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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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This paper consolidates the different parts of the second set of CESR contributions to the European Commission in relation to the MiFID Review. It contains technical advice (Sections I-III) and responses (section IV) to the request for additional information made by the European Commission.

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 - Standardisation and Organised Platform Trading of OTC Derivatives

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Executive Summary

<u>*Standardisation*</u>

In order to further the objectives of the G20, in relation to the promotion of an efficient and sound derivatives market, CESR considers that the current situation is unsatisfactory and proposes that steps should be taken to increase the proportion of OTC derivatives being standardised by asset class.

CESR believes that a higher level of legal, operational and product standardisation (including increased use of electronic confirmation systems) can be achieved and would be beneficial for operational efficiency and the reduction of systemic risk. This should be achieved through the development of carefully defined industry targets, with arrangements to monitor the achievement of the targets, according to the scope and processes described below.

Legal, process and product standardisation

CESR agrees that market participants should develop further legal and product standardisation and more automated processes and does not recommend at this stage mandating the use of electronic confirmation systems, understood as 100% electronically confirmed contracts, but ambitious targets should be set for an increased and high level of standardisation and electronic confirmations in order to achieve a higher level of straight-through processing.

CESR is also of the view that European regulators, with appropriate involvement by ESMA, should be strongly involved in international fora where such issues are discussed to ensure consistency of approaches and level playing field.

Calibration and monitoring of industry targets

It is proposed to launch a process to set targets by asset class for increased legal, process and product standardisation, and to make arrangements to monitor the achievement of the targets.

Measurement and Further Action

The core principles of the objectives pursued and the approach taken by regulators to promote standardisation of OTC derivatives should be set in regulatory measures.

In case the targets were not met, appropriate mandatory regulatory intervention should be adopted by ESMA (in conjunction with EEA national regulators) to lead to their achievement by the industry.

<u>*Trading on organised platforms*</u>

In relation to trading on venues offering an organised trading environment (referred to in the consultation paper as “exchange trading” and in this advice as “organised trading venues”) CESR understands that current situation is unsatisfactory and believes that trading of standardised derivative products on organised trading venues is to be incentivised by regulators, even though not mandated at this stage.

Nature of Proposed Regulatory Action

It is proposed that this action takes the form of carefully defined industry targets, with arrangements to monitor their achievement by the industry. In case the targets were not met, appropriate mandatory regulatory action should be adopted by ESMA (in conjunction with EEA

national regulators) to ensure their achievement by the industry.

The minimum characteristics necessary for a platform to qualify as an Organised Trading Venue

CESR considers that further work is necessary in order to define the term "organised trading venue" in this context and determine the range of characteristics that a derivatives venue should possess, so as to qualify as an organised trading venue and meet the objectives set forth by the G20. CESR recommends that such work be initiated as soon as possible and stands ready to assist the Commission in this regard.

In CESR's view, it is clear that the characteristics of market transparency and operational efficiency are, as a minimum, necessary to meet the G20 objectives. In addition, CESR considers that it may be necessary to incorporate further functional characteristics into the definition of an organised trading venue, based on a fuller assessment of their role in furthering the G20 objectives. Such characteristics may include some or all of the following:

- easy and non-discriminatory market access
- non-discretionary and transparent rules
- objective criteria for the efficient execution of orders
- multi-laterality
- authorisation/regulation and monitoring by competent authorities
- operational resilience; and
- surveillance of compliance with the organised trading venue's rules.

As an initial conclusion, it is clear that trading platforms regulated as Regulated Markets and MTFs meet the full range of functional characteristics described above and, accordingly, unequivocally meet the objectives of the G20.

In legislative terms, the key objective of CESR's further work should be to determine whether other trading platforms, in addition to RMs and MTFs, meeting all or part of the criteria set out above, may qualify as organised trading venues.

If a concept beyond the RM and MTF definitions was necessary, it is clear in CESR's view that the equities-focused regimes for systematic internalisers and broker crossing systems would not be appropriate as currently formulated.

Eligibility of products for Organised Trading Venues

It is proposed that, in order for a derivative product to be deemed eligible for trading on an organised trading venue, a number of pre-conditions must be satisfied. These are:

a) The derivative contract is standardised from the product, legal and process point of view; and
b) The market for the derivative contract is sufficiently liquid. .

A derivative product which meets these pre-conditions is referred to in this paper as an "Eligible Derivative".

A derivative product already traded on a RM or an MTF should be presumed to be an Eligible Derivative (a minimum period of trading on a RM could be considered), unless in ESMA's judgement specific circumstances, such as a lack of liquidity in a RM/MTF-traded product, make this inappropriate.

Regarding bespoke contracts for non-financial-institutions with specific hedging needs, these are not covered by the “standardised derivatives” scope of CESR’s present work.

The calibration and monitoring of industry targets

In order to effectively design, implement and oversee a system of targets, CESR proposes that ESMA be appointed to fulfil these functions. ESMA’s responsibilities would include:

(a) The determination of the Eligible Derivatives covered by the targets.

(b) The determination of the targets and in particular the proportion of business in Eligible Derivatives that should take place on organised trading venues over a specified period of time (expressed as a percentage of total business by relevant participants in Eligible Derivatives over the same period of time).

When calibrating those targets, the following general principles should be applied:

- The targets should be set at a sufficiently ambitious premium to these existing levels in order to effectively encourage increased platform trading;
- The targets should allow market participants to trade in Eligible Products on an OTC basis in specific circumstances such as non-addressable liquidity and non price-forming transactions;
- The targets should be drawn up in consultation with the industry; and
- Where appropriate, the targets should be differentiated by asset class.

(c) The publication of the targets on the basis of determined objective criteria. ESMA should also have discretion to publish a general statement, at an appropriate juncture, regarding the compliance or non-compliance of the industry with the targets.

Measurement and Further Action

The core principles of the objectives pursued and the approach taken by regulators to incentivise trading of standardised OTC derivatives on organised venues should be set in regulatory measures.

In case the targets were not met, appropriate mandatory regulatory intervention should be adopted by ESMA (in conjunction with EEA national regulators) to lead to their achievement by the industry.

1. Introduction

1. The financial markets turmoil that started in June 2007 has revealed shortcomings in the management of counterparty credit risk and an absence of sufficient transparency in OTC derivative markets. In order to improve resilience of OTC derivative markets going forward, at its meeting of 25 September 2009, the G20 called for the strengthening of OTC derivatives markets stating that "all standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate".

2. In the U.S., legislation has been recently passed to strengthen the safety of derivative markets through standardisation, central clearing and organised platform trading.[1]. On July 21st 2010 the Wall Street Reform and Consumer Protection Act, also known as the Dodd-Frank Act, was signed into law. Part of the provisions of this Act enacts that contracts that are eligible for central clearing are also obliged to trade on swap execution facilities or boards of trade. Due to the number of regulations to be approved by SEC/CFTC, it is still difficult to assess at this stage the exact impact of the Dodd-Frank Act.

3. In Europe, the European Commission has outlined in its Communication "Ensuring efficient, safe and sound derivatives markets: Future policy actions" [COM (2009) 563 final] the core lines of the policy actions it intends to take in 2010 to address these problems[2]. The Commission states that in line with the G20 declaration, consideration should be given to ensuring that trades in eligible products take place on organised trading venues, as defined by MiFID. It also foreshadows joint work with the industry to increase the degree of standardisation of legal regimes and processes.

4. To support implementation of the G20 objectives, at the initiative of the Financial Stability Board (FSB), a working group led by the Committee on Payment and Settlement Systems (CPSS), the International Organisation of Securities Commissions (IOSCO) and the European Commission was formed to consider policy options for promoting increased use of standardised products and for developing a clear process to implement at the global level exchange or electronic trading requirements, amongst other subjects. The working group is scheduled to suggest policy options to the FSB in October 2010[3].

5. Further work on OTC derivatives, including on standardisation and market transparency, continues through initiatives amongst a number of supervisory and other authorities, led by the Federal Reserve Bank of New York, called the OTC Derivatives Supervisors Group (ODSG), and market participants, currently made up of the so-called G14 major derivatives dealers and a number of buy-side institutions. Since 2005, market participants have set out detailed commitments, together with their timeframes for completion, in a series of letters to the ODSG. The ODSG monitors compliance of the market participants with their commitments. The most recent letter was dated on 1 March 2010[4].

6. CESR has decided to look into these matters and published a consultation paper (CP) and held an open hearing with market participants to seek views on the topics of standardisation and organised platform trading of OTC derivatives. The open hearing attracted a broad range of interested stakeholders and a lively debate took place on some of the key issues tackled in the

[1] Please note that the Dodd-Frank Wall Street Reform and Consumer Protection Act was signed into law by the US President on 21 July 2010 as public law 111-203. Further details of the U.S. initiatives are discussed in Sections 2.5 and 3.5.
[2] Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee, the Committee of the Regions and the European Central Bank, *Ensuring efficient, safe and sound derivatives markets: Future policy actions*, 20.10.2009 [COM (2009) 563 final].
[3] http://www.financialstabilityboard.org/publications/r_100419.pdf.
[4] http://www.newyorkfed.org/newsevents/otc_derivative.html

CP. CESR's final report reflects the outcome of both the consultation and the open hearing. 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 resilience of the market as a whole.

7. Fifty eight submissions (including sixteen confidential responses) were received in response to the CP from a range of European associations, investment banks, data vendors, non-financial companies and other interested parties.

8. As a preliminary indication, in the rest of this Technical Advice the term "Organised Trading Venue" is used as an alternative to the term "Exchange Trading", in light of industry feedback that the latter term caused confusion when used in CESR's CP.

9. It is also relevant to highlight that, despite the evident links between the concepts of standardisation, organised platform trading and eligibility for clearing, this report focuses solely on the first two aspects. CESR's work regarding eligibility for clearing is carried out in the context of the Commission proposal for a regulation on OTC derivatives, central counterparties and trade repositories published on 15 September 2010[5]. The proposed regulation is central to implementing the obligation to clear all 'standardised OTC derivatives' as agreed in the G20.

10. This Report is organised as follows. Section 2 describes CESR's position concerning standardisation as a preliminary step on the way to organised platform trading but also includes thoughts on the value of standardisation as such. Section 3 outlines CESR's view on organised platform trading of OTC derivatives.

2. A PRELIMINARY STEP ON THE WAY TO ORGANISED PLATFORM TRADING: STANDARDISATION

2.1. Background

11. There are three elements to be considered in relation to standardisation:

    a. Legal uniformity: this includes standard transaction documentation and definitions;
    b. Process uniformity (automation): this includes straight-through-processing matching, confirmation, settlement and event handling:
    c. Product uniformity: including standard valuation, payment structures and dates.

12. In the CP, CESR recognised that legal and contract uniformity is the driver to achieving other elements of standardisation and acknowledged that there seemed to be widespread adoption of standard legal definitions and documents in the market. Nevertheless CESR remained keen to understand whether more needs to be done in this area, especially with a view to achieving other elements of standardisation.

13. To that end, the CP discussed the benefits and possible limitations of standardisation together with an assessment of the current degree of standardisation in the OTC derivatives markets. CESR considered the views of market participants in its assessment of the degree of standardisation.

14. CESR also recognised in the CP that bespoke OTC derivatives are often used for hedging purposes by non-financial firms and, as a result, CESR expressed the preliminary view that

[5] COM(2010) 484/5.

firms should be able to retain the flexibility to customise aspects such as standard valuation, payment structures, payment dates, and so forth for OTC derivative transactions. However, it was considered that this possibility needs to be carefully balanced against the benefits that adoption of straight-through processing and other automated confirmation systems can deliver. CESR was therefore eager to explore what measures could be taken to foster a higher degree of product standardisation based on the firm belief that a wider use of electronic post-trade processes would enhance the resilience of the market.

15. CESR expressed the preliminary view that greater standardisation of OTC derivatives contracts can deliver efficiency benefits to the market, but recognised the role that bespoke products can play in this context.

