential client.

Member States may decide that investment firms can verify whether the tied agents which they have appointed are of sufficiently good repute and possess the knowledge as referred to in the third subparagraph.

The register shall be updated on a regular basis. It shall be publicly available for consultation.

[…]

Amendments to Article 31 and 32 of MiFID

Article 31(2)

Any investment firm wishing to provide services or activities within the territory of another Member State for the first time, or which wishes to change the range of services or activities so provided, shall communicate the following information to the competent authorities of its home Member State:

(a) the Member State in which it intends to operate;

(b) a programme of operations stating in particular the investment services and/or activities as well as ancillary services which it intends to perform and whether it intends to use tied agents in the territory of the Member States in which it intends to provide services. In cases where it

intends to use tied agents, the investment firm shall communicate to the competent authorities of its home Member State the identity of those tied agents.'

In cases where the investment firm intends to use tied agents, the competent authority of the home Member State of the investment firm shall, ~~at the request of the competent authority of the host Member State and within a reasonable time~~ within 1 month of receiving the information, communicate to the competent authority of the host member state the identity of the tied agents that the investment firm intends to use to provide services in that Member State. The host Member State ~~may~~ shall make public such information.

[…]

Article 32(2)

Member States shall require any investment firm wishing to establish a branch within the territory of another Member State first to notify the competent authority of its home Member State and to provide it with the following information:

(a) the Member States within the territory of which it plans to establish a branch;

(b) a programme of operations setting out inter alia the investment services and/or activities as well as the ancillary services to be offered and the organisational structure of the branch and indicating whether the branch intends to use tied agents and the identity of those tied agents;

(c) the address in the host Member State from which documents may be obtained; and

(d) the names of those responsible for the management of the branch.

In cases where an investment firm intends to use tied agents established in a Member State outside its home Member State, such tied agents shall be ~~assimilated to the branch and shall be~~ subject to the provisions of this Directive relating to branches.

Part 6: MiFID Options and Discretions

CESR's advice

Proposed deletion of discretions:

CESR proposes the deletion of the following discretions:

Delegation of supervisory tasks

Article 5(5) of MiFID provides that Member States may allow the competent authority to delegate administrative, preparatory or ancillary tasks related to the granting of an authorisation, in the case of investment firms which wish to provide only investment advice or the service of reception and transmission of orders under the conditions established in Article 3 MiFID.

Article 16(3) of MiFID provides that Member States may allow the competent authority to delegate administrative, preparatory or ancillary tasks related to the review of the conditions for initial authorisation in the case of investment firms which provide only investment advice.

Article 17(2) of MiFID provides that Member States may allow the competent authority to delegate administrative, preparatory or ancillary tasks related to the regular monitoring of operational requirements in the case of investment firms which provide only investment advice.

CESR's proposals will exclude the possibility for Member States to allow the competent authority to delegate such administrative, preparatory or ancillary tasks.

Theoretically, the ability to delegate the above mentioned supervisory tasks may result in a more efficient allocation of the necessary human and economic resources. Nevertheless, CESR members do not see any need in maintaining such ability, because these tasks can be effectively undertaken using internal resources. Moreover, in case of delegation, CESR members face liability issues whenever the entity to which these tasks have been delegated would fail to comply with these tasks.

Given that no competent authority has exercised the above mentioned discretions the impact of deleting them will be negligible.

CESR's advice continued

Proposal to amend the discretion:

CESR proposes amending the following discretion:

Tied Agents:

- **Article 23(2) of MiFID:** CESR proposes that Member States should prohibit tied agents in their territory from handling client money and financial instruments.

Proposal to transform the discretion into a rule:

CESR proposes to transform the following discretions into a rule:

Tied Agents:

- **Article 23(1) of MiFID:** Discretion for Member States to allow investment firms to appoint tied agents for certain purposes

- **Article 31(2) of MiFID:** Discretion for the host competent authority to publish information on the identity of tied agents

Please see Part 5 of this Paper.

Telephone conversations and electronic communication:

- **Article 51(4) of Commission Directive 2006/73/EC** – Discretion for Member States to impose obligations on tape recording – Article 13(6) MiFID

Please see Part 1 of this Paper.

Article 61(1) and (2) of MiFID: Reports from branches:

Article 61(1) and (2) of MiFID provides that Member States may:

- for statistical purposes, require all investment firms with branches within their territories to report to them periodically on the activities of those branches (par. 1);
- require branches of investment firms to provide the information necessary for the monitoring of their compliance with the standards set by the host Member State that apply to them (par. 2).

The majority of the Member States -14 for Article 61(1) of MiFID and 24 Members for Article 61(2) of MiFID have opted to exercise these discretions in order to increase information received from branches.

CESR is proposing an amendment to MiFID in order to transform such discretions into a rule, requiring all Member States to allow competent authorities to have the power to require certain information from all investment firms with branches within their territories, for statistical and supervisory purposes.

CESR proposes to change Article 61 of MiFID as follows (provisions which are not reproduced remain unchanged whilst amendments are underlined):

1. Host Member States shall provide that the competent authority may, for statistical purposes, require all investment firms with branches within their territories to report to them periodically on the activities of those branches.

2. In discharging their responsibilities under this Directive, host Member States shall provide that the competent authority may require branches of investment firms to provide the information necessary for the monitoring of their compliance with the standards set by the host Member State that apply to them for the cases provided for in Article 32(7). Those requirements may not be more stringent than those which the same Member State imposes on established firms for the monitoring of their compliance with the same standards.

Indeed, it might be crucial for competent authorities to have the power to require information from branches in order to have a complete series of data of investment activities performed in their Member State on the one hand for statistical purposes under Article 61(1) of MiFID and, on the other hand, to effectively discharge their duties when monitoring the branches' compliance with the applicable rules, for supervisory purposes under Article 61(2) of MiFID.

In particular, it is important for competent authorities to have the ability to gather information on the activities performed by investment firms within their territory, irrespective of their status as a branch or an established home Member State firm, in order to have a wider perception of the market as a whole as well as to promote market integrity and improve investor protection.

Nevertheless, given the different supervisory approaches to this information within the EEA, it is considered more proportionate not to impose on competent authorities to gather (and make use of) the above mentioned information from branches established within their territory.

There is no significant impact arising from the proposed amendment.

Introduction and background

168. MiFID and its implementing measures include 41 discretions, allowing Member States to implement non-harmonised requirements at a national level.

169. Although the use of discretions within MiFID is fully legitimate, the Ecofin Council conclusions of December 2007 aimed at reducing discretions and the Ecofin Council conclusions of May 2008 and June 2009 more generally intended to enhance European supervisory convergence.

170. The Road Map on the revision of the Lamfalussy process set up by the Ecofin Council in December 2007 invited Member States to keep under review the options and discretions implemented in their national legislation and limit their use wherever possible. In a similar way, the Communication of the EC of the 4th of March 2009 took on board the recommendations of the de Larosière Group on the need to develop a harmonised core set of standards to be applied throughout the European Union and the Ecofin recalled in its meeting held on 9 June 2009 the following goal: "Moving towards the realisation of a single rulebook, with a core set of EU-wide rules and standards directly applicable to all financial institutions active in the Single Market, so that key differences in national legislations are identified and removed."

171. Therefore, based on the work conducted by CESR since 2007[30], options and discretions in relation to MiFID and its implementing measures were considered by CESR with the aim of

[30] In October 2007, before MiFID came into force, CESR published an "Overview of National Options and Discretions under MiFID Level 1" (CESR/07-703), which showed if and how Member States have exercised

singling out proposals for further convergence in relation the MiFID review for the investor protection and intermediaries area.

discretions in implementing MiFID; in 2008, the Review Panel conducted a mapping on MiFID, focusing on "Supervisory powers, supervisory practices, and administrative and criminal sanction regimes" (CESR/08-220).