16. CESR acknowledged the significant progresses made by the industry towards an intensified use of electronic confirmation systems, but considered that there is – depending on the asset class - significant room for further improvement in this area. CESR was therefore considering recommending to the European Commission that it take regulatory action so as to make the use of electronic confirmation systems mandatory.

17. As part of this assessment CESR considered the most appropriate way in which a mandatory requirement might be applied. In doing so CESR committed to take into account the cost implications for all participants and in particular for smaller participants.

18. In the CP, CESR consulted market participants on its assessment of the degree of standardisation and the benefits and limitations of standardisation, paying particular attention to the quantification of those limitations. It also consulted on whether greater standardisation was desirable and what should be the goal of standardisation, and how the industry and regulators could continue to work together to build on existing initiatives and accelerate their impact. CESR further consulted on whether there were obstacles to standardisation which could be removed by regulatory action and where the priorities should be set. In line with its preliminary opinion of recommending the mandatory use of electronic confirmation systems, CESR requested information on the eventual costs of implementing such measure.

19. In preparing this report, CESR has kept track of other initiatives taken at international level, and in particular, CESR considers that its present advice should not be considered in isolation but understood as complementary to the recommendations of other international fora where EEA regulators are involved, such as the FSB. The ODSG initiative should also be taken into consideration.

2.2. Summary of feedback

20. Regarding the question on the desirability of greater standardisation and the goals of standardisation, respondents generally agreed that legal and process standardisation is desirable, but did not see a need for further product standardisation. Many respondents stress that product standardisation should be driven by market needs and priorities. They also indicate that standardisation should not be a goal in itself. Various goals of standardisation were mentioned such as: to increase market efficiency, to reduce legal and operational risks, to increase pre-trade transparency, to increase post-trade efficiency, reductions of systemic risks and ensuring adequate protection for investors.

21. As regards the question on how the industry and regulators can continue to work together, the industry commitment letters agreed with the ODSG were mentioned in many responses. Some responses suggest that the approach taken by EU regulators should build on the existing initiatives or consultations, joint working groups and other forms of partnership. Legislation is

not seen (by some) as an effective way forward because of possible unintended negative consequences.

22. When commenting on obstacles to standardisation that could be removed by regulatory action, some respondents indicated that regulatory action would not help to remove obstacles. Standardisation should be a market led process in their opinion. Others point out accounting rules, overlapping and conflicting regulation, legal and fiscal differences between jurisdictions as examples where regulatory action could be helpful.

23. Regarding mandatory use of electronic confirmation systems, many respondents supported the use of electronic confirmation systems in general, but were opposed to mandatory use of electronic confirmation systems. The costs may be prohibitive for smaller market participants (or market participants who trade OTC derivatives infrequently). Mandatory action was seen as neither desirable nor practicable and would lead to increased costs for all market participants. There was a general agreement that this should be a market-driven development. Almost all respondents indicate that it is difficult to give a quantification of the cost estimate of implementing electronic confirmation systems, but for these respondents costs are however expected to be higher than the benefits delivered by it.

2.3. Policy Recommendation

24. In order to further the objectives of the G20, in relation to the promotion of an efficient and sound derivatives market, CESR proposes that steps should be taken to increase the proportion of OTC derivatives being standardised by asset class.

25. CESR believes that a higher level of legal, operational and product standardisation (including increased use of electronic confirmation systems) can be achieved and would be beneficial for operational efficiency and the reduction of systemic risk. This should be achieved through the development of carefully defined industry targets, with arrangements to monitor the achievement of the targets, according to the scope and processes described below.

26. The level of the targets needs to be calibrated by asset class, and the scope of the targets defined by reference to the range of firms/institutions that it is desirable to cover. Regulators need to be involved in the process to provide the framework for discussion, set appropriate targets and monitor their achievement. Therefore, CESR recommends the following policy approach taking into account the comments received in the consultation and the regulatory needs identified.

2.3.1. Legal, process and product standardisation

27. CESR agrees that market participants should develop further legal and product standardisation and more automated processes. Acknowledging the response to the consultation, CESR does not recommend mandating the use of electronic confirmation systems, understood as 100% electronically confirmed contracts. However, ambitious targets should be set for an increased and high level of standardisation and electronic confirmations in order to achieve a higher level of straight-through processing.

28. CESR feels that European regulators, with appropriate involvement by ESMA should take part on other global initiatives under way as this would help make significant progress and that EU authorities should also collaborate closely on their contributions.

2.3.2. Calibration and monitoring of industry targets

29. It is proposed to launch a process to set targets by asset class for increased legal, process and product standardisation, and to make arrangements to monitor the achievement of the targets.

In case the targets set out were not met, appropriate mandatory regulatory action to lead to the achievement of the targets should be initiated.

30. CESR therefore proposes that ESMA on an EEA level has the following tasks building on work of other international initiatives:

i) Analyse legal barriers to legal and process standardisation as mentioned by respondents to the consultation (e.g. legal, accounting, tax barriers);
ii) Develop and set appropriate targets for legal, process (including electronic confirmation) and product standardisation levels per asset class, in consultation with the industry, recognising that in relation to product standardisation there is a balance to be struck between allowing a role for bespoke products for purposes of hedging risk and increased product standardisation for operational efficiency purposes. ESMA should determine the targets to be met, deadlines and deliveries in a transparent manner;
iii) Define the scope of the targets by reference to the desired range of firms/institutions and agree on targets with relevant OTC derivatives market participants;
iv) Monitor the achievements reached by market participants against the agreed targets;
v) Monitor level of standardisation vs. trading in non-standardised products; and
vi) ESMA should have the power to decide on the publication of the targets achieved.

31. At this stage, CESR does not have a definitive view on the exact targets that should be reached in each asset class or on the range of firms/institutions that should be covered. However, CESR considers that a sufficiently ambitious approach should be adopted, taking into account the scope of other EU and international measures in relation to OTC derivatives, to ensure that the proportion of standardised OTC derivatives increases.

2.3.3. Measurement and Further Action

32. The core principles of the objectives pursued and the approach taken by regulators to promote standardisation of OTC derivatives should be set in regulatory measures.

33. On that basis, ESMA would then determine the specific targets to be met. It is proposed that the measurement of compliance with industry targets could be performed using data from various sources, including data obtained from trade repositories, when such data becomes available.

34. In case the targets were not met, appropriate mandatory regulatory intervention should be adopted by ESMA (in conjunction with EEA national regulators) to lead to their achievement by the industry.

3. ORGANISED PLATFORM TRADING

3.1. Background

35. In the second part of the CP, CESR considered issues related to the trading of OTC derivatives on organised trading platforms. It included an assessment of the current degree of organised platform trading of standardised OTC derivatives, a part exploring the benefits and drawbacks of ‘organised trading’ of standardised OTC derivatives, consideration of the characteristics and the level of standardisation necessary in order for a derivative product to be eligible for organised platform trading, an analysis of the concept of ‘trading on organised markets’ in the EU legislative context and an assessment of existing market-led and regulatory initiatives promoting organised trading of OTC derivatives.

36. CESR stated its view that trading on ‘organised markets’ could deliver a number of benefits such as improved price formation, a higher level of transparency, enhanced liquidity, greater operational efficiency and easy access for market participants. There are however also a number of pre-requisites to organised platform trading of derivatives that may explain why the OTC segment of the market remains very large such as the need for the contracts to be standardised. As a preliminary opinion, CESR stated in the CP that it favoured incentivising the increased use of ‘organised trading venues’ but also mentioned that it continued to consider whether mandatory usage is desirable, taking into account the discussions currently taking place on this issue in other jurisdictions and international fora. CESR also expressed the will to further explore with market participants which kind of incentives could effectively promote organised platform trading.

37. As explained above, immediately after the CP was published, the Dodd-Frank Act was passed where the concept of 'swap execution facility' (SEF) appeared for trading systems or platforms in which multiple participants have the ability to execute or trade swaps by accepting bids and offers made by multiple participants in the facility or system, through any means of interstate commerce, including any trading facility, that (A) facilitates the execution of swaps between persons; and (B) is not a designated contract market.” In practice, the types of platforms that fulfil these criteria will have to be further determined by the US authorities (SEC and CFTC).

3.2. <u>Summary of Feedback</u>

38. As regards the benefits of regulatory action to mandate trading of standardised OTC derivatives on organised trading venues, a majority of respondents opposed (or strongly opposed) regulatory intervention to mandate platform trading. Many respondents cited the crucial and complementary role of OTC execution models, which underpin the ability to effectively hedge risk. Many respondents also question the incremental benefits of platform trading in the context of existing EU initiatives (e.g. transparency in non-equity markets) and the core objective of reduction of systemic risk. In this regard, some respondents considered that organised platform trading may limit the ability of the industry to develop new products and several references were made to the commercial viability of mandatory action in the context of less liquid products which may lead to the withdrawal of execution facilities. In addition, several respondents pointed to the pro-competitive model under MiFID which facilitates innovation, as an appropriate framework. Some respondents however favoured mandatory action, citing the need to overcome inertia in the existing market structure.

39. As regards the question of regulatory arbitrage between the US approach and the European legal environment in terms of MiFID, respondents generally noted the uncertainty regarding the practical application of the US regulations, in light of the rule-setting responsibilities of US regulators that will be necessary to flesh out the detailed requirements (such as in relation to the types of venue that may fall within the relevant definitions). Many respondents supported a high degree of global coordination in principle, to mitigate the risk of regulatory arbitrage – but some note that this principle has a wider application than the US/EU, as there are other potential financial centres to which liquidity may move. Some respondents noted that EU regulators should maintain focus on the core objectives of the review of OTC markets, and the particular characteristics of the EU market structure which are different in certain respects to the US. However, regulatory and legislative developments in other jurisdictions such as the US should be taken into account by CESR to minimise the scope for regulatory arbitrage.

40. Responding to the question on which sectors of the market would benefit from and/or be suitable for (more) organised platform trading, the following market sectors/asset classes were identified as suitable for more organised platform trading: Equity, (single-name and index) CDS contracts, plain vanilla credit/interest rate swaps and equity futures, on-the-run credit indices, ABX indices, currency derivatives, Swaptions, Variance Swaps, plain vanilla long

options. In more general terms it was suggested that products would be especially suitable where they are highly standardised, high in volume and eligible for CCP clearing. However, it was also pointed out that instruments with a lower level of standardisation may also be platform traded and that standardisation is only one factor among others determining the feasibility of organised platform trading.

41. As regards the requirements of 'organised trading venues' many respondents were of the view that only platforms meeting all the requirements listed in paragraphs 86 and 87 of the CP would be in a position to meet the goal of improving the stability and efficiency of the market. Some of these respondents claimed that the same rules should apply for the same trading model, and that the application of the requirements in paragraph 86 only would lead to an unlevel playing field. Other respondents stressed that these requirements accomplish a fairer and non discriminatory access to derivative trading. Many other respondents called for the definition of an organised trading platform to be cast as wide as possible to allow the maximum flexibility for the market to gravitate towards the execution method most suited to it. OTC derivatives could benefit from a similar interpretation of the concept of "organised trading" as currently enshrined in MiFID, which reflects concepts for additional types of trading platform[6]. It was stated that mandating or forcing trading on platforms that meet the requirements set out in paragraphs 86 (or 86 and 87) would be likely to significantly damage many product markets. In the market environment, alternative trading models, such as communication networks streaming indicative prices by dealers to clients had been developed which are successful. One respondent did specifically disagree with a multilateral character of the market. In his view, multilateral market may impact risk associated with provision of liquidity to markets. Other respondents elaborated that benefits of multilateral systems appear only in certain cases, not generally. In this view, a multilateral system is not suitable for derivatives because of the bilateral character of contracts and little use of transparency information which disregard counterparty risk.

3.3. Policy Recommendation

42. CESR believes that trading of standardised derivative products on Organised Trading Venues is to be incentivised by regulators, even though not mandated at this stage. Taking into account the comments received in the consultation and regulatory needs, CESR considers that a precise set of criteria has to be determined to define Organised Trading Venues. The proposed way forward is through the determination by ESMA of targets to be met by the industry. Should these targets not be met, appropriate mandatory regulatory action would then have to be taken to lead to the achievement of the targets by market participants. Therefore, CESR recommends the following policy approach taking into account the comments received in the consultation and the regulatory needs identified.

3.3.1. Nature of Proposed Regulatory Action

43. In order to further the objectives of the G20, in relation to the promotion of an efficient and sound derivatives market, CESR proposes that steps should be taken to incentivise the increased use of organised platforms for the purpose of trading eligible derivatives products.

44. It is proposed that this action takes the form of carefully defined industry targets, with arrangements to monitor the achievement of the targets, according to the scope and processes described in the sections that follow. Regulators need to be involved in the process to provide the framework for discussion, ensure appropriate commitments and monitor their achievement. In case the targets were not met, appropriate mandatory regulatory action should be initiated to ensure their achievement by the industry.

[6] Systematic internaliser and a new concept of broker crossing system, according to CESR Technical Advice to the European Commission in the context of the MiFID Review- Equity Markets (Ref. CESR/10-802).

45. On the basis of an appropriate system of targets including appropriate monitoring and regulatory follow-up action, it will not be necessary to mandate trading of eligible derivatives on organised venues at this stage.

3.3.2. The minimum characteristics necessary for a platform to be treated as an Organised Trading Venue

46. CESR considers that further work is necessary in order to determine the range of characteristics that a derivatives venue should possess so as to qualify as an organised trading venue and meet the objectives set forth by the G20. CESR recommends that such work be initiated as soon as possible and stands ready to assist the Commission in this regard. At this stage, CESR sets out the framework within which this further work should be conducted and the initial conclusions which can be reached.

47. CESR considers that the term "organised trading venue" should be defined by reference to a range of functional characteristics that, collectively, will ensure that trading platforms meet the objectives set forth by the G20. Accordingly, a variety of trading methodologies might qualify as organised trading venues, subject to satisfaction of the specific functional characteristics identified.

48. In CESR's view, it is clear that high standards with regards to market transparency and operational efficiency are, as a minimum, necessary to meet the G20 objectives. Hence, it should not be possible for a trading venue which did not meet these characteristics to qualify as an organised trading venue in this context. The existing market pre- and post-trade transparency standards set out in MiFID for equities should be used as a basis for further discussion of the appropriate trade transparency regime for derivatives, and to set out the benchmark against which these platforms should be measured. Such work should build on existing CESR recommendations in relation to transparency for derivatives products[7] and take into account the particular needs of participants in derivatives markets. In addition, CESR considers that the incorporation of further functional characteristics into the definition of an organised trading venue will have to be assessed, based on a fuller assessment of their role in furthering the G20 objectives. Such characteristics may include some or all of the following:

- easy and non-discriminatory market access
- non-discretionary and transparent rules
- objective criteria for the efficient execution of orders
- multi-laterality
- authorisation/regulation and monitoring by competent authorities
- operational resilience; and
- surveillance of compliance with the organised trading venue's rules.

49. As an initial conclusion, it is clear that Regulated Markets and MTFs, as defined by MiFID, are organised trading venues in this context. These trading platforms meet the full range of functional characteristics described above and, accordingly, unequivocally meet the objectives of the G20.

50. In legislative terms, building on the conclusion of paragraph 48, the key objective of CESR's further work should be to determine whether other trading platforms, in addition to RMs and MTFs, meeting all or part of the requirements set out above, may qualify as organised trading venues. If a concept beyond the RM and MTF definitions was necessary, it is clear in CESR's

[7] CESR Technical Advice to the European Commission in the Context of the MiFID Review: Non-equity Markets Transparency (Ref. CESR/10-802).

view that the equities-focused regimes for systematic internalisers and broker crossing systems would not be appropriate as currently formulated.

51. In the context of the global nature of the derivatives market, and market reforms currently being pursued in the US, CESR considers that an additional objective of its further work should be to ensure international level playing field and mitigate the risk of regulatory arbitrage between markets in EEA countries and other financial centres. In particular, the further assessment of which ones of the characteristics set out above should be applicable to the EU concept of an organised trading venue, over and above the core characteristics of market transparency and operational efficiency, should accordingly be informed by the requirements for “Swap Execution Facilities” in the US. CESR notes that further clarification of how the US regime will be implemented should be forthcoming within the next few months, with rules due to be in place by July 2011. In principle, CESR considers that the definition of “organised trading platforms” to be developed in the European context should take into account the criteria defined above for the SEF aiming at the alignment of the regulatory outcomes.

3.3.3. Eligibility of products for Organised Trading Venues

52. It is proposed that, in order for a derivative product to be deemed eligible for trading on an organised trading venue, a number of pre-conditions must be satisfied. These are:

    (a) The derivative contract is standardised from the product, legal and process point of view; and
    (b) The market for the derivative contract is sufficiently liquid.

53. A derivative product which meets these pre-conditions is referred to in this paper as an “Eligible Derivative”.

54. A derivative product already traded on a RM or an MTF should be presumed to be an Eligible Derivative (a minimum period of trading on a RM could be considered), unless in ESMA’s judgement specific circumstances, such as a lack of liquidity in a RM/MTF-traded product, make this inappropriate.

55. Regarding bespoke contracts for non-financial-institutions with specific hedging needs, these are not covered by the “standardised derivatives” scope of CESR’s present work.

3.3.4. The calibration and monitoring of industry targets

56. In order to effectively design, implement and oversee a system of targets, CESR proposes that ESMA be appointed to fulfil these functions. ESMA’s responsibilities would include:

    (a) The determination of the Eligible Products covered by the targets. In the case of a derivative product not already admitted to trading on a RM or an MTF, this would clearly be dependent on the willingness of a platform operator to make arrangements to trade the derivative. Where an organised trading venue would start offering trading in an OTC derivative, ESMA would follow developments and, in case of unsuccessful launch, seek to understand the reasons for it and take any further step that may be considered as appropriate. In the case where no organised trading venue comes forward with a proposal to trade standardised OTC derivatives identified in this process, ESMA will further discuss with the industry and particularly operators and/or potential operators of organised trading venues to, where appropriate, review the list of Eligible Derivatives identified.

(b) The determination of the targets: It is proposed that ESMA would determine the targets and the proportion of business in Eligible Derivatives that should take place on organised trading venues over a specified period of time (expressed as a percentage of total business by relevant participants in Eligible Derivatives over the same period of time).

In the calibration of those targets, the following general principles should be applied:

- Work should be undertaken to clarify with an appropriate degree of precision, the proportion of business in Eligible Derivatives already undertaken on RMs and MTFs. Targets should be set at a sufficiently ambitious premium to these existing levels, in order to effectively encourage increased platform trading

- The targets should take into account the possibility for market participants to undertake an appropriate level of business in Eligible Derivatives on an OTC basis, to meet their legitimate needs e.g. non-addressable liquidity and non price-forming transactions;

- The targets should be drawn up in consultation with the industry; and

- Where appropriate, the targets should be differentiated by asset class.

(c) ESMA should be responsible for publishing the targets on the basis of determined objective criteria. ESMA should also have discretion to publish a general statement, at an appropriate juncture, regarding the compliance or non-compliance of the industry with the targets.

3.3.5. Measurement and Further Action

57. The core principles of the objectives pursued and the approach taken by regulators to incentivise trading of standardised OTC derivatives on organised venues should be set in regulatory measures.

58. On that basis, ESMA would then determine the specific targets to be met. It is proposed that the measurement of compliance with industry targets could be performed using data from various sources, including data obtained from trade repositories, when such data becomes available.

59. In case the targets were not met, appropriate mandatory regulatory intervention should be adopted by ESMA (in conjunction with EEA national regulators) to lead to their achievement by the industry.

COMMITTEE OF EUROPEAN SECURITIES REGULATORS

Date: October 2010
Ref.: CESR/10-882

TECHNICAL ADVICE

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

Post-trade Transparency Standards

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Executive Summary

In order to enhance the quality and consistency of post-trade transparency data on shares admitted to trading on a regulated market (RM) under MiFID, CESR proposed in its April Consultation Paper on MiFID Equity Markets Review (Ref. CESR/10-394) to use common standards and provide further guidelines to clarify the transparency obligations. CESR also proposed to establish a joint CESR/Industry Working Group to assist CESR with refining proposals for detailed standards for post-trade transparency and shaping the clarifications of the MiFID post-trade transparency obligations with a view to minimising the extent of duplicative trade publications.

Based on the discussions within the CESR/Industry Working Group, CESR makes recommendations for legally binding post-trade transparency standards and guidelines. These are summarised below:

Standards for Post-Trade Transparency

Regarding the extent of harmonisation of standards, CESR outlines two options in the Technical Advice which will both improve the quality of post-trade data and interoperability of data formats and protocols. Subject to the outcome of a proper cost/benefit analysis, CESR has an initial preference for the option to require a common message protocol (Option 2) instead of only mapping the data of RMs, MTFs and APAs against the harmonised standards (Option 1).

Reference data

CESR recommends – in line with its previous Level 3 guidelines and recommendations on publication and consolidation of market transparency (Ref.: CESR/07-043) - to amend MiFID to make the use of ISO standards and other harmonised formats mandatory for the following transparency publication fields: day, time, instrument identification, price notation, unit price, quantity and venue identification.

Transaction type standards and other trade flags

CESR recommends using the following trade flags.

‘B’	Benchmark trade flag	OTC
‘X’	Agency cross trade flag	OTC
‘G’	Give-up/give-in trade flag	OTC
‘E’	Ex/cum dividend trade flag	OTC
‘T’	Technical trade flag	OTC
‘D’	Dark trade flag	RM, MTF
‘N’	Negotiated trade flag	RM, MTF
‘C’	Cancellations flag	Publication arrangements (RM, MTF, APA)
‘A’	Amendment flag	Publication arrangements (RM, MTF, APA)

The use of a unique transaction identifier along with a unique code identifying the publication arrangement should also be required to help reconciling cancellations and amendments with the original trade reports and to facilitate the consolidation of the data. Cancellations and amendments should be published with a ‘C’ or ‘A’ flag together with the unique transaction identifier of the original transaction as soon as possible and no later than 1 minute after the decision to cancel or amend is made.

Further CESR/ESMA work on trade flags

Since some of these flags have been developed with OTC trades in mind, it should be further explored whether the specific flags proposed for OTC trades, if appropriate and as far as relevant, should also be applied for trades executed on RMs and MTFs. CESR also supports greater harmonisation of flags used by RMs/MTFs for on-order book trades and proposes that work by CESR in collaboration with the industry should continue to determine whether it is possible to develop a minimum set of standard flags.

Once the recommendations have been implemented, CESR intends to conduct further work together with the industry to provide guidelines, as necessary, on the use of each of the flags outlined above. Going forward, it will also be necessary for ESMA to be able to establish an efficient, on-going process with the industry to react quickly to new developments and provide guidance as needed to the market.

Clarifications of post-trade transparency obligations

CESR recommends the following amendments and clarifications of MiFID in order to ensure a consistent application of MiFID for transactions executed OTC without duplicative publication of OTC trades.

Article 27(4) of the MiFID Implementing Regulation should be amended to clarify that where a trade is not executed under the rules of the RM or an MTF the following applies, only one investment firm should make the information public which is determined by proceeding sequentially from point (i) to (iii) below unless there is a divergent standing agreement between the parties:

(i) the EEA investment firm which acts as the executing broker in the transaction

(ii) in the case that two EEA executing brokers are involved in the transaction or in the absence of an EEA executing broker, the EEA investment firm which sells the share or acts on behalf of or arranges the transaction for the seller

(iii) in the absence of a selling EEA investment firm, the EEA investment firm which buys the share or acts on behalf of or arranges the transaction for the buyer.