Annex 1 – Legislative or supervisory recording requirements in EEA Member States [31]			
Country	**Scope of requirement**	**Mobile phones?**	**Duration**
Austria	There are no legal or supervisory regulations which oblige the taping of telephone conversations. Although concerning treasury units of credit institutions it is usual that telephone conversations between the salesperson and the client are taped. In relation to the Vienna stock exchange there are no legal regulations which oblige the taping of telephone conversations, but it is usual to tape telephone calls related to the execution of orders.		
Belgium	No requirement.		
Bulgaria	No requirement.		
Czech Republic	All investment firms are obliged by the regulatory authority's rules to keep records of any communications with clients related to investment activity.	If the firm chooses to communicate with clients by mobile phones, it has to record such calls as well.	10 years.
Cyprus	All investment firms are obliged by the Law to keep records for all the investment services and transactions undertaken. It is up to each investment firm to decide the type of record. In practice, if an order/advice is given by the telephone then it is recorded. Prior warning of the recording must be given.	If an order/advice is given through mobile phones, the Investment Firm should record it otherwise will not have other evidence to show its compliance with the relevant obligation.	At least 5 years.
Denmark	No requirement.		

[31] In some Member States without legislative or supervisory recording requirements, investment firms are required to keep tapes under the rules of regulated markets. For example, the Irish Stock Exchange requires member firms to operate an effective telephone recording system in relation to any trading activities they undertake on the exchange. Records must be kept for at least one month after the normal settlement period of the transaction to which they relate.

Country	Scope of requirement	Mobile phones?	Duration
Estonia	There is no direct requirement in place that would oblige the service provider to tape-record the telephone conversations with a client. Although, a requirement applies according to which the service provider must keep records *inter alia* of the communication between the client and the service provider and retain such records. The records must be retained in a durable medium in a way accessible for future reference by the Supervision Authority and in such a form and manner that the following conditions are met: 1) the Supervision Authority must be able to access the records readily and to reconstitute each key stage of the processing of each transaction; 2) it must be possible for the Supervision Authority to ascertain easily any amendments, and the contents of the records prior to such amendments; 3) it must not be possible for the records to be altered otherwise. In practice, many service providers are using tape recording to best fulfill the latter conditions.	Where firms use tape recording, mobile phones are usually not allowed if not equally taped as the office phones.	Firms keeping records *inter alia* of the communication between the client and the service provider, retain such records for 5 years.
France	Under the current AMF general regulation taping of phone lines within an investment service provider is required for traders (persons subject to approval by the firm according to a procedure defined by the AMF who is informed of all such approvals) and, where so decided by the head of compliance (because of the size or riskiness of the trades involved), additional staff participating in the commercial relationship with clients. In the Euronext market rules, there is a requirement for cash market members to voice record conversations relating to any transaction made, or intended to be made, on the securities market. With respect to the Euronext derivatives market, whether there is such a requirement depends on the market. On MONEP and MATIF,	Special authorisation by the firm is required for a trader to be able to conclude trades outside business hours or outside the firm's premises (which would involve using an untaped phone). Requirement applies to conversations regardless of the kind of telecoms equipment used if on the member's premises.	At least 6 months. 6 months 6 months

Country	Scope of requirement	Mobile phones?	Duration
	there is a requirement to have adequate procedures for recording telephone conversations pertaining to the reception, execution or confirmation of orders on a medium that allows subsequent verbatim reproduction of such conversations.		
Finland	All investment firms are required to keep records of client orders in financial instruments.	Requirement applies regardless of telecom equipment used.	2 years and maximum as long as there is a need for ensuring the execution of rights and obligations relating to the order.
Germany	Credit institutions and financial services institutions are recommended by BaFin circular to tape traders' telephone conversations relating to transactions for the entity's own account. In addition, each Exchange has rules which apply to specialists operating on them, who will usually also be subject to a similar requirement. E.G., the Frankfurt Exchange requires specialists to tape every call which is related to the execution of their tasks as a specialist.	According to BaFin circular, the use of mobile phones is only exceptionally permitted if firms have implemented adequate organisational measures to minimise the risk resulting from the use of mobile phones. In practice, As far as recording of mobile phone calls in most cases cannot be ensured, most firms prohibit traders to trade via mobile phones. Mobile phone use is not allowed within the exchanges so calls must be made by land line.	3 months 3 months.
Greece	Since 2005 any person professionally arranging transactions in financial instruments is obliged to record telephone orders to trade. The caller must be notified, at the beginning of the call, that the conversation is being recorded, and, client contracts must include a specific term that provides that	Receiving orders on a mobile phone is not allowed if this will not be recorded by the internal system of the investment firm.	Recordings must be kept for at least 1 year, but the HCMC may order investment firms to retain the data for an additional period, up to 2 years, when an investigation into market abuse is carried out.

Country	Scope of requirement	Mobile phones?	Duration
	orders transmitted via telephone will be recorded and filed and put at the disposal of the HCMC, on request.		
Hungary	Pursuant to the regulations of Government Decree No. 22/2008 on the Business Rules of Investment Firms if an investment firm accepts orders from clients via telephone, fax or other electronic method, the business rules of such firm shall provide for the detailed provisions: a) on the procedure for accepting such orders (voice recording or written recording by the person accepting the order) and preparation of a written contract, timeframe for preparing the contract in writing; b) on the retention period of voice recording. If the order is recorded, the business rules shall regulate customer access rights to such recordings. Pursuant to consumer protection provisions (effective since January 1, 2010) investment firs shall provide for receiving complaints from clients via telephone. Such conversations shall be recorded and retained for a period of 1 year.		1 year.
Italy	Intermediaries, including fund management companies, are required to tape all orders received from any customer.	The regulation applies regardless of the type of phone used.	5 years.
Ireland	No requirement.		
Latvia	Rules approved by the FCMC require that all telephone conversations where clients place orders shall be recorded. (This comes from the provision that investment firms should have in place evidence that orders are given by clients).	The regulation applies regardless of the type of phone used.	At least 10 years.
Lithuania	Rules approved by the Securities Commission require recording of telephone conversations in which a customer order is placed. The Rules apply to all companies providing investment and /or auxiliary services	Not known.	At least 10 years (the general term of limitation of actions).

Country	Scope of requirement	Mobile phones?	Duration
	and carrying out investment activities that accept customer orders.		
Luxembourg	No requirement.		
Malta	No requirement.		
Netherlands	No requirement.		
Norway	All brokers are required to tape record all buy/sell orders and indications of such orders made by telephone.	The regulation applies regardless of the type of phone used.	All recorded material has to be retained for 3 years from the day the recording was made.
Poland	Firms are required to tape orders received by telephone.	The regulation applies regardless of the type of phone used.	All tapes have to be retained for 5 years.
Portugal	According to Portuguese law, telephone orders between a client and a financial intermediary have to be taped (Article 307.º-B PSC-Portuguese securities Code).	The regulation applies regardless of the type of phone on which the order is received.	All tapes have to be retained for 5 years.
Romania	Financial intermediaries are obliged to record on magnetic tape or by other similar means the transmissions of clients' orders and disclosure of information regarding conflicts of interest to the client. All clients must give written consent to telephone orders being recorded; where consent is not given then telephone orders cannot be accepted.	The requirement does not specify the type of phone and therefore applies to both landline and mobiles.	At least 5 years.
Slovakia	Not known.		
Slovenia	Not known.		
Spain	Entities providing investment services must tape record any telephone conversation in which an order is made. Prior warning of the taping must be given to the relevant client, which can be done in the contract which allows for orders to be made over the telephone.	The requirement does not specify the type of phone and therefore applies to both landline and mobiles.	Telephone recordings must be kept for a minimum of 5 years. Whenever the transaction is disputed by the client, the recording must be kept until the relevant

Country	Scope of requirement	Mobile phones?	Duration
			dispute is solved.
Sweden	All telephone conversation at the broker desk at an investment firm should be recorded. This also apply to conversations which relate to client orders on other telephones in premises with access to the trading system of a regulated market or an MTF, or premises which have been specifically adapted for financial instruments trading. The requirements apply to investment firms authorised by Finansinspektionen, not EEA-branches in Sweden.	Mobile phones used in the business should be owned by the investment firm/bank. Client orders received by mobile phone or in a meeting with the client, and therefore not recorded, should be documented according to the entity's guidelines.	At least 5 years.
UK	Conversations and electronic communications covering the receipt of client orders and dealing in financial instruments within the scope of the UK's market abuse regime. There is an exemption for portfolio managers.	The FSA consulted in March 2010 on removing an exemption for conversations on mobile phones And is expected to publish its decision in Q4, 2010.	6 months. The FSA can request a firm to hold records for longer.