It is also recommended to amend Article 27(4) of the MiFID Implementing Regulation to strengthen the requirement to report two matching trades as one single transaction and to clarify that 'two matching trades' would include the situation where an investment firm acts on its own account and on behalf of a client and simultaneously executes a buy and a sell transaction with no change in price.

Transactions on behalf of a client

CESR recommends clarifying in MiFID that, in the situation where an investment firm acts on behalf of a client (whether on its own account or on an agency basis) and executes a market-side leg and a client-side leg, only the market side leg should be published to avoid double publications (if there is no change in price). If the transaction is executed on a RM or MTF, the market itself will publish the trade. If the market-side transaction involves two or more investment firms, there is no change in price and the investment firms are not putting their capital at risk, the trade should be published in accordance with the recommendation for a new rules on the responsibility for trade publications (falling back to the EEA executing broker) unless the investment firms have a standing agreement that deviates from this.

CESR also recommends a solution for trade publications in the specific situation where the client demands that the client-side leg of a trade be undertaken under the rules of a RM/MTF as a negotiated trade.

Chain of transactions

CESR recommends clarifying in MiFID that a chain of transactions that does not involve a change in price should be considered as one single transaction. The responsibility for the trade publication should be determined in accordance with proposed cascade of responsibilities for Article 27(4) of the MiFID Implementing Regulation.

Further work of CESR/ESMA

Once the standards and obligations under MiFID are agreed, CESR stands ready to conduct further work together with the industry to provide guidelines specifying other worked scenarios and providing further clarification, as needed.

1. Introduction

1. 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 to guard against potential adverse impacts of fragmentation of transparency information post-MiFID.

2. However, in its April Consultation Paper on Technical Advice to the European Commission concerning equity markets in the context of the MiFID Review[1] CESR observed that there were concerns among market participants that the quality of post-trade transparency data had deteriorated significantly since the implementation of MiFID in November 2007. These concerns were particularly pronounced in jurisdictions where all equity transparency information was previously published by the main regulated market (RM) and where the main RM not only consolidated equity data but monitored the quality and took appropriate remedial action as necessary. The concerns particularly related to the OTC market where it was considered that the current MiFID legislation did not provide a sufficient level of granularity in publication standards, leading to a lack of consistency in their application.

3. Among the measures which CESR proposed to address these concerns was to establish a joint CESR/Industry Working Group ("the Group"). The purpose of the Group was to assist CESR in:

   i) refining proposals for detailed standards for post-trade transparency; and

   ii) helping shape the clarifications of the MiFID post-trade transparency obligations with a view to minimising the extent of duplicative trade publications.

4. The Group met five times under the joint chairmanship of the UK FSA, as the Chair of CESR's Secondary Markets Standing Committee, and the CESR Secretariat. The membership of industry members of the Group is shown at Annex 1. The Group took account in its work of the responses to CESR's Consultation Paper. The final Technical Advice to the Commission represents CESR's conclusions from the discussion within the Group and the submissions of industry members of the Group.

2. Proposed Standards for Post-Trade Transparency

5. The issues considered by the Group were mainly those set out in Annex II of CESR's April Consultation Paper:

   - Reference data
   - Transaction type standards for the exchange of shares determined by factors other than the current market valuation of the share and non-addressable liquidity
   - Identification of dark trading
   - Unique transaction identifier
   - Cancellations and amendments of trades
   - Negotiated trades

6. The Group also discussed the possibility of harmonising publication prices as 'gross prices' and a minimum set of harmonised flags for trades conducted on-exchange and on-order book, particularly in respect of certain 'market conditions' (i.e. the flags which indicate whether a transaction was executed in a period of continuous trading or occurred in an auction period).

[1] Ref. CESR/10-394, available at http://www.cesr.eu/popup2.php?id=6548.

CESR

Extent of Harmonisation

7. A general question relating to the above issues is the extent to which the harmonisation of post-trade transparency standards should be pursued. At present, the level of data standardisation within the EEA securities industry is not very high. RMs, MTFs and investment firms publish quotes and prices of trades executed using a variety of protocols, flags and formats. While the market is clearly already dealing with many different standards and sources of data in order to consolidate the information in a fragmented post-MiFID trading environment, the cost of market data management can be significant for those retrieving direct data feeds from all the sources and may contribute to higher overall information cost for the market as a whole. When thinking about simplifying trading across different systems, harmonisation of standards and facilitation of consolidation of data, there are two basic options.

   - The first and less radical option is to prescribe the standards to which the post-trade data needs to be mapped for dissemination to end users but not require all primary data providers (RMs, MTFs, APAs) to use a common message protocol employing these standards. Under this option individual data providers could continue to provide post-trade data using their own protocols, codes and symbols. However, the data would need to contain all the information prescribed by the standards and would need to be 'mappable' to the standards. The data providers would also need to supply to data consolidators and individual users of direct data feeds a key which would enable the latter to map the data to the agreed standards. End users would thus get the data in the standardised form via data vendors or publications of primary data providers. This option would not require primary data providers to make costly efforts to develop and implement a standard protocol and changes to their systems but data consolidators, as well as individual investment firms who wished to take feeds from multiple data providers, would – similar to the current situation- still have to incur the costs for the conversion of the data to the agreed standards. This could act as a barrier to entry and impede competition. There would also be greater potential for errors given the need to undertake mapping from multiple sources.

   - The second and more sweeping option would be not only prescribe the standards but also require the use of a common message protocol for the post-trade data by RMs, MTFs and APAs, preferably based on a non-proprietary open protocol. Under this option, all those data providers would need to use the same protocol conforming to the agreed standards for the agreed minimum set of post-trade information. It would be up to each RM, MTF and APA to decide whether they want to provide this common protocol as a replacement for their current protocol or provide an additional feed conforming to the prescribed standards and common message protocol. Importantly, though, if they opted for the latter the two feeds should not be subject to significantly differing latency (i.e. the additional feed should be no slower than the existing feed). There would thus be no requirement for data consolidators to map the data they receive into the standards since it would already be in the prescribed form. The costs and benefits of this option are the opposite of the first option. Data providers would face costs in changing their systems to comply with the additional standard protocol but the data would be easier to consolidate. Data vendors may also face additional costs for adapting their systems to the new feeds in the common protocol. On the other side, users of the data would not face the costs of mapping the data to the standards (at least for the set of standardised post-trade data), reducing the barriers to entry, and there would be less scope for mistakes given that there would be no requirement for data conversion.

8. The industry members of the Group unsurprisingly did not have a unanimous view on which option should be pursued.

Recommendation

9. CESR is of the view that the implementation of either option would help to improve the quality of post-trade data and interoperability of data formats and protocols but has an initial preference for the second option (noting that if the dual feed variation is pursued there should not be different latency between the two feeds). However, in the time available CESR has not been able to carry out a proper cost/benefit analysis of the two options. CESR stands ready to provide the Commission with assistance in a comprehensive cost/benefit analysis which needs to take into account that there are two possible ways of implementing option 2 and, if necessary, to further work with the industry on the technicalities of either solution.

i) Reference Data

10. MiFID requires a transaction in shares admitted to trading on a RM to be published using a unique code to identify the instrument; the price notation to identify the currency in which the price is expressed; and the unique harmonised identification code to be used to identify the venue. However, MiFID does not specify what codes or identification methods should be used. Although CESR has published Level 3 recommendations in February 2007 to promote the use of consistent formats, contents and protocols across the EEA, different identifications for instruments, price notations and venues are used in the marketplace. To fill these gaps CESR proposed in its Consultation Paper that International Organisation on Standardisation (ISO) standard formats for post-trade transparency information should be used. As regards the currency code, CESR considered that - deviating from its Level 3 advice - the unit price should be provided in major rather than the minor currency (e.g. Euros rather than Euro cents).

11. Industry members of the Group agreed with most of CESR's proposals. In respect of instrument identification it was noted that some financial instruments (a very small number of shares and ETFs) had the same International Securities Identification Number (ISIN) but were settled in different Central Securities Depositaries (CSDs) and therefore might trade at different prices. However, the Group did not believe this was a significant problem which would warrant using another instrument identifier than ISIN. Nor did they see the need for requiring any additional fields in order to identify the settlement venue of such a share.

12. The Group also agreed with the use of the ISO Market Identifier Code (MIC) as the method to identify a trading venue. To avoid the problem of multiple trading venues operating under a single MIC code it was noted that each trading venue should have a unique identifier with the trading venues being separately identified with different MICs (e.g. an operator of a RM also operating an MTF has a MIC for its RM and a separate one for its MTF). Some members of the industry suggested that it would make smart order routing more efficient if each individual order book operated by a single entity could also be separately identified, but overall this was not considered to be necessary and CESR does not recommend pursuing this option.

13. On price notation the industry members of the Group took the view that the ISO currency code (i.e. major currency) should be used except for stocks quoted in Sterling where standardisation should be on the basis of the minor currency (i.e. pence). This reflected the current market practice for the prices of these stocks to be quoted in pence rather than pounds. Little value was seen in requiring the conversion of prices into pounds when data consolidators would then need to provide an additional data feed turning the prices back into pence in order to make them meaningful to end users of data concerning stocks quoted in Sterling as long as the quotes are not standardised in the major currency. Harmonisation to the major currency for all shares admitted to trading on an EEA RM was also questioned in the context of the current practice of MTFs on the continent that admitted shares in Sterling as they tend to quote and publish trades in Sterling in the minor unit too.

14. CESR considers that full harmonisation of trade publication standards in accordance with ISO standards requires the prices of all EEA securities to use the major currency. Using the minor currency for one category of shares while the remainder used the major could cause confusion for market participants and increase the risk of mistakes when reporting the prices of shares to trade publication arrangements particularly when transaction reporting requirements are aligned on the basis of the major currency throughout the EEA. The expectation is that pre-trade quotes would also then be converted. However, CESR recognises that this change would involve a major move away from an established market precedent for Sterling-denominated securities and that the issues associated with doing so should be included in a cost-benefit analysis on the proposed changes to post-trade transparency standards.

Recommendation

15. To ensure that the relevant details to be published in accordance with Article 27(1)(a) and table 1 of Annex I of the MiFID Implementing Regulation, particularly the financial instrument, the price notation and the venue, are identified in a consistent way, CESR recommends – in line with its previous Recommendation °2 of CESR's Level 3 guidelines and recommendations on publication and consolidation of market transparency (Ref.: CESR/07-043) - to amend MiFID to make the use of the following ISO standards (and content where relevant) and proposed harmonised formats mandatory:

Transparency publication field	**Standard**[2]
Day	ISO 8601 – 8 character numeric code YYYY-MM-DD
Time	ISO 8601 – 6 character numeric code HH:MM:SS
Instrument identification	ISO 6166 International Securities Identification Number (ISIN) – 12 character alpha-numerical code
Price notation	ISO 4217 – 3 character alpha currency code identifying the major currency
Unit price	ISO 4217 – identification of the major currency to the appropriate number of decimals (e.g. 2.00 EUR)
Quantity	Use of integer numbers of whole units
Venue identification	ISO 10383 - Market Identifier Code (MIC) where the venue is a regulated market or multilateral trading facility, with separate identifiers where a group operated different venues (e.g. an RM as well as an MTF) ISO 9362 - Bank Identifier Code (BIC) where the transaction is executed by an SI or the acronym 'SI' if the SI publishes periodic reports. The acronym 'BCS' where a transaction is executed by a broker crossing system; where an investment firms operates an SI business that interacts with its BCS, the trade should be reported as 'SI' if the investment firm has committed its capital on one side of the trade, otherwise as 'BCS'. The acronym 'OTC' for all other trades executed OTC.

16. The relevant detail to be published when a trade has been executed by a systematic internaliser which publishes periodic reports should be the acronym 'SI' and, for trades executed by a broker crossing system, the acronym 'BCS'. If the investment firm's SI business interacts with its BCS, a trade executed on the respective system needs to be reported as either SI or BCS depending on whether the investment firm committed capital when executing the trade. However, in line with CESR's advice to the European Commission in the Context of the MiFID Review – equity

[2] CESR notes that the amendment to MiFID will need to provide for the adjustment of these standards in case subsequent changes to the relevant ISO standards are made.

markets (CESR/10-802), a BCS needs to identify itself with a Bank Identifier Code (BIC) in accordance with ISO 9362 when it makes public aggregate information about the number, value and volume of transactions executed in its internal crossing systems at the end of each trading day. The same applies to periodic reports of SIs. If an investment firm is operating an SI as well as a BCS, it is necessary to use separate BIC codes.

17. Since no ISO standard exists to express the quantity, in line with its previous Recommendation °2 of CESR's Level 3 guidelines and recommendations on publication and consolidation of market transparency (Ref.: CESR/07-043), it is also recommended to express the quantity in an integer number of whole units.

ii) Transaction Type Standards

18. MiFID[3] requires RMs, MTFs and investment firms to publish additional information in relation to some transactions. This includes an indication that the exchange of shares is determined by factors other than the current market valuation of the share. MiFID requires that this information is included in the trade report. However, there is no legally binding requirement to identify such transactions in a standard way and there is no consistency in the way these transactions are identified[4]. This is considered to adversely affect the quality of post-trade information.

19. It has also been suggested that an OTC transaction where another investment firm could not have been a party to the transaction should be identified. An example would be where a firm providing the service of portfolio management transfers the beneficial ownership of a share from one fund to another, acting on behalf of both buyer and seller, and where consequently no other investment firm is involved (i.e. inter-fund transfers). Other types of 'non addressable liquidity' would include 'give up/give in' transactions[5]. It was considered that distinguishing such 'non-addressable liquidity' transactions would be useful for the purposes of transaction cost analysis and assist the operation of the best execution obligation as it would allow for those trades to be excluded from the analysis that are not considered "new" liquidity or liquidity that could have been traded against.

20. To deal with these two issues CESR put forward in the Consultation Paper proposals for each type of transaction to be identified in a harmonised way by using standard identifiers for various categories of transaction - e.g. 'P' for portfolio trades. The intention was to ensure both consistency in the application of the relevant identifiers and to provide useful information to the market that is beneficial to the overall market efficiency.

21. Industry members of the Group fully supported CESR's intentions in this area but there was some debate on the identifiers which should be recommended as the standard ones. Unnecessary granularity in the identifiers should be avoided. However it would be useful for market participants to have additional information in relation to certain trades for their transaction analysis purposes. The industry members of the Group concluded that the following three transaction type standards were likely to be the best means of meeting CESR's objectives.

    B "Benchmark" trade flag to be used to report trades where the price was derived over a period of time from post-trade prices according to a specified benchmark and hence did not

[3] Article 27(1)(b) of the Implementing Regulation.

[4] As non-binding rules see Recommendation °3 of CESR's Level 3 guidelines and recommendations on publication and consolidation of market transparency (Ref.: CESR/07-043), available at http://www.cesr.eu/popup2.php?id=4228.

[5] A 'give-up/give-in' transaction occurs where an investment firm transfers a hedge position acquired on a client's instruction to another investment firm who is selling that client a derivative contract. The volume is typically traded on external venues and (re)reported with price adjustment for the give up to a prime broker.

reflect the current price of the stock. VWAP trades would be one example of this Benchmark category.

X Agency cross trade flag to be used for trades[6] where an intermediary had brought together two clients' orders with the purchase and the sale conducted as one transaction and involving the same volume and price.

T "Technical" trade flag to be used to mark other trades based on factors which indicate that they generally should not be considered as addressable or were ones not directly relevant for price formation purposes. This generic category would include ex/cum dividend trades; give up/give in; OTC hedges of a derivative where, by agreement between the parties, the pricing of the equity and derivative legs are inter-dependent; equity hedge trades related to the creation/redemption of Exchange Traded Funds; Exchange for Physical trades[7]; and inter-fund transfers.

A trade could be marked with more than one flag according to its nature – e.g. BX.

22. CESR agrees that the proposed set of flags for OTC transactions outlined above would help enable consumers of post-trade data to identify what kinds of liquidity were non-addressable for them and/or which trades were determined by other factors than the current market valuation of the share, and would allow for improved execution quality and transaction cost analyses to be undertaken. However, CESR sees value in separately flagging (and therefore excluding from the 'T' box) two categories of trades – ex/cum dividend trades and give-up/give-in trades. These two types of trade are easily defined and it is considered that the additional granularity does not seem to be harmful to the market but would allow market participants to better exclude or include certain trades for volume and/or price analysis.

23. In addition, CESR recommends that it should be further explored whether the specific flags proposed for OTC trades if appropriate and as far as relevant should be also applied for all trading mechanisms, including organised trading venues (i.e. RM and MTFs) in order to facilitate the consolidation of data. (The issue of a general standardisation of the flags used for trading on RMs and MTFs is considered in paragraph 39 below.)

Recommendation

24. CESR recommends amending MiFID to:

a) include the following OTC transaction type standards:

'B' A flag for "benchmark trades" including all kinds of VWAP[8], TWAP[9], CVWAP[10] and all other trades where the price is calculated over multiple time instances according to a given benchmark.

'X' A flag for 'agency crossing trades';

'G' A flag for 'give-up/give in trades';

[6] Some industry members of the Group consider that crossing trades can also represent non-addressable liquidity and while this was not a unanimous view, it was considered that there would be benefit in having crossing trades separately flagged.
[7] Exchange for Physicals, known by their acronym -- EFPs, are transactions in which the buyer of a security or a basket of securities transfers to the seller a corresponding amount of long derivatives contracts, or receives from the seller a corresponding amount of short futures, at a price difference mutually agreed upon.
[8] Volume-weighted average price.
[9] Time-weighted average price.
[10] Consolidated volume-weighted average price.

‘E’ A flag for ‘ex/cum dividend trades’; and

‘T’ A “technical trades’ flag as a generic category covering trades which either represented non-addressable liquidity or were ones where the exchange of shares is determined by factors other than the current market valuation of the share. Non-exhaustive examples of such trades include OTC hedges of a derivative; inter-fund transfers; equity hedge trades related to the creation/redemption of ETFs; Exchange for Physical trades.

A non-standard settlement trade should not be published with a ‘T’ flag. The financing costs should be included in the commissions and the reported as a normal trade.

A trade should be marked with more than one flag according to its nature – e.g. ‘BX’ for a VWAP cross.

b) adjust Articles 3 and 27(1)(b) of the MiFID Implementing Regulation to the new structure.

25. If this recommendation is implemented, CESR intends to conduct further work together with the industry to provide guidelines on clarification of the content of each of these flags, as necessary. It will also be necessary for ESMA to be able to establish an efficient and on-going process with the industry to quickly react to new developments and provide guidance as needed to the market.

iii) Identification of dark trading

26. There is currently no requirement under MiFID for transactions on RMs and MTFs that were the result of orders that were not pre-trade transparent to be flagged as such. CESR proposed in the Consultation Paper that a transaction that resulted from a dark order should be identified. The Group agreed.

27. There was an overall view that where a dark order executes against a lit order, the transaction should be reported according to the state of the order resting in the order book (i.e. an aggressive dark order executing against a resting lit order would not be flagged as dark).

28. Regarding Iceberg orders, one industry participant of the CESR/Industry WG argued that a trade involving the hidden part of an Iceberg in a hybrid order book (i.e. when dark orders can interact with lit orders in the order book) should be published with a ‘dark’ flag. The main argument was that in a hybrid order book it would otherwise be easy to identify an Iceberg because market participants would not have seen the respective volume quoted on the order book before. However, in CESR’s view the hidden part of the Iceberg always rests in an order management facility which is distinct from the order book and the consecutive peaks of an Iceberg are lit when they come onto the order book even if they are immediately executed. Thus, CESR considers - in line with the current practice at most RMs and MTFs – that the parts of an Iceberg order executed when disclosed to the order book are to be considered as lit and the resulting trade should not be flagged as ‘dark’.

Recommendation

29. CESR recommends amending MiFID to require the identification of ‘dark trading’ with a ‘D’ flag in post-trade transparency reports. This requirement should include trades on RMs and MTFs under the reference price waiver and the large in scale waiver. Where a dark order executes against a lit order, the transaction should be reported according to the status of the resting order in the order book. The parts of an Iceberg order executed in the moment they are disclosed to the order book are to be considered as lit.

iv) Unique transaction identifier

30. MiFID does not currently require that each transaction published has to be assigned a unique transaction identifier (UTI). While many publication arrangements already use an identifier of this type, not all do. Without a UTI, it is impossible to determine which transactions were later subject to amendment or cancellation, and so post-trade data analysis is made more difficult and imprecise.

31. The Group agreed that a UTI should be required provided that this did not publicly identify the parties to the trade. Some industry members noted that some trading platforms use an identifier that is unique within each trading day, but may be used again on different trading days. The Group agreed that this was an acceptable procedure as long as all reports of cancellations and amendments included the date of the original trade along with the transaction identifier so that the original trade can be positively and uniquely identified. CESR notes that the requirement to provide a UTI would apply at the point at which the information is made public. This means the identifier could be provided by the Approved Publication Arrangement (APAs) in the case of OTC transactions. This does not need to be the same identifier as that provided by the investment firm that executed the underlying trade, as long as the publication arrangement is able to determine the underlying transaction for each trade made public. When made public the UTI would need to be accompanied by a unique code identifying the trading venue (RM/MTF) or the publication arrangement.

Recommendation

32. CESR recommends amending MiFID to require the use of a unique transaction identifier along with a unique code identifying the publication arrangement.

v) Cancellations and Amendments

33. Article 27(1)(d) of the MiFID Implementing Regulation requires any amendments to previously disclosed information to be made public. However, there is no legally binding requirement that specifies how this obligation should be met and so there is not consistency in the way information related to amendments is made public[11]. CESR has proposed in its Consultation Paper that information relating to the cancellations or amendments would need to be published together with the unique transaction identifier of the original transaction as soon as possible and no later than 1 minute after the decision to cancel or amend is made and with a “C” or “A” flag (for cancellation or amendment).

34. The Industry members of the Group agreed with the overall proposal that cancellations and amendments be published within 1 minute and with the unique transaction identifier included. There was agreement that these publications should be made with a “C” or “A” flag. Similarly to the general discussion in paragraph 7 above, a decision will need to be taken as to whether this should also be included in the underlying publication message communicated by the RM, MTF or APA to the publication arrangement or data vendor, or whether the requirement is only that the end user must see a ‘C’ or ‘A’ in the cancellation or amendment trade-report.

Recommendation

[11] As non-binding rules see Recommendation °3 of CESR’s Level 3 guidelines and recommendations on publication and consolidation of market transparency (Ref..CESR/07-043), available at http://www.cesr.eu/popup2.php?id=4228.

35. CESR recommends amending MiFID to include an obligation that cancellations and amendments should be published together with the unique transaction identifier of the original transaction as soon as possible and no later than 1 minute after the decision to cancel or amend is made and with a 'C' or 'A' flag (for cancellation or amendment). Where a trading venue (RM/MTF) or an approved publication arrangement (APA) uses the same transaction identifiers over multiple days, the date of the original trade would also need to be published along with the UTI when publishing a cancellation and the amended trade. The cost/benefit analysis recommended in paragraph 9 above should also extend to the flags for cancellations and amendments.

vi) Negotiated Trades

36. Article 27(1)(c) of the MiFID Implementing Regulation requires that an indication be provided where a trade was a negotiated trade. However, there is no legally binding requirement that specifies how this obligation should be met and so there is no consistency in the way this information is made public. CESR proposed in its Consultation Paper that where a transaction is a negotiated trade, in accordance with the CESR Level 3 Recommendation, the flag "N" would need to be used.