COMMITTEE OF EUROPEAN SECURITIES REGULATORS

Date: 29 July 2010
Ref. CESR/10-860

CESR's Responses to Questions 15-18 and 20-25 of the European Commission Request for Additional Information in Relation to the Review of MiFID

Conduct of business rules

CESR considers that the European Commission (EC) questions 15 to 25 raise some more general issues that CESR develops below. These issues concern the way some existing MiFID conduct of business rules are applied by investment firms, as well as problems related to client protection with which CESR members were confronted during the financial crisis.

1) Clarification of some definitions and scope

CESR believes that it is necessary to ensure that the scope of MiFID is as clear as possible. Clarity facilitates compliance and also means that competent authorities can take effective action to protect investors.

CESR believes that there is a degree of ambiguity about the way in which MiFID applies to some aspects of the issuing of securities. Underwriting and placing are performed on behalf of the issuer or owner of the relevant financial instruments. However the issuance or placing of securities involves the sale of financial instruments to investors. In some cases it is very clear that the sale of the financial instruments involves the reception and transmission of orders or the execution of client orders by an intermediary. If an investor subscribes to an issue of new securities through an intermediary who is not acting on behalf of the issuer then that intermediary is clearly receiving and transmitting or executing an order on behalf of a client. However, the directive does not explicitly mention whether or not an investment firm acting on behalf of an issuer can as part of the same transaction be acting on behalf of the investor as well.

It cannot have been the intention of European legislators to leave investors unprotected in circumstances where they would have a reasonable expectation that an investment firm is acting on their behalf. Therefore, CESR believes it would be helpful to clarify this as well as the situation when an investment firm or credit institution issues its own securities.

The issue of a credit institution issuing its own securities was raised in a question to the Commission's Q&A database on MiFID. The question asked and the response given was as follows:

Question: *Are the "know your client" requirements applicable to the credit institutions (banks) in those cases where they issue their own securities for primary trading (bearing in mind the fact that such MiFID rules are not applicable to the regular issuers)?*

Answer: *Public offering is not a MiFID service or activity in itself; the regulatory obligations in respect of public offerings are primarily addressed in the Prospectus Directive 2003/71/EC and these obligations apply to any issuer (subject to certain exceptions), regardless of whether it is a credit institution or another corporate entity.*

Conduct of business obligations apply when a MiFID service is provided in the subsequent sale and distribution of such issued securities to clients. The nature of the obligations will depend on the type of the client to whom the service is provided. This would include providing appropriate risk warnings and product information, performing a suitability or an appropriateness test if required (including relevant "know your client" requirements) and going through the client classification process.

For example, a credit institution issues shares and distributes them to its clients through its branch network. When a client visits the branch the computer of the branch sales person reminds the sales person to engage in a conversation with the client to see if the client would be interested in subscribing to the new shares issued by the credit institution. The sales person effectively takes the initiative in recommending the investment to the client, who accepts the investment.

In this case, MiFID does not apply to the public offering of shares by the credit institution, which is governed by the Prospectus Directive. However, MiFID does apply to the sale of a financial instrument

–an advised sale of own shares in the above scenario. The 'know your client' requirements will therefore apply to the advised sale and the credit institution will need to perform a suitability test on its client.

CESR believes that it is necessary to consider revisiting MiFID to see if greater clarity can be provided in this area. Such work could look at the treatment of clients entering into transactions (advised or not) with an investment firm or credit institution in relation to the firm's own securities and securities of other issuers, including where these are part of a public offer of securities.

CESR also believes it is necessary to amend the technical wording of MiFID in other areas in order to clarify the scope of the directive. In particular, the review should clarify the treatment of the common situation where an investment firm is simultaneously both dealing on own account and providing an investment service to a client. This will require an examination of several provisions that use the word "order": for example, in the best execution regime and in the client reporting requirements (investment firms must report transactions to clients when they have "carried out an order" according to Article 40 of the Level 2 Directive), since such terminology appears inappropriate outside traditional broker markets and may be wrongly understood as ruling out the application of these provisions to dealer markets in all cases.

2) The execution-only regime

Article 19(6) of the MiFID Level 1 Directive provides that under the execution-only regime the investment firm should comply with its obligations under Article 18. This provision can cause confusion if it is wrongly interpreted as the only conduct of business rule firms need to comply with under the execution-only regime. CESR considers that it should be made clearer that, even under the execution-only regime, firms must comply with all the applicable conduct of business rules (such as, for example, the obligation under Article 19(1) to act honestly, fairly and professionally in accordance with the best interests of its clients) and the Article 19(3) obligation to provide appropriate information to clients to help them take investment decisions on an informed basis).

Furthermore CESR is of the opinion that the condition of Article 19(6), according to which the service is to be provided at the initiative of the client, should be clarified further (recital 30 of MiFID provides some guidance on the phrase) in order to enhance the protection of the client. Some CESR members were, for example, confronted with the practice that clients who used to be in an advice relationship, and therefore should be treated under the suitability regime, were asked by some firms to execute their transactions under the execution-only regime when the intended transactions were not considered to be suitable for those clients.

3) Disclosure measures for OTC derivatives and other complex or tailor-made products

Recital 44 of the MiFID Level 2 Directive refers to the right of a professional client to ask for information from investment firms and the obligation on investment firms to respond to reasonable and proportional requests for information. As a result of the financial crisis, CESR believes that there is a case for strengthening investors' right to request information for professional and retail clients who trade OTC derivatives and other complex or tailor-made products, although on an appropriately calibrated basis. CESR thinks that it is worth exploring strengthening the right of retail and professional clients to request information in the following two areas:

- First, prior to the transaction, a risk/gain profile in different market conditions.
- Second, independent quarterly valuations of such complex products. A right of this sort would require a definition of the meaning of "independence" for valuation purposes.

As part of considering these proposals it would obviously be necessary to assess the potential costs for investment firms, particularly in relation to the proposal for independent valuations.

4) Specific organisational requirements related to the launch of new services or products

Many of the recent incidents detrimental to investors resulted from the inappropriate design of new products, the existence of distribution and sales policies that are not compliant with Articles 18 or 19 of the Level 1 Directive or the lack of adequate controls around product development.

MiFID requires investment firms to have "adequate policies and procedures" designed to detect and minimise any risk of non-compliance with the obligations set forth by MiFID, but this appears to be too high-level. Although many firms have such controls already, it appears necessary to strengthen compliance controls around new products (new for the market or for the individual firm). Some CESR members have already, or are in the process of, highlighting the importance of such controls and detailing the types of systems and controls firms should set up.

Accordingly, CESR believes that under MiFID investment firms should be required to have specific organisational requirements to ensure that for new products and services offered to retail and professional clients (and variations to existing products and services):

- as part of acting in the best interests of the client under Article 19(1) of MiFID that an assessment is made of the compatibility of the product or service with the characteristics and needs of the clients to whom these products will be offered;

- the compliance function, in discharging its responsibilities under Article 6 of the MiFID Level 2 Directive, has the responsibility for ensuring that procedures and measures are in place to ensure the product or service complies with all applicable rules including those relating to disclosure, suitability/appropriateness, proper management of conflicts of interest and inducements;

- that under Article 7 of the MiFID Level 2 Directive, an investment firm has policies and procedures in place to ensure that the risks to the firm of new products and services are adequately managed in the light of the level of risk tolerance that the investment firm has set;

- where appropriate, products and services are stress tested to identify how they might perform in a range of market environments and how clients could be affected;

- investment firms review periodically the distribution and performance of products and services to ensure that what is occurring in practice corresponds to what was originally envisaged in terms of the performance or the product or service and its distribution; and

- information about products and services should be inside of the scope of the compliance reports to senior management required under Article 9(2) of the MiFID Level 2 Directive.

As per the second paragraph of Article 6 of the MiFID Level 2 Directive, these organisational requirements would obviously have to:

"… take into account the nature, scale and complexity of the business of the firm, and the nature and range of investment services and activities undertaken in the course of that business."

Part of the nature of the business that would need to be taken into account would be whether an investment firm is a 'product provider' or 'distributor'. For example, a requirement such as stress testing the characteristics of a product sits more naturally with a product provider than a distributor, although the distributor will need to know about the characteristics of the product. Regarding conflicts of interest, it is indeed important that the corporate compensation mechanisms are built on criteria that do not conflict with the best interests of the customer. Specific focus should be placed on the remuneration of 'relevant persons' (as defined in Article 2(3) of the MiFID Level 2 Directive) in relation to the various types of products offered in order to limit the risk that those

products offering the best remuneration to the firm's relevant persons are pushed in front of other (less lucrative) products that would be more in line with the best interests of customers.