37. The Group agreed that a standard flag for negotiated trades would be beneficial. It was clarified that the negotiated trade flag should only be used for trades which occurred under the negotiated trade waiver in Article 18(1)(b) of the MiFID Implementing Regulation. Thus, this flag only needs to be used by RMs and MTFs making use of this exemption from pre-trade transparency. A negotiated trade could also be marked with an additional flag according to its nature, e.g. NB for negotiated trade relating to a benchmark price.

Recommendation

38. CESR recommends amending MiFID to oblige RMs and MTFs to use an 'N' flag indicating a negotiated trade as of the waiver under Article 18(1)(b) of the MiFID Implementing Regulation and to clarify in Article 27(1)(c) of the said Regulation that it only applies to RMs and MTFs. The cost/benefit analysis recommended in paragraph 9 above should also extend to the negotiated trade flags.

vii) Standardisation of flags for trading on RMs and MTFs

39. The Group also discussed whether a minimum set of other standard identifiers for trades conducted on the order books of RMs and MTFs should be developed. Particularly some buy-side and sell-side members of the Group felt that some standardisation in respect of market condition flags would be of value. In this respect, it was noted that, for example, there were no standard flags used by RMs and MTFs to distinguish those trades which had been conducted in auctions (e.g. opening and closing auctions) from those executed in continuous trading which were considered by some members of the Group as having the greatest informational content for buy-side and sell-side market participants. In the time available it has not been possible to formulate a definitive recommendation in this area.

Recommendation

40. CESR supports greater harmonisation of flags used by RM/MTFs for on-order book trades and proposes that work by CESR in collaboration with the industry should continue to determine whether it is possible to develop a minimum set of standard flags which can be used for on-order book trading in RMs and MTFs.

3. Clarifications of the post-trade transparency obligations

41. Article 27(4) of the MiFID Implementing Regulation currently provides that where a transaction is executed OTC there are arrangements under which the transaction should be disclosed by one of the investment firms involved. The objective is to ensure that the trade is published whilst avoiding duplicative publications. However, it is recognised that there are difficulties in applying the requirements to complex trading scenarios and that trades are sometimes being published more than once, leading to a distorted picture of the market and adverse effects for both firms and regulators.

42. To deal with these problems CESR proposed that the reporting obligation should be strengthened by stressing that trades should be made public by only one of the investment firms involved.

43. CESR also put forward various proposals to clarify which party should provide for the trade publication in three particular scenarios:
    - two matching trades;
    - transactions on behalf of a client; and
    - where ownership of a share is transferred from one investor to another via a chain of investment firms with no change in price and no own capital at risk ('chain of transactions').

44. The Group fully supported the objective of eliminating duplicative reporting and agreed that these were relevant scenarios where reporting obligations needed clarifying to avoid multiple reports of the same transaction. The industry members of the Group noted that the most common reason for duplicative reporting was that an investment firm would not know how its counterparty had handled a particular trade (e.g. whether as part of the transaction chain the counterparty had traded on a regulated market/MTF and thus the trade was already published). The first investment firm would therefore not know whether or not it should make a report and to avoid the risk of there being no report would itself often report the trade to be safe. The Group considered that as a general rule in these situations the onus should be on the investment firm which executed the trade – the executing broker[12] - to make the report, defaulting to the selling firm reporting if it was not clear which firm was the executing broker.

45. The Group agreed with CESR's proposed clarification in the April Consultation Paper that, where a transaction is executed outside the rules of a RM or MTF and one of the parties is not an investment firm (e.g. retail client or proprietary trading firm exempted from MiFID), the information shall be made public by the investment firm.

Recommendation

46. CESR recommends amending Article 27(4) of the MiFID Implementing Regulation to clarify that where a trade is not executed under the rules of the RM or an MTF the following applies:

    <u>Only one</u> investment firm should make the information public which is determined by proceeding sequentially from point (i) to (iii) below unless there is a divergent standing agreement between the parties:

[12] An executing broker is the investment firm which executes the 'market leg' of an order whether this is via a transaction carried out on an RM or MTF or concluded OTC with another counterparty or by crossing the order with an order from another client of the investment firm or from its own inventory. An investment firm which merely receives and transmits an order to another investment firm for execution would not be the executing broker. An example of a situation involving an executing broker would be where an investment firm (A) acting on behalf of a client was seeking to purchase shares on a market where it was not a member. A therefore approaches another investment firm (B) which is a member of that market to carry out the transaction. B buys the shares from a counterparty on the market and sells them to A which in turn sells them on to its client. In this example B would be the executing broker. Firm A would only be responsible for making a trade report in the event that there was any change in terms from the execution received from B**.**

(i) the EEA investment firm which acts as the executing broker in the transaction;

(ii) in the case that two EEA executing brokers are involved in the transaction or in the absence of an EEA executing broker[13], the EEA investment firm which sells the share or acts on behalf of or arranges the transaction for the seller;

(iii) in the absence of a selling EEA investment firm, the EEA investment firm which buys the share or acts on behalf of or arranges the transaction for the buyer.

i) Two matching trades

47. The last paragraph of Article 27(4) of the MiFID Implementing Regulation states that two matching trades entered at the same time and price with a single party interposed shall be considered as a single transaction for trade reporting purposes and the parties 'shall take all reasonable steps to ensure' it is made public as such. CESR proposed in its Consultation Paper that this latter requirement should be strengthened and be turned into the obligation that the parties 'must ensure' that the trades are published as one single transaction.

48. The industry members of the Group debated whether a collective requirement that the 'parties must ensure' would work without an agreement between the parties. The concerns were mitigated by the fact that it is unlikely that a regulator will enforce this requirement as a 'collective' one and seek to take action against an investment firm which actually had no duty to report.

49. As regards clarification of the obligation, CESR proposed to clarify that 'two matching trades' would include the situation where an investment firm acts on its own account and on behalf of a client and simultaneously executes a buy and a sell transaction and where there is no change in price (see example 1 below).

Example 1 – Riskless principal[14] Investment firm A has an order to sell 100 shares on behalf of client A. In order to execute this order, investment firm A buys these shares on its own account from client A and sells the shares to investment firm B on own account. Client A (selling) ↔ (buying) Investment firm A (selling) ↔ (buying) investment firm B Publication: Investment firm A publishes the 'matched trades' as one single transaction Market sees: Total volume of 100 shares

A transaction should be published as a single matching trade only if it involves one counterparty on each side of the trade. So, for example, a buy order for 100 shares from one client cannot be matched with two sell orders each for 50 shares from two different clients and then published as one single trade.

50. The industry members of the Group agreed that these clarifications would be helpful. The Group considered that the trades should only be regarded as matched – and published as a single trade marked with a cross flag – if the price, the size and the time are the same.

[13] An example of a situation where an EEA execution broker is absent would be where two EEA investment firms are trading bilaterally on own account without any clients involved.

[14] CESR's Technical Advice to the European Commission in the Context of the MiFID Review – Transaction Reporting (Ref. CESR/10-808), p.6, proposed to use the term 'client facilitation trade' for the concept of riskless principal.

51. Where an investment firm acts for the account of and on behalf of both the buyer and seller and where there is no change in price (see example 2 below), for the purposes of trade publication this should be considered as one trade which needs to be published (no matter how the investment firm has booked the two sides of the trade).

> **Example 2 – Agency cross**
>
> Investment firm A has an order to buy 100 shares on behalf of client A and an order to sell 100 shares of the same issuer on behalf of client B. Investment firm A crosses both orders OTC in order to execute the trade.
>
> Client A (buying) ↔ Investment firm A ↔ (selling) client B
>
> Publication: The investment firm crossing the 'matched trades' should make them public as one single transaction.
>
> Market sees: Total volume of 100 shares

Recommendation

52. CESR recommends amending Article 27(4) to strengthen the requirement to report two matching trades as one single transaction by obliging the parties to ensure this and to clarify the obligation (as set out in paragraph 49 above).

<u>ii) Transactions on behalf of a client</u>

53. CESR is concerned about the broader application of the post-trade transparency requirements where an investment firm executes one or more transactions on behalf of one or more clients.

54. CESR's objective regarding transactions on behalf of a client is to avoid double-reporting of OTC transactions where there is an OTC 'market-side' leg (the buying investment firm purchases the shares from a selling counterparty) and a 'client-side' leg (the buying firm then sells the shares to the client) but there is no change in the price of the shares[15]. To achieve this, CESR proposed that the default position to be adopted (unless the two investment firms in the market-leg of the transaction agreed other arrangements) was that only the <u>selling</u> investment firm should report the 'market-side' trade between the two investment firms (see examples 3 and 4).

55. Where one leg of the transaction is executed under the rules of a RM or an MTF and the client-leg is executed OTC, CESR proposed to clarify that only the transaction undertaken on the RM/MTF should be made public (by the platform in question). The client-side leg should not be published provided that there is no change in price (see example 4).

> **Example 3 – Single over the counter transaction on behalf of a client[16]**
>
> Investment firm A buys 100 shares over the counter on behalf of a client (whether on its own account or on an agency basis) from investment firm B:
>
> Client (buying) ↔ (selling) Investment firm A (buying) ↔ (selling) Investment firm B
>
> Publication: Investment firm B (unless investment firms A and B have a standing agreement about who makes information public)

[15] The ... not be ...
[16] The ...

Market sees: Total volume of 100 shares

Example 4 – Multiple transactions on behalf of a client

Investment firm A buys 100 shares on behalf of a client (whether on its own account or an agency basis), 80 on a RM or MTF and 20 over the counter from Investment firm B:

Client (buying) ↔ (selling) Investment firm A (buying) ↔ RM or MTF (80 shares)
Client (buying) ↔ (selling) Investment firm A (buying) ↔ (selling) Investment firm B (20 shares)

Publication: RM or MTF makes information public in relation to 80 shares
Investment firm B makes information public in relation to 20 shares (unless investment firms A and B have a standing agreement about who makes information public).

Market sees: Information related to 80 shares and information related to 20 shares

56. The Industry members of the Group agreed with CESR's proposals here.

57. It was also noted that in some cases the client would require the 'client leg' of the trade (even though the market leg had been conducted OTC) to be formalised as a negotiated trade by a RM or MTF. This might be for tax reasons or because this was considered to provide greater certainty in the event of default. If such a negotiated trade was published by a RM/MTF in the same way as any other negotiated trade without further granularity, this could lead to misleading indication as to the actual trading volume due to the publication of both the market and the client sides of a transaction. To deal with this circumstance, it was proposed to specify that if the market-side leg of the transaction was executed OTC or on a RM/ MTF and the client wishes to bring the client-side leg under the rules of a RM or MTF as a negotiated trade, publication of the latter trade by the RM/MTF should be with an 'N' flag and an additional flag indicating that the negotiated trade is the client-side of a trade of which the market-side was already published.

58. The Group also suggested that it would be helpful to investment firms in complying with their post-trade reporting obligations under MiFID if as comprehensive a list as possible of worked scenario examples of how to meet the obligations was produced by CESR/ESMA (in consultation with the industry) and published. CESR agrees this would be helpful but notes that work on such guidelines would probably need to wait until the revised MiFID obligations on post-trade reporting were clear.

Recommendation

59. CESR recommends clarifying in MiFID that, in the situation where an investment firm acts on behalf of a client (whether on its own account or on an agency basis) and executes a market-side leg and a client-side leg, only the market-side leg should be published to avoid double publications (if there is no change in price). If the transaction is executed on a RM or MTF, the market itself will publish the trade. If the market-side transaction involves two or more investment firms, there is no change in price and the investment firms are not putting their capital at risk, the EEA investment firm should publish the trade which is determined in accordance with the recommendation in paragraph 46 above (falling back to the EEA executing broker) unless the investment firms have a standing agreement that deviates from this.

60. In the case that the client demands that the client-side leg be undertaken under the rules of a RM (as a negotiated trade) and the market-side leg of the transaction was executed OTC or on a

RM/MTF, publication of the client-side trade by the RM/MTF should be with an 'N' flag and an additional flag indicating that the trade is the client-side of trade the market-side of which was already published.

iii) Chain of transactions

61. As noted in paragraph 38 above CESR's objective is to avoid multiple reports in a transaction chain where there is no change in price and investment firms are not putting their capital at risk[17].

62. CESR proposed in its Consultation Paper that the 'chain' should be considered as one transaction with the default position being that the initiating seller has the reporting responsibility. The Group noted that placing the obligation on the executing broker was the best option in this respect (although if the chain of transactions involved an inter-dealer broker this could not ensure there would not be multiple reports as the involvement of an inter-dealer broker would mean that it was not always possible to identify the executing broker).

Example 5 – Chain of investment firms

An order for 100 shares passes through a chain of investment firms where there is no change in price.

Selling client (selling) ↔ (buying) Investment firm A (selling) ↔ (buying) Investment firm B (selling) ↔ (buying) Investment firm C (selling) ↔ Buying client

Publication: Investment firm A (unless the investment firms have a standing agreement who shall make information public)

Market sees: Information related to 100 shares

Recommendation

63. CESR recommends clarifying in MiFID that a chain of transactions without change in price should be considered as one single transaction. The responsibility for the publication of the trade should be determined in accordance with the recommendation in paragraph 46 above.

v) Other issues

64. The Group also examined whether there were other types of transaction which should be considered as duplicative or which could be excluded from trade reporting requirements for other reasons. Examples of duplicative transactions included give-ups and trades reported for tax purposes (i.e. where it was necessary for the trade to be reported to avoid the imposition of a tax liability). However, it was noted that give-ups are not considered as transactions in all jurisdictions. The Group considered that the best solution in respect of the two categories was to report the transaction but flag it as 'Technical' (see paragraph 24 above).

65. Furthermore, a question was raised whether a trade should be published when investment firms trade in shares that have a main listing outside the EU but are also admitted to trading on an EEA RM. Where these trades are executed and published on the main market outside the EEA, the question was raised whether these would still need to be published inside the EEA. There was particular concern for OTC trades between an EU investment firm and non-EU investment firm. CESR notes that MiFID does not distinguish between a primary listing inside and outside

[17] Mere receipt and transmission of an order does not, of course, require a trade report to be made.

the EEA in terms of transaction reporting requirements to competent authorities and trade publication requirements. Trades executed in the EEA in all shares admitted to trading on an RM in the EEA are therefore included in the MiFID transparency regime[18]. If the trade is executed on an EEA RM/MTF, it always needs to be published. OTC trades need to be published if they are executed in the EEA and one of the parties to the trade is an EEA investment firm.

66. Industry members of the Group also noted that there will be a need for ongoing arrangements to consult representatives of market participants (sell-side, buy-side, trading platforms, approved publication arrangements and data consolidators) when interpreting the application of the post-trade transparency standards in the light of market developments.

Recommendation

67. Once the standards and obligations under MiFID are agreed, CESR stands ready to conduct further work together with the industry to provide guidelines specifying other worked scenarios and providing further clarification, as needed.

[18] The shares admitted to trading on EEA RMs are included in the CESR MiFID database.

ANNEX I: INDUSTRY MEMBERS OF THE WORKING GROUP

Stakeholders	Association	Firm	Representatives
Exchanges	Federation of European Securities Exchanges (FESE)	• NYSE Euronext • Deutsche Börse • BME • NASDAQ OMX	• Laurent Fournier • Combie Cryan • Michael Schaedel • Christiane Baumgarten • Julian Navas • Randall Hopkins • Ludovic Aigrot
Exchanges		• London Stock Exchange	• Jarod Hillman
MTFs		• Chi-X: • BATS	• Enzo Stingone • Paul O'Donnell • Anna Westbury
Sell-side firms	European Banking Federation (EBF) European Association of Cooperative Banks (EACB) European Association of Public Banks (EAPB) European Forum of Securities Associations (EFSA) Association for Financial Markets in Europe (AFME)	• JPMorgan Chase • Société Générale • Crédit Agricole Cheuvreux • Dexia Bank • Grupo Santander • Nomura International • Morgan Stanley • Deutsche Bank AG	• Mark Goulden • Stéphane Giordano • Stéphane Loiseau • Philippe Guillot • Charles Lehalle • Stefaan Simaey • Gabriel Alvarez de Toledo • Andrew Bowley • Gareth Carrol • Eleanor Jenkins • Stephen McGoldrick
Buy-side firms	European Fund and Asset Management Association (EFAMA)	• Blackrock GI • Fidelity International • DWS Investments • JP Morgan Asset	• Scott Cowling • Mark Northwood • Silvia Wagner • Kristian West

		Management • Schroder Investment Management	• Rob McGrath
Data vendors		• Thomson Reuters • Bloomberg	• Andrew Allwright • Alex Clode
Trade data monitors		• Markit BOAT	• Sophia Kandylaki

Date: October 2010
Ref.: CESR/10-1040

TECHNICAL ADVICE

CESR Technical Advice to the European Commission in the context of the MiFID Review – Client Categorisation

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Executive summary

This paper sets out CESR's response to Question 19 (on client categorisation) of the European Commission request for additional information in relation to the review of MiFID.

CESR considers, and the vast majority of respondents to the consultation paper (Ref. CESR/10-831) agree, that the (now established) client categorisation regime has worked well since the implementation of MiFID. In particular, the current MiFID rules on the categories of clients, and the obligations attaching to each, are generally appropriate and do not need changing – certainly not on a major scale.

CESR believes that the current tiered approach to client categorisation provides adequate and appropriate levels of investor protection to the three categories, and anecdotal evidence suggests that it is working well: that is, there has been no significant increase since MiFID implementation in customer complaints about mis-classification; there are very few issues on this subject that have been posted on the Q&A section of the Commission's website - which possibly reflects the fact that the current regime is well understood by market participants; and there are no widespread practical problems in the day-to-day business of industry players that would make significant change necessary. As MiFID already allows clients to opt down at any time (for example, eligible counterparties can always opt down to professional client status where they manage money on behalf of others eg: pension funds), those clients that do not feel comfortable with their classification can request additional regulatory protection. This is an important safety feature already built into the process and should not be overlooked by the Commission in proposing any changes to the regime.

While agreeing that per se professional clients (MiFID Annex II.I) and eligible counterparties (MiFID Article 24) include entities presenting differences in their nature, their size and the complexity of their businesses, a few respondents specifically pointed out, and CESR agrees, that these differences do not necessarily suggest differences in their respective capabilities to properly assess the risks of the financial markets in which they participate or in asking for more protection where they have doubts. In setting any criteria, there is a risk that those that should be included have been left out, and vice versa. But the current flexible regime strikes the right balance on this front. Also, there is little evidence that the current criteria are perceived by clients as being set too low as there are not significant numbers of clients requesting greater levels of regulatory protection.

In spite of the general majority opposition (by respondents) to major amendments to the regime, most respondents supported clarifications to the relevant definitions and terms in MiFID where there may be some ambiguity; and CESR does not rule out the possibility of future work at Level 3 to provide guidance or explanations as to what some terms mean in this context.

In the same vein, CESR (and most respondents) considers that it would be helpful to clarify that local authorities do not fall within the scope of "public bodies that manage public debt"; and that, when dealing with ECPs, investment firms have to (i) act honestly, fairly and professionally, and (ii) communicate with ECPs in a way that is fair, clear and not misleading (especially as these standards are consistent with the way in which firms already seek to act in the marketplace).

CESR notes (and many respondents stated) that the current client categorisation regime was implemented at great cost to the industry. In the absence of market failure and against the background of a principle-based regime that already allows for a customised treatment of different advice or selling situations and the accumulated experience with this regime so far, and without any persuasive evidence to the contrary, many respondents considered, and CESR agrees, that there are no grounds that may justify a revision of client categorisation rules. Categorisation is part of a larger system of investor protection, consisting also of suitability and appropriateness tests for certain services, information rules and fitness and propriety tests for prospective directors. Any evidence of mis-selling of certain products to certain per se professional investors is limited to specific sectors

and products and should be measured against the background of all transactions. Therefore, any change in the categorisation rules should be seen in this context and in the context of the present system that, generally speaking, works well. CESR asks the Commission to note that any attempt to address any perceived problem by altering the current regime is likely to have another large, and perhaps disproportionate, cost impact on firms (eg: as a result of changes to client take-on procedures, business practices and record-keeping systems).

I. Introduction

1. On 2 March 2010, the European Commission (EC) posed a series of questions to CESR in the context of its review of the Markets in Financial Instruments Directive 2004/39/EC (MiFID). Several of those questions related to the conduct of business rules in MiFID, including questions on the client categorisation regime.

2. CESR provided most of its responses to the EC's questions and request for additional information in relation to the conduct of business rules in July 2010. However, in a letter to the EC dated 19 March 2010, CESR indicated that its response to Question 19, on client categorisation issues, might be delayed because of the need to consult.

3. The questions posed by the EC on client categorisation were as follows:

   - Q19: "Professional clients per se" (Annex II.I of MiFID) and eligible counterparties (Article 24 MiFID) include a number of entities presenting differences in their nature, their size and the complexity of their business (for instance, small and big financial entities providing different types of activities; different categories of "institutional investors", municipalities and other public bodies). In the perspective of further calibrating the treatment of clients:
   - Q19 (a): Please share your supervisory experience and data related to problems encountered in the provision of investment services to professional clients or eligible counterparties. This includes any alleged mis-selling which may have involved public local authorities (e.g. municipalities), small and medium undertakings, institutional investors (e.g. pension funds), or small credit institutions. We ask CESR to provide details about the kind of entities and products concerned;
   - Q19 (b): Please consider possible technical criteria to further distinguish within the current broad categories of clients ("other authorised or regulated financial institutions", "locals", "other institutional investors" (Annex II.I(1)(c), (h), (i) of MiFID), public bodies managing public debt (see Article 24(2) and Annex II.I(3) of MiFID).

4. CESR considered that it was necessary to consult with stakeholders on the responses to these questions before responding to the EC, as the questions raised significant policy issues, including those which go beyond the confines of the questions asked. In this regard, CESR published its Consultation Paper (CP) "CESR Technical Advice to the European Commission in the context of the MiFID Review – Client Categorisation" (Ref. CESR/10-831) on 12 July 2010. The consultation period closed on 9 August 2010.

5. The CP sought views on whether distinctions should be made between regulated entities for the purposes of determining which entities are to be treated as "per se" professional clients; asked whether it is necessary to clarify, for the purposes of the client categorisation regime, whether local authorities/municipalities can be treated as public debt bodies; and sought views on whether tests of knowledge and experience should be used more widely for client categorisation than is currently the case, whether for very complex products (such as asset-backed securities and non-standard over-the-counter 'OTC' derivatives) the scope of the eligible counterparty categorisation should be narrowed and what standards should apply to transactions done with ECPs.

6. CESR received 43 responses to the CP (9 of which were confidential). All non-confidential responses have been published on the CESR website and are available there for viewing. CESR is grateful to all respondents for taking the time to give CESR their views.

Status of this paper

7. This paper sets out CESR's response to the EC's questions on client categorisation (Question 19). It does not make specific drafting suggestions for revisions to MiFID, but provides a suggested policy approach to the EC in answer to its questions on client categorisation.

8. This paper has been prepared by CESR's Investor Protection and Intermediaries Standing Committee (IPISC), which is chaired by Mr Jean-Paul Servais, Chairman of the CBFA.

II. Part 1: Technical criteria to further distinguish within the current broad categories of clients ["other authorised or regulated financial institutions", "locals", "other institutional investors" (Annex II.I(1) (c), (h), and (i) of MiFID)]

CESR's advice

CESR considers, and nearly all respondents to the CP agreed, that the opening sentence of Annex II.I(1) sets the scope of that provision and that points (a) to (i) are just examples of "Entities which are required to be authorised or regulated to operate in financial markets"; and are not meant to be taken as an exhaustive list.