Such a reform would of course help to protect both retail and professional clients. In order to improve efficiency of external control, CESR believes that periodic reports to the firm's senior management, and to regulators on request, should be made by investment firms regarding their new products and financial innovation, presenting their added value for clients and the type of clients for whom those products are suitable.

General assessment

<u>**Complex/non-complex financial instruments and appropriateness test.**</u>

Q15: In the feedback statement to the CESR consultation paper "MiFID complex and non-complex financial instruments for the purposes of the Directive's appropriateness requirements", CESR raised some concerns about the classification of UCITS, which are always classified as non-complex instruments under Article 19(6) of MiFID and referred to the European Commission initiative on this topic. In addition to the work already carried out, please consider technical criteria to possibly distinguish UCITS between complex and non complex financial instruments for the purposes of the execution-only regime.

In CESR's Feedback Statement[1] on the MiFID complex and non-complex financial instruments, CESR recalled that Article 19(6) treats all UCITS as automatically non-complex and raised the question as to whether this remains a correct approach. As CESR reported in its Feedback Statement, responses to the consultation on this point were sharply divided. Some respondents felt that the treatment of the UCITS category for the purposes of the appropriateness requirements could better reflect the nature of the underlying investments, while a majority of respondents felt that (given the agreed EU UCITS regime) all UCITS should continue to be treated as automatically non-complex for the purposes of the appropriateness requirements. This majority view was also again expressed in responses to CESR's consultation on draft technical advice to the Commission in the context of the MiFID Review (CESR 10-417).

CESR recognises that making any definitive proposals on the UCITS category at present is difficult. Any definitive proposal raises wider issues about the established and agreed EEA UCITS regime (which regulators deem suitable and which is a powerful global brand) that are outside the scope of CESR's current exercise. However, CESR believes that there is a case for considering treating structured UCITS and UCITS which employ complex portfolio management techniques as complex financial instruments for the purposes of the appropriateness test (this is a concept that would need to be elaborated possibly through binding technical standards).

The Commission should be aware that there are several practical issues that would flow from considering some UCITS funds as complex financial instruments which would also need to be considered:

– first, whether it would be left to investment firms distributing UCITS to determine whether any individual fund was complex or non-complex or whether fund operators should be required to provide such information to distributors;

– second, how information about the classification of a UCITS as complex or non-complex financial instrument would be communicated to clients, particularly given that the nature of the UCITS may change over its lifetime, and how the way that classification relates to the Synthetic Risk Reward Indicator in the Key Investor Information document would be explained to clients (because complexity and risk may differ);

[1] CESR/09-558.

– third, whether non-UCITS collective investment schemes (and other substitutable products if the scope of the appropriateness test were to be extended through the PRIPS initiative) would be treated consistently with UCITS in determining whether or not they are complex financial instruments; and

– fourth, whether the appropriateness test should be applied to direct sales by UCITS management companies to prevent an unlevel playing field between direct and intermediated sales of UCITS.

Q16: Please assess possible additional criteria to further refine the scope of financial instruments under Article 19(6) MiFID, such as:

Q16(a): Extending the element of the admission to trading on regulated markets - currently only required in the case of shares - to other financial instruments,

Q16 (b): Taking into account the element of the risk of the financial instruments (e.g. high quality rating of the financial instruments involved).

See CESR's technical advice on the MiFID review.

Q17: Please assess the possibility, in addition to or as an alternative to the assessment under Q16, to require a general consideration of the ability of the client to understand the implications of execution-only services in terms of reduction of applicable protections.

Regarding the execution-only regime, CESR considers that it is unclear whether an additional requirement (beyond what MiFID already requires) for firms to undertake a general assessment of the client's ability to understand the implications of execution-only services - in terms of reduction of the client's applicable protections - would provide additional benefits to the client. In particular, the difference in outcomes between such an assessment and the appropriateness test is considered to be unclear; as both requirements may relate to the same criteria - knowledge and experience of the client. If the intention of proposing the new requirement is to avoid firm's mis-selling execution-only services to retail clients, any new requirement should (as now) focus on the types of financial instruments that can be bought under the execution-only regime and the other eligibility conditions (such as the "initiative" test) rather than on a further ex ante assessment.

<u>**Inducements requirements**</u>

Q18: In a 'Level 3' context, CESR already focused on inducements in 2007[2] and in 2009[3] and is currently finalising a report on good and poor practices. The different aspects of Article 26 of the Implementing Directive have been considered, such as the different categories of inducements, the conditions provided in order to allow firms to provide or receive commissions and other benefits (e.g. the requirement to disclose certain inducements or the design to enhance the quality of the service to clients and the ability not to impair compliance with duty to act in the best interest of the client), and the classification of "proper fees" (Article 26(c)).

We ask CESR to share its supervisory experience and to consider whether, in the different national contexts, the existing regime is able to deliver an appropriate level of investor protection or whether further action may be needed. This may include focusing on the following areas: 1) classification of different categories of inducements; 2) disclosure regime under Article 26(b)(i); 3) conditions under Article 26(b)(ii).

[2] CESR/07-228b.
[3] CESR/09-958.

The CESR report on good and poor practices regarding inducements[4] (and the associated feedback statement) summarises CESR's findings and reactions concerning the application of the MiFID inducements rules in the EEA. As a CESR document, this report reflects the views of the various European supervisors.

Further to that report the following points can be highlighted:

- the vast majority of investment firms seem to understand correctly the **classification** regime under the MiFID inducements rules;
- there are differences between investment firms regarding the level of **disclosure** (which can hinder access to and comparability of information). Moreover, the MiFID inducements rules do not deal properly with the (frequent) situation where it is, in practice, impossible to disclose inducements in advance;
- several firms seem to have difficulties understanding or applying properly the "**enhancement condition"** under Article 26(b)(ii).

Those points are developed below, together with CESR's concerns about them as well as CESR members' experience.

Classification regime

The classification issue seems to concern mainly the way firms comply with the MiFID and is therefore probably better dealt with through Level 3 work. By providing guidance, the CESR report on good and poor practices regarding inducements should be helpful. Level 3 work also offers the necessary flexibility to handle the great diversity of situations that can be encountered regarding that issue.

Disclosures

CESR and its members have noticed that the disclosure requirements - especially those in relation to inducements made or received in connection with the distribution of financial instruments[5] - are not applied uniformly, which raises investor protection issues.

More especially, three types of problems have been identified:

- the content of the disclosures to be provided to clients varies considerably from firm to firm, limiting the ability of the client to use that information in making decisions about particular firms and services, and there is uncertainty concerning the distinction between a summary and full disclosure;
- MiFID does not foresee any ex-post reporting while it appears that - in practice - it is not always possible to disclose a priori the exact amount of inducements (in many cases, firms may only be able to disclose ex ante the method of calculating inducements using bands);
- investment firms have considerable discretion as to how they make disclosures about inducements and as a result these disclosures are not necessarily well integrated with other product or service specific information.

CESR has expressed its view regarding the content of the disclosures in its report on good and poor practices concerning inducements (CESR/09-958 - see paragraphs 95 to 97, as well as paragraphs 113 and 114).

As stated in CESR's report on good and poor practices regarding inducements (see paragraphs 89 to 91), supervisors have also observed that most investment firms disclose third party payments made or received in a summary form.

[4] CESR/09-958.

[5] The distribution of financial instruments is indeed the area that impacts the most retail clients and where the most problems have been identified.

The combination of incomplete disclosures (as a consequence of varying interpretations of the disclosure requirements) with the widespread use of summary disclosures can create problematic situations. For example, summary disclosures are generally provided at the beginning of the client relationship. When investment advice is provided at a later point and the client does not request additional information concerning the inducements according to Article 26 MiFID Level 2 Directive, the client may be uncertain about the precise amount of inducements the firm will receive for the financial instrument that has been recommended to him.

Concerning the reporting requirements, firms cannot always disclose a priori the exact amount of inducements (or provide a priori detailed information about that amount) but only provide, by using bands, the method of calculating such an amount. Some firms disclose, on a voluntary basis, the exact amount ex-post. CESR regards this as a good practice, as this enhances the quality of the information received by the client and thus investor protection.

Furthermore, CESR's work also illustrates the difficulty in distinguishing between summary and detailed disclosure, the content of both being, in fact, quite similar.

Also, where payments from third parties are linked to specific products it would help if the relevant disclosure about the payments under the inducement rules were to be linked to other information about the product.

Finally, three further remarks can be made:

– One CESR member (BaFin) has found that in practice - due to the difficulty firms have in implementing the "enhancement condition" - the disclosure requirements appear to be a more effective tool in combating conflicts of interests arising from payments received from product providers than the "enhancement condition" (this highlights - if needed - the importance of disclosures but does not mean however that the "enhancement condition" is useless).

– In one Member State (France), a study conducted on financial products offering special tax benefits highlighted that inducements may not be transparent enough for investors and that fees may be significantly increased by the high level of commissions given to distributors, who do not always provide a level of advice proportionate to the amount of the fees received.

– Another Member State (UK), has developed rules which would allow investment firms providing investment advice to continue to be paid by a rebate from the commission the client pays to a product provider but prevent the product provider from setting the amount of the rebate (which would have to be agreed between the client and the adviser).

"Enhancement condition" and ""best interests of the client condition"

CESR is of the opinion that the "enhancement condition" is an important question. CESR has however observed that the "enhancement condition" appears to be difficult to handle and assess. It requires a subjective assessment, and has thus been interpreted differently by firms, sometimes creating an unlevel playing field. Accordingly, it has appeared that external auditors charged with assessing compliance with code of conduct requirements had difficulties in reviewing firms on their compliance with the inducement regulation and more especially the "enhancement condition". The difficulties often concern the question as to which measures are deemed to enhance the quality of services provided to clients.

The difficulty in applying the "enhancement condition" is also linked to the different distribution systems and market structures in the EEA Member States.

Recital 39 of the MiFID Level 2 Directive seems to provide wide protection for investment advisers when receiving payments from product providers.

The fact that some firms tend not to understand properly the distinction between the “enhancement condition” and the “best interests of the client condition” also contributes to the difficulties surrounding the application of those conditions.

The rule does not seem to take into account the differences that may exist - regarding conflicts of interest and their intensity - depending on the type of service provided.[6] This is particularly true regarding portfolio management and investment advice services, where there is a higher risk of conflicts of interest, due to the fiduciary duty the firm owes to its client (when providing such services, an investment firm is acting in the exclusive interest of its client).

This risk is highest when the firm provides portfolio management due to the fact that the portfolio manager may take a decision for the client without prior consent from the client. It is thus hard to imagine how a firm providing a portfolio management service, for example, can receive inducements from a third party without impairing its duty to act in the exclusive interest of its client.

Here, it is worth considering:
- How the MiFID inducements requirements work in relation to the distribution of financial instruments through portfolio management or investment advice services?
- How conflicts of interest can be dealt with (and can they be dealt with) in such situations?
- How to minimise the product provider influence when it pays inducements to the distributor?

During its recent survey, CESR has observed that few firms have been able to demonstrate appropriately that making or receiving inducements when providing portfolio management services or investment advice services is designed to enhance the quality of the service provided to the client.

In its 2007 paper on inducements (CESR/07-228b), CESR had highlighted that “*the receipt of commission in addition to the management fees received for the service of portfolio management is clearly of a nature that could impair the firm’s duty to act in the best interests of its client*”. Therefore it has been highlighted that, outside the option to repay to clients any commissions received, “*it would be difficult for portfolio managers to meet the … conditions within Article 26*” (example V).

Taking into account those elements, the CESR members wonder if this does not raise the issue of whether inducements should not be forbidden when portfolio management services are being provided. Possible drawbacks of a ban could be that it might favour group products over third-party products, lead to hard selling and higher turnover of client portfolios.

Tied agents

Q20: Please share your experience regarding any widespread supervisory problems involving tied agents notably concerning any organisational or conduct of business matters related to tied agents and to firms appointing tied agents.

As stated in Part 5 of CESR’s technical advice for the MiFID review on investor protection and intermediaries issues, CESR considers that the regime governing investment firms’ use of tied agents has worked well since the implementation of MiFID. In particular, CESR does not believe that there is a need to change the rules governing tied agents’ supervision and investment firms’ oversight of their tied agents. However, this does not rule out the possibility of future work at Level 3 to provide guidance on how investment firms oversee tied agents through effective internal controls and other arrangements.

Underwriting

Q21: Corporate finance business is covered in MiFID under different investment and ancillary services: underwriting and placing, advice to undertakings, including services

[6] Each service does not give rise to the same type of conflict of interest and the intensity of the conflict may vary depending on the service provided.

relating to mergers, services related to underwriting (Annex I, Section A(6) and (7) – Section B(3) and (6)). Investment firms providing the investment services of underwriting and placing should be authorised and are subject to the MiFID requirements. However, further aspects concerning these services are not regulated under the Directive. This includes the relationship between intermediaries and issuers, the process of issuing and allocating the financial instruments, the organisation of underwriting syndicates, the pricing of financial instruments.
Please provide a general description concerning the following aspects:

Q21(a): The process followed by investment firms and credit institutions in providing the services of underwriting and placing in equity and bond markets;

Q21(b): Your experience in supervising entities providing the above mentioned services;

Q21(c): Concrete cases which, over the last years, may have attracted substantial level of criticisms from investors, issuers or intermediaries.

Below are some notes offering descriptions and observations on underwriting and placing.

The underwriting and placing process – some examples.

There is no one single process followed by investment firms and credit institutions in providing the services of underwriting and placing in equity and bond markets across Europe. Processes depend on the instrument involved, the issuer and the *mores* and rules of the local market. Below are descriptions of the process of equity rights issues in the UK and Eurobond debt issues. These are intended to give a flavour of the sorts of processes involved in underwriting and placing, but are obviously far from exhaustive and are not intended to be a model description of how these processes should work.

Underwriting rights issues in the UK. Depending on the funding requirement, multiple underwriters may be engaged. For example, the £13.5 billion Lloyds Banking Group plc rights issue in November 2009 had a total of 21 banks involved, two of them acting as global coordinators (or lead underwriters).

The following steps are involved in a typical capital raising by way of a rights issue (the preferred equity capital raising method in the UK):

- A company will identify the need to raise additional capital (this may be for a new acquisition, to repay debt, alleviate pressure on key financial ratios, offset portfolio losses, etc) and together with corporate finance advisers will decide on how much is required and the type of funding (debt or equity).

- Then the choice of mechanism will be decided (e.g. rights issue, open offer, or "placing").

- Then a lead underwriter(s) is selected and discussions on the precise structure of the issue (issue price, timing) and the detailed work on pulling together financial statements, the prospectus and investor communications begins. This will involve working with law firms, accounting, and investor relations professionals.

- In the lead up to the announcement of the capital raising (usually a few days, but perhaps up to a week, before launch of the issue), the lead underwriters will usually undertake "pre-marketing" activities.

- On launch, the lead underwriters will be at risk for the entire issue until they are able to secure sub-underwriting commitments from institutional investors. Usually the commitments are secured within a few hours after launch.

- Following the close of the issue, any rights not taken up will be placed with sub-underwriters or sold in the market. This is managed by the lead underwriters.

The whole exercise described above will take a minimum of two months and could stretch to six months or more. During this period, the market is constantly moving which makes the whole process very challenging.

The structure and quantum of the capital raising are decided at the very start of the process and, after that planning stage, are generally not open for negotiation – they are decided according to the needs of the company and investor appetite. After this the negotiations will focus on the pricing of the issue. The use of independent financial advisers, other than the issuer's existing corporate broker, to advise on the funding decision is widespread but their involvement in the underwriting negotiations and offer process is limited.

The terms on which the underwriting is to be provided are set out in an underwriting agreement between the underwriter(s) and the issuer. They are generally drafted by the underwriter's legal advisers and follow a fairly standard form, but as with any commercial contract there is scope to alter the standard terms. Restrictions on hedging by underwriters and sub-underwriters (i.e. short selling) during the rights issue have become commonplace in underwriting agreements. Other areas where negotiations may focus are the warranties, indemnities and termination rights. Contractual agreements are also signed between the lead underwriters and any sub-underwriters. These usually mirror the obligations in the underwriting agreement.

There are four ways underwriters seek to reduce the underwriting exposure that arises on signing an underwriting agreement. All of these methods might be used to mitigate risk. These include: pricing at a deep discount; pre-marketing; securing sub-underwriters; and hedging trades. Pre-marketing involves making the major shareholders of the company insiders up to a week (or perhaps longer) before the public announcement of the capital raising in order to get strong indications of their appetite for the issue and their likely level of sub-underwriting participation. The number of insiders could therefore be relatively large but all such investors will have policies and procedures in place for handling inside information. The lead underwriter(s) use their sales people to syndicate the underwriting risk amongst a group of sub-underwriters. These may be other banks, institutional shareholders or even hedge funds. As sub-underwriting is a risk mitigation tool of the underwriter, it is up to them to determine how much of the issue to syndicate – the issuer does not normally get involved in this decision. Hedging trades usually take the form of market index put options where the issuer makes up less than 10% of the index.

Underwriters/advisors communicate regularly with the issuer and its board in the lead up to the launch of the capital raising to appraise them of market conditions and the likelihood of deal success. This communication becomes very frequent during the capital raising subscription period.

Underwriting in the Eurobond debt markets. In the Eurobond debt markets, underwriting normally takes place on a soft basis. An obligation only arises for the underwriters after a process of book building has been completed. Investment firms and credit institutions compete to win mandates from issuers. Their proposals will cover various aspects of the detail of the issue including the fees they expect to receive. Issuers will then select a few of the bidders to run the issue and the successful bidders then work as a single team in providing a service to the issuer. Communication with the issuer is on a joint basis and they are normally responsible for an equal share of the offer and they operate a single 'pot' order book for the issue rather than individual books.

The issuer negotiates the fees it will pay the bookrunners (each of whom may have suggested different fees in their bids). Fees will vary with market conditions, the creditworthiness of the issuer and the sort of instrument to be issued. This competitive bidding and negotiation over fees contrasts with the situation in the US where there is a schedule of fees for different types of issue.

The subsequent key steps in the process of the issue are then all subject to the approval of the issuer. This will include the information that will be given to investors about the issue, the approach to allocation that the intermediaries will take and the price of the transaction. Investors get equal

access to information about the issue with relevant announcements being made through dealing screens.

As part of finalising the details of a transaction the bookrunners are likely to have 'pre-sounding' conversations with investors in order to get a sense of the likely appetite amongst investors for an issue. Such discussions will work from a common script. In certain cases this will involve wall-crossing a small number of investors to enable a more detailed conversation to be held about a prospective issue. Such wall-crossing conversations are more likely to happen where volatility in markets makes it more difficult to get a sense of likely investor appetite for an issue from more general conversations that do not require investors to be wall crossed.

The pricing of an issue is agreed with the issuer. Price normally mainly reflects market conditions at the point of the issue and the current price of comparable issues.

During pre-sounding or following the announcement of an offer but before the book opens investors may give the bookrunners indications of their likely appetite for the offer. These indications do not bind the investors and are not taken as firm orders by the bookrunners. Once the book opens the bids received are transparent to the issuer but not to investors. Books traditionally have been open for a period of up to two days but recent strengthened investor appetite and market volatility has frequently seen them open for only two hours. Authorisation is sought from the issuer to close the book.

Once the book has closed and the underwriter is on risk, then allocation takes place based on the parameters that have previously been indicated to the issuer. A broad range of criteria normally influence allocations. These will include a desire to balance long and short term investors, the degree of commitment that investors have shown to an issue or an issuer and judgements about the extent to which orders have been inflated. Issuers can, if they wish, go through the allocation line-by-line with the bookrunners before agreeing it.

Underwriting and placing – supervisory concerns
Competent authorities have long been concerned by potential problems connected to the offering of equity and debt securities. This is because of the potential conflicts of interest between:

- the investment firms and credit institutions undertaking the underwriting and placing and the issuer of the equity or debt;

- the investment firms and credit institutions undertaking the underwriting and placing and investors in the offering of equity or debt;

- the issuer of the equity or debt and the investors in the offering; and

- different investors in the offering.

The specific sorts of potential problems that competent authorities have sought to deal with have included:

- information being provided to investors about offerings on a selective basis and/or being not fair, clear and not misleading;

- inadequate controls over flows of information within investment firms and credit institutions between their corporate finance teams on the one hand and their teams responsible for proprietary trading and execution of orders and portfolio management on the other;

- allocations of securities in oversubscribed offers which have served the interests of the investment firm or credit institution rather than the issuer;

- when acting for investors the distribution of allocations received in an offering which have favoured the interests of some investors at the expense of others;

- pricing of offerings which have favoured institutional investors rather than issuers, or issuers rather than retail investors;

- exploitation of the relative ignorance of retail investors about pricing;

- failing to look after the best interests of retail clients when placing new issues of securities with retail investors; and

- poor record keeping.

General guidance on underwriting and placing

In 1999 CESR's predecessor organisation (FESCO) sought to address some of these issues through a paper on "Market Conduct Standards for Participants in an Offering".[7] This paper attempted to support the EU legislative framework that existed at the time (Public Offers Directive 89/298, Admission to Listing Directive 79/279, Investment Services Directive 93/22 and Insider Dealing Directive 89/592) which was quite high level. The standards FESCO produced covered: information disclosure to the market, information flow within organisations and trading issues.

CESR itself published guidance in 2002[8] on stabilisation and allotment. This was intended to serve as a baseline for further EU work in this area. The material on stabilisation was picked up in the subsequent EU regulation on stabilisation as part of the Market Abuse Directive. The material on allotment applied in distributions where there was a significant retail participation. It did not apply to exclusively wholesale distributions. The Prospectus Directive picked up part of the elements of the CESR standards on allotment.

The FESCO standards were published towards the height of the boom in technology, media and telecom stocks. This was a period when there was a high level of regulatory focus on issues of securities in both Europe and the US. In the light of abuses that the SEC discovered in the US, the FSA in the UK decided to clarify how its conduct of business rules applied to issues of securities. The guidance[9] issued in 2003 covered, amongst other things:

– the overriding responsibility of the firm to have in place systems and controls to ensure the duties owed to clients (both issuers and investors) were identified and discharged appropriately;

– ensuring that the corporate finance client receives unbiased advice on pricing which is not driven by the part of a firm acting on behalf of investors;

– agreeing objectives with issuers on allocations;

– ensuring allocation decisions were not influenced by other business the firm was conducting or hoped to conduct;

– reviewing how systems and controls worked on an issue after the event.

The International Capital Markets Association has a Handbook covering underwriting. This deals with issues relating to the underwriting of debt, equity and medium-term note issues. The provisions of the Handbook are not legally binding obligations but set out certain requirements that ICMA members believe should be adhered to in order for the underwriting process to run smoothly.

[7] http://www.cesr.eu/index.php?docid=320
[8] http://www.cesr.eu/index.php?docid=179
[9] See CP 205 http://www.fsa.gov.uk/Pages/Library/Policy/CP/2003/205.shtml

The provisions in the ICMA Handbook mainly deal with the relationship between the lead manager and other investment firms involved in the underwriting rather than the relationship between the lead manager and the issuer or between investors and investment firms. In relation to the underwriting of debt issues there are a couple of provisions dealing with the provision of information to investors. There is also one provision dealing with the "pre-sounding" of transactions which requires the firms involved in a new issue to collectively discuss the potential sensitivity of the information to be disclosed and the procedures for managing the disclosures.

Current regulatory framework

Much of what FESCO said remains of relevance today but obviously the regulatory framework has undergone a complete overhaul. The relevant Directives are now the Prospectus Directive 2003/71, the Consolidated Admissions and Reporting Directive 2001/34, the Markets in Financial Instruments Directive 2004/39 and the Market Abuse Directive 2003/6. This revision of the Directives has led to a more detailed regulatory framework which, amongst other things:

- has very specific information requirements for prospectuses when there is a public offering of securities;
- prohibits market manipulation;
- regulates the stabilisation of new issues of securities;
- sets specific rules dealing with conflicts of interests;
- regulates payments to third parties in connection to the provision of investment services;
- requires firms to have appropriate systems and controls including keeping proper records of their activities;
- obliges investment firms and credit institutions to act in the best interests of their clients; and
- requires information to clients to be fair, clear and not misleading.

This new framework does apply to the relationship between intermediaries and issuers, the process of issuing and allocating financial instruments, the organisation of underwriting syndicates, and the pricing of financial instruments. For example:

- intermediaries have to act in the best interests of the issuer and communicate with them in a way that is fair, clear and not misleading (even where the issuer is a professional client); and
- allocations and pricing are governed by conflicts of interest rules.

It is, however, true to say that the legal framework deals with these issues in a general rather than a specific way reflecting the principles-based nature of part of the regulatory framework. It is also the case that CESR has not updated the FESCO standards or its own 2002 standards in the light of the revision to the regulatory framework. There is therefore no pan-European guidance on the application of the current regulatory framework to the issuing of equity and debt. There is, however, a certain amount of guidance that has been issued by individual competent authorities.

Retail investor protections

Competent authorities in some Member States have paid particular attention to the dangers of detriment to retail clients when integrated intermediaries involved in underwriting and placing financial instruments also distribute products to retail clients.

In 2005 one CESR member issued guidance regarding the application of conduct of business rules to fixed income securities issued by financial institutions and marketed to retail clients. This guidance said:

1. Intermediaries shall establish internal procedures in order to verify that the financial conditions of the issue are market conditions, taking into account the differences that might arise due to volume, credit quality, time to expiration and liquidity. In order to ensure that it complies with this, the firm could:
   - Assign a percentage of the issue, higher than 10%, to institutional investors so that the financial terms of the issue are determined by the wholesale market.
   - Fix the financial terms of the issue according to at least two valuations provided by independent expert firms.
   - Produce a report where it is proved that the issuing price meets the market conditions.
   - Any other mechanism that ensures that the price of the issue is a market price.
2. The firm's structure shall ensure that conflicting areas within the organisation are separated, i.e., areas in charge of price fixing, prospectus preparation and sale to investors (trading desk, corporate finance, financial analysts and sales force).
3. The internal control procedures shall be approved by the Board of Directors or the body responsible for the compliance with the rules of conduct.

In 2009 this same Competent Authority published new criteria on the valuation reports produced by independent experts during the issue of fixed income securities. The reports aim at determining if the conditions of the issue marketed to retail clients are similar to issues marketed to the wholesale market. If no institutional tranche has been planned, the financial institution must provide reports from independent expert firms.

The issuer has to inform this Competent Authority about the selected experts and the reports have to be sent directly it and it may contact the expert firms for explanations.

The expert reports have to contain:

- Cash flows and conditions of the issue.
- Identification of any embedded derivatives.
- Description of the valuation methodology (hypothesis, parameters, yield curve used).
- Components and calculation of the "all in spread".

The reports shall deal with all possible inputs to ensure that the price is aligned with the market conditions, among others:

- Conditions of the recent issues in the same sector and with the same credit rating.
- Conditions of tranches with different seniority of similar issues.
- CDS spreads.
- Relevant data from the secondary markets.
- Recent valuations carried out for institutional investors.

The reports shall express whether the expert considers that the spread or price of the issue is in line with the current wholesale market conditions and with prices of comparable securities. The language should be simple and comprehensive.

If this Competent Authority considers that the issue conditions are clearly unfavourable compared with the wholesale market or comparable products it will ask the firm to include an express warning in the issue prospectus in order to alert the retail clients about the unfavourable conditions. This faculty has been used in certain issues in 2009 and 2010.

If this Competent Authority considers that the reports are biased or confusing for the investor, it may exclude them from the prospectus, insert a warning on the biases in the reports or require the issuer to select a different expert.

Another Competent Authority considers that intermediaries must adopt tools to calculate fair value based on widely recognised methodologies of common use on the market and proportionate to the complexity of the product. The process for determining pricing conditions must be structured in an objective way in order to steer personal discretion. Post-transaction, the intermediary's internal procedures must allow a simple, precise reconstruction of the operations, with particular regard to the conditions applied, benchmarks and mark ups adopted.

Eurobond market developments

2009 was a record year for corporate bond issuance in Europe. Corporate bond issuance was €250 billion, up from €130 billion the previous year. A wider range of companies sought to issue bonds and a wider range of investors sought to gain exposure to corporate bonds.

The frenetic rate of activity in the primary bond market brought a number of strains with it. The normally close relationship between investment firms underwriting issues and investors buying the issues was tested as the range of investors increased. This made it more difficult for the underwriters to judge levels of demand. It also meant that investors were disappointed more frequently with the allocations they received.

This is the background against which concerns have been expressed about the way corporate bond markets have operated. Concerns expressed include:

– *Inappropriate "pre-sounding" of deals*: "Pre-sounding" of deals involves contacting potential investors in an effort to assess the likely demand for a bond issue. It is an important part of the process of underwriting a bond issue. However, institutional investors have expressed concern that the "pre-sounding" conversations have included too much specific information which has then meant that they are constrained in their trading activities because they are in possession of inside information.
– *Inflating of orders*: It is said that some investors routinely overbid for new securities in order to ensure that they receive a good allocation if the issue is oversubscribed. This can help to give a misleading impression of the strength of demand for an issue and disadvantage investors who are required to limit their bids to the allocation they want to receive.
– *Over-marketing of issues*: Linked to the above some institutional investors have complained that some issues have been aggressively marketed by investment firms on the back of an inflated order book.
– *Shadow book-building*: This refers to a process of seeking indications of interest before an issue is announced. This has been associated with a shorter official book-building process which some investors have claimed has left them with insufficient time to properly evaluate a new issue.

The issues set out above all fall within the existing regulatory framework under MAD and MiFID. For example, firms are supposed to have proper controls on inside information and information to clients. But MAD and MiFID do not contain provisions spelling out the specific application of provisions in MAD and MiFID to underwriting and placing and CESR has issued no Level 3 guidance on the application of the new legislative framework in this area.

Equity underwriting fees
In 1997 the UK's Office of Fair Trading referred the market for the underwriting of shares to the Competition Commission to investigate. The Competition Commission concluded its investigation and issued a report in 1999.[10] The report stated that:

"We therefore conclude that the practice of using standard sub-underwriting fees operates against the public interest in that it results or may be expected to result in some issuing companies being charged higher fees than would otherwise be the case."

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[10] http://www.competition-commission.org.uk/rep_pub/reports/1999/424under.htm

The Competition Commission decided that there should not be a requirement for sub-underwriting to be a tendering process but made some recommendations for greater transparency (including the production of a booklet on share issuance by the Bank of England[11]).

0n 10 June 2010 the UK's OFT announced that it was going to undertake a market study into equity underwriting and related services.[12]

Conclusion
Underwriting and placing raise a number of important issues about the application of the framework of EU securities legislation. Since the legislation that was brought in under the Financial Services Action Plan these issues have not been specifically addressed. Previous relevant CESR guidance has not been updated. CESR will look again at these issues in order to consider providing Level 3 guidance.

There might be a case for including some specific provisions in MiFID on underwriting and placing in the way that specific conflict of interest provisions are set out for investment research. However, at this point CESR does not have any specific recommendations to make for changes to MiFID.

Q22: The granting of credits or loans to clients in connection with the provision of investment services is currently classified as an ancillary service under MiFID (Annex I, section B(2) of MiFID). The provision of this service increases significantly the exposure of clients to risk. Please consider whether the granting of credits or loans is commonly associated to the provision of investment services and whether, based on supervisory experience, it may raise regulatory or supervisory concerns.

Please refer to CESR's Technical Advice (Ref. CESR/10-859) on complex/non-complex financial instruments (in Part 3 "Additional proposals") which deals with this matter.

Technical information

<u>Services under Article 19</u>

Q23: Please provide any available data about the following areas:
Q23(a): The break-down of retail client transactions involving (i) the provision of investment advice, (ii) services covered under Article 19(5) of MiFID and (iii) services only consisting of execution and/or reception and transmission of orders under Article 19(6),
Q23(b) In the case of the provision of services under Article 19(5) of MiFID:
- The frequency of clients' refusal to provide information regarding their knowledge and experience,
- The frequency of warnings to clients concerning the inappropriateness of proposed financial instruments.

<u>Supervisory experience/observations:</u>

No CESR member has yet collected comprehensive data on these points, though some are able to report their impressions and general assessment of the prevalence of advised and non-advised transactions in their markets.

Most reported that advised services remain more common than non-advised or execution-only.

One commented that the service of execution and/or reception and transmission of orders under MiFID Article 19(6) is in the main restricted to online brokerage activities. Another noted that it is aware that some clients have opened an account with a credit institution and may employ both

[11] http://www.bankofengland.co.uk/markets/gilts/shareissuing.pdf
[12] http://www.oft.gov.uk/news-and-updates/press/2010/61-10

investment advice given by the credit institution and execution-only services through the same account. (This very fact makes it difficult to gather any meaningful data in this area).

A further member commented that in its experience some firms were claiming to provide an execution-only service but in fact providing advice and recommendations without having obtained the necessary information for an advisory service. This member also reported that standardised warnings under the appropriateness test were possibly being used excessively for any clients with the slightest aversion to risk, and some firms have helped the client with answers to the appropriateness test questions.

One CESR member has carried out a review of how its firms have implemented the appropriateness requirements and published examples of specific responses and approaches to implementation it found, in order to share and promote good practices. This member's review identified what it saw as some evidence of potential benefits to vulnerable consumers as a result of the appropriateness test, especially in terms of helping to promote client awareness of risks associated with more complex products. These benefits resulted from a better highlighting and reinforced disclosure of relevant risks by means of questions asked of clients, warnings given and the encouragement firms give clients to access information the firms make available. Its review suggested that the questions that clients have to answer when taking the appropriateness test force clients to think more carefully than would otherwise be the case about the risks they face in relation to the products they are seeking to purchase, and whether buying such products without advice is wise. This member also found examples of where since the introduction of the appropriateness test there has been an increase in the take up of educational support offered by spread betting firms (seminars, on-line training etc), more use of accounts with stop losses and more clients being rejected. For example, one large firm said it had turned down 50% of prospective new clients under the pre-MiFID regime and this had risen to 75% under the appropriateness test.

Two members highlighted the point that it is important that a firm always makes a correct distinction between services provided at its initiative (were the firm is responsible for the choice of the instrument) and those bought at the initiative of the client. One of these regulators also highlighted the point that it is important to ensure that instruments held by a firm as a result of such different services are properly distinguished where the service requires this. One regulator had found instances of client portfolios which involve a mix of instruments, some bought following advice given by a firm and others bought at the initiative of the client.

One member identified some other situations it had found which it felt raised investor protection issues:

- Sometimes, when a transaction is unsuitable for a client, a firm might suggest to the client that the client transacts on a non-advised or execution-only basis. The regulator feels that firms should not be allowed to make such suggestions.
- Firms often forget that the general duty to act in the clients' best interests under Article 19(1) applies even when they provide execution-only services.

No member reported that clients were routinely refusing to provide the necessary information for an advisory service.

Q24: In the case of warnings concerning the inappropriateness of investments, please consider whether, based on supervisory experience, retail clients may better understand warnings mentioning the specific reasons why the transaction is not appropriate instead of receiving warnings in a standardised format.

<u>**Supervisory experience/observations:**</u>

One CESR member commented that it was not sure that a more detailed warning would help and that other means might better address any issues identified by the EC. That member as well as another one commented that since the firm is making warnings concerning the inappropriateness of investments on the basis of the client's knowledge and experience only (and not on the basis of, for

example objectives or financial situation as for the suitability assessment), it may well be difficult to be more specific in terms of a set of reasons. The specific relevant risks of the particular type of financial instrument should have been set out for the client already, in accordance with the existing MiFID requirements for risk warnings. Furthermore, those CESR members have observed that many warnings are provided to clients as part of an on-line account opening or transaction process. With such channels, standardised warnings (if appropriately drafted) can be the most straightforward but still effective route.

Another member reported that, in its experience, clients in direct contact (phone or face to face) with an investment firm get an oral warning from the representative of the investment firm and a written warning as well. (Furthermore, as a different CESR member said under Q23, some firms now give clients fact sheets and essential basic information regarding complex financial instruments in the form of educational booklets, in order to help the client to improve his knowledge.)

Another member commented, however, that in its view clients do not usually pay much attention to standardised warnings and these warnings thus serve only to provide a defense for the investment firm in case of complaints or suits. Another member replied that they believe individualised warnings are just as likely to be dismissed by clients if provided via an on-line account, electronically or in writing.

Another member suggested that enhanced point-of-sale disclosure should be a focus of the MiFID review, in particular for risk warnings.

Suitability requirements

Q25: Please provide information on your experience in the application of the suitability requirements (Article 19(4) MiFID). Directive 2006/73/EC further specifies these requirements (so called suitability requirements – Articles 35 and 37 of Directive 2006/73/EC). For example:

Supervisory experience/observations:

Several CESR members explained that they have had suitability requirements - or similar requirements - for many years before the implementation of MiFID, and therefore the MiFID requirements have not created a significant change in their regulation of investment advice, even though the drafting of their rules has changed in order to transpose MiFID. However, feedback they have received in their post-implementation review indicated that firms found their reformulated MiFID-based rules to be more coherent and better articulated than the previous rules. Some of those members also commented that they had not identified significant quantifiable benefits for 'professional' clients as a result of the extension of detailed suitability requirements to cover this category of client. However, discussions with firms and their representatives suggested that firms may be applying a greater discipline in their processes for investment advice and portfolio management for professional clients, because of MiFID implementation in this area.

One member noted issues it had found with two firms that were not properly complying with the suitability test. For some members, MiFID required the authorisation and regulation of investment advice for the first time in its own right.

Q25 (a): How do you monitor that intermediaries are adequately organised (internal arrangements and procedures, internal controls) and comply with the suitability requirements?

The monitoring of an intermediary's internal arrangements, procedures and internal controls form an integral part of the day-to-day supervision of a firm by a CESR member. There is a range of techniques used by CESR members to supervise firms, this includes, for example: regular interaction between the supervisor and the firm; routine or ad hoc firm visits; analysis of the firm's management information; and thematic work. Other techniques include reviewing a pool of transcripts from client

meetings to assess whether the advice provided was assessed as suitable for the client; and comparing information collected by the firm about its client to the written 'suitability reports' or other records of the recommendations and advice provided to the client to assess whether the recommendations/advice are suitable in the light of the client's objectives, needs and circumstances. Another supervisory tool is the performance of regular reviews – focused on the firms' adherence to code of conduct regulations – carried out by external auditors.

In jurisdictions where firms do not reach the CESR member's expectations or are in breach of the requirements, legal proceedings or other regulatory action may be brought against the firms.

Q25(b): Do you have evidence of any evolution of complaints for unsuitable advice before and after MiFID (provided that a suitability regime was applicable in the jurisdiction concerned)?

The majority of CESR members perform regular reviews of the complaints received by intermediaries; this includes complaints where the cause of complaint is in relation to the suitability of the advice provided by the firm. For some members, this complaints data existed before MiFID was implemented. That said, given the market conditions since the implementation of MiFID and the fact that for some CESR members differentiation is not made between MiFID and non-MiFID products and MiFID or non-MiFID firms in the complaints reporting, in some Member States it is difficult to identify trends which indicate any evolution of complaints for unsuitable advice before or after the implementation of MiFID.

Q25(c): Based on supervisory experience do you think that modifications are needed in the suitability requirements?

CESR members have recently considered whether the suitability requirements under MiFID required modification. However, it was felt that the current requirements were comprehensive, yet sufficiently flexible, to apply to different types of clients, instruments and advised services and therefore did not need modifying.

CESR members would suggest, however, clarifying in the Level 2 Directive that advice about hedging of risks is investment advice.

One member specifically commented that in its experience some clients are reluctant to give detailed information regarding their financial situation, but suggested some specific additions to make explicit some aspects of the information to be collected: that a client should be required to certify that he does not need access to the sums he intends to invest at all times and that he has other assets to cover his daily financial needs. This member also suggested that it become mandatory for a client to sign a document containing the information collected on him, to certify its accuracy and truth. Some members highlighted, on the contrary, that this may be counterproductive: the client investment profile is often attached to the document containing the information about the client. If the client signs that set of documents, the client may be regarded as taking over (from the investment firm) the responsibility of setting the correct profile. This would limit the firm's responsibility regarding the suitability test.