Nevertheless, a few respondents said that given the similarity in terminology used for entity type (i) "other institutional investors" and the fourth type of entity eligible for treatment as a per se professional set out in Annex II.I(4) "other institutional investors whose main activity is to invest in financial instruments, including entities dedicated to the securitisation of assets or other financing transactions", further clarification of the interaction and linkage between these two entity categories would be beneficial. CESR agrees.

CESR, and most respondents, believes that there is no case for narrowing the range of entities that are deemed to be per se professional clients - not least because no evidence has been provided that the current definition is deficient, or that the entities in question have suffered detriment as a result of being per se professional clients, or that the Directive has failed, or that criteria set out in Annex II.I(1) have led to any serious cases of mis-selling or large-scale fraudulent activity when dealing with clients in the wholesale markets.

CESR does not believe, and the majority of respondents agree, that the language necessarily needs to be clarified, especially as the Directive appears to be achieving its objectives and the current wording provides sufficient guidance as to the classification of customers. Having said that, CESR believes that additional clarification within the range of entities could possibly benefit firms and their clients (for instance, by providing more examples within each entity type) - as long as it does not lead to any narrowing of the range of entities included in the category of per se professional clients. Additional definitional and explanatory text could help to clarify the language in points (h) and (i); and this would provide more certainty on the intended coverage and remove any doubt about entities included within the scope of the current terms. In this regard, the Commission could consider the suggestions made in paragraph 19 of the CP.[1]

Alternatively, CESR suggests that in order to encourage a consistent understanding of the coverage of Annex II.I in the market, it may be more appropriate (in terms of clarifying language), and would certainly be helpful, to set out some typical examples and their appropriate treatment on the Q&A section of the Commission's website or through CESR's own Q&A. For example, the fourth type of entity eligible for treatment as a per se professional set out in Annex II.I(4) states that this category is intended to include entities dedicated to the securitisation of assets or other financing transactions. Illustrative examples of the types of entities which would be appropriate as being considered to be dedicated to such transactions would promote additional consistency across the markets.

[1] Paragraph 19 of CP CESR/10-831: "... possible clarifications might include:
- making a link to the CRD definition of a financial institution in point (c);
- using wording from Article 2(1)(l) of MiFID to help define a "local" in point (h); and
- making clear that "other institutional investors" in point (i) covers entities whose main activity is investing in financial instruments".

Introduction and background

9. MiFID Annex II.I sets out clients that are considered to be professionals (termed "per se" professionals to distinguish them from clients that opt, or request, to be professionals under MiFID Annex II.II). This part I of the annex ("Categories of client who are considered to be professionals") is divided into four sections, the first of which deals with entities "authorised or regulated to operate in the financial markets".

10. The EC asked CESR to consider possible technical criteria to further distinguish within the broad categories of authorised or regulated entities listed in Annex II.I(1) of MiFID. CESR considered this issue and whether the language describing the entities covered by these points should be clarified.

Issues and feedback

Scope of Annex II.I(1)

11. CESR believes that the scope of Annex II.I(1) of MiFID is set by the opening sentence of its chapeau: "Entities which are required to be authorised or regulated to operate in financial markets." The second sentence and list that follow this opening sentence help in understanding the first sentence, but do not change the scope of the provision. The second sentence explains that the entities covered by the first sentence fall within one of three categories:

    - entities authorised by a Member State under a Directive;
    - entities regulated or authorised by a Member State without reference to a Directive; and
    - entities authorised or regulated by a non-Member State.

12. Therefore, the entities that fall under points (c), (h) and (i) of Annex II.I(1) of MiFID are sub-divisions of the entities that are within the scope of the opening sentence of the chapeau and fit into one of the three categories above. CESR believes that the wording of the points (a) to (i) does not change the scope of the entities that are considered to be professional clients by virtue of this limb of the definition of per se professional clients.

Interpretation of points (c), (h) and (i) of Annex II.I(1) of MiFID

13. MiFID does not define, or refer to a definition of, "financial institution" (point (c)); neither does it define the term "locals" (point (h)). However, CESR understands that the term "locals" covers the sorts of entities - where they are subject to authorisation or regulation - described in MiFID Article 2(1)(l): "firms which provide investment services and/or perform investment activities consisting exclusively in dealing on own account on markets in financial futures or options or other derivatives and on cash markets for the sole purpose of hedging positions on derivatives markets or which deal for the accounts of other members of those markets or make prices for them and which are guaranteed by clearing members of the same markets, where responsibility for ensuring the performance of contracts entered into by such firms is assumed by clearing members of the same markets".[2]

14. CESR assumes that "other institutional investors" (point (i)) is intended to cover institutional investors not covered under points (d), (e) and (f). In contrast to the language used in Annex II.I(4), there is no specific reference to the investors investing in financial instruments as their main activity. However, one would expect the concept of institutional investors in a MiFID context to be mainly focused on investing in financial instruments.

[2] The same wording is used in Article 3(1)(p) of Directive 2006/49/EC which provides - for the purposes of the Capital Requirements Directive - a definition of a "local firm".

Possible changes to Annex II.I(1)

15. The motivation for revising Annex II.I(1) would be to strengthen investor protection by narrowing the range of regulated entities that can qualify to be treated as clients that are considered to be professionals. This implies that there are some regulated entities that, in some situations, do not have the knowledge and expertise to make their own investment decisions and properly assess the risks they incur.

16. To introduce criteria to distinguish between entities covered by points (c), (h) and (i) would require a revision to the text of Annex II.I(1) so that the points help to set the scope. In these circumstances possible criteria CESR considered for distinguishing between entities covered by these points included:

    - whether the entity was regulated or authorised in a jurisdiction with an equivalent regulatory regime to the EU;
    - whether the entity was conducting business on behalf of underlying clients or not; and
    - for points (c) and (i) the size of the entity.

17. CESR believes that there is no need to narrow the scope of Annex II.I(1) by distinguishing between entities authorised or regulated to act on financial markets. It agrees with CP respondents that there is insufficient evidence that the current breadth of the provision has caused significant detriment and that there are problems involved in saying that there are some regulated entities that are not capable of making their own investment decisions.

18. In terms of the language of the points in circumstances where they set the scope of the Annex II.I(1), then possible clarifications CESR considered included:

    - making a link to the CRD definition of a "financial institution" in point (c);
    - using wording from Article 2(1)(l) of MiFID to help define a "local" in point (h); and
    - making clear that "other institutional investors" in point (i) covers entities whose main activity is investing in financial instruments.

19. Because the scope of the paragraph is not set by these points, CESR does not believe the language used causes a particular problem in relation to interpreting the provision as a whole. There is not therefore a strong case for change.

20. The use of "locals" (point (h)) might cause a casual reader of the directive some confusion given that it is a piece of financial services jargon and is not defined in MiFID. To make the directive more reader friendly there may be a case for using the words in Article 2(1)(l) to explain what constitutes a local. However, given that locals are exempted from MiFID, this might cause some confusion in a provision which only applies to entities that are authorised or regulated.

21. CESR does not believe it is sufficiently clear that the main purpose of "other institutional investors" (point (i)) is to invest in financial markets / instruments.

22. Rather than amending the legal text, another approach to clarifying language in Annex II.I(1) would be through Q&A from the Commission or CESR.

III. Part 2: Public debt bodies

CESR's advice

CESR notes, and several industry respondents to the CP made the same point, that there are substantial differences between Member States with regard to any local legislation in place for the financial market activity of their respective local authorities: the powers and competence of different local authorities, and the arrangements for managing public debt, vary extensively from State to State.

Having said that, CESR thinks there is a case for clarifying that it is not the intention under the definition of per se professional clients or per se ECPs that regional governments and public debt bodies include local authorities.

Introduction and background

23. There is no definition of what constitutes a public debt body in MiFID Article 4 ("Definitions"); and yet there are references to public debt bodies in MiFID Annex II.I(3) (in relation to clients that are considered to be professionals), and in MiFID Article 24(2) (in relation to undertakings that are considered to be eligible counterparties).[3]

24. The EC asked CESR whether there should be technical criteria to distinguish between public debt bodies. Based on the chapeau to the Commission's questions, CESR understands that the EC has particular concerns about how these terms might affect the categorisation of local authorities and municipalities (referred to below as "local authorities").

Issues and feedback

25. There is a difference in the wording of the references to public debt bodies in MiFID Annex II.I(3), and in MiFID Article 24(2). The reference in Article 24(2) is to "public bodies that deal with public debt", but is given in the context of the phrase "national governments and their corresponding offices". The reference in Annex II.I(3) is to "public bodies that manage public debt", and there is no qualification about such bodies being a corresponding office of national government.

26. This difference in language means that the words in Annex II.I(3) are potentially wider than those in Article 24(2). In some Member States local authorities have been classified as per se professional clients under this provision, whilst in most others they have not because it has been assumed that the reference is to standalone bodies managing public debt.

27. Response ID 249 on the Commission's MiFID Q&A database, regarding the classification of non-national layers of government, makes clear that "regional governments" in Annex II.I(3) should be interpreted narrowly. It then goes on to say that: "Public sector bodies which are not regional governments and do not manage public debt may be treated as professional clients on request if the conditions in Annex II, Part II are met."

28. CESR asks the Commission to take into account the fact that the ability of local authorities to engage in financial markets varies from Member State to Member State under laws and rules governing the activities of local authorities. In some Member States, local authorities are, for

[3] MiFID Article 24(2) sets out a list those entities that are automatically recognised as eligible counterparties (ie: an investment firm does not need to undertake any further steps); and MiFID Article 24(3) gives Member States the option to recognise as eligible counterparties entities other than the per se eligible counterparties as defined in Article 24(2), if those entities so request. Article 50 of the MiFID Implementing Directive specifies the requirements that such entities need to meet in order to request treatment as an eligible counterparty.

example, prohibited from entering into derivatives transactions and subject to codes and regulations governing their interaction with financial markets.

29. In the light of the above, CESR believes there is a case for clarifying the scope of Annex II.I(3) to make clear that local authorities do not fall within the scope of “public bodies that manage public debt”. There was general agreement amongst respondents to the CP that clarification is needed, and there was majority support for excluding local authorities from the scope of Annex II.I(3). It could also be worth clarifying that regional governments do not include local authorities.

IV. Part 3: Other client categorisation issues

<u>**CESR's advice**</u>

On cost-benefit grounds, CESR does not consider that it is appropriate to require investment firms to assess the knowledge and experience of some entities currently considered to be per se professional clients. All are likely to be actively engaged in capital markets, are conversant with the MiFID rules, and can avail themselves of the option to request additional regulatory protection should they so wish.

Neither does CESR believe that the client categorisation rules need to be changed in relation to OTC derivatives or complex products. In particular, CESR does not believe that new concepts of "super ECP" or "highly complex products" are appropriate, not least because these concepts are not only difficult to define, but also because any resultant definitions are likely to very quickly lose their relevance over time, and will therefore lead to legal uncertainty.

The relationship between intermediaries and clients asking for financial instruments suitable for their hedging needs will likely amount to investment advice since it will include the provision of personal recommendations from the intermediary. In this case, a suitability assessment is needed and the ECP status is not available under the current legal framework.

CESR believes that the standards that apply when dealing with ECPs are not set out clearly in the directive and that it should be made clear that when dealing with ECPs that firms have to: (i) act honestly, fairly and professionally; and (ii) communicate in a way that is fair, clear and not misleading.

Introduction and background

30. The purpose of the client categorisation regime is to tailor client protections in the light of clients' ability to make their own investment decisions and understand the risks involved. Inevitably it does this in a broad brush way. For entities that are considered to be per se professional clients or per se eligible counterparties there is no specific test of their ability to make their own investment decisions and understand the risks involved. The categorisation also does not look through to the specific transactions a client is undertaking, although a client can opt for a higher level of protection in relation to specific transactions.

31. The broad brush approach taken by the client categorisation regime could potentially mean that there are some clients considered to be professional clients or eligible counterparties that do not in fact have the knowledge and experience implied by their categorisation either generally or in relation to certain financial instruments. CESR has considered:

    - whether there should be more use of tests of a potential client's knowledge and experience in the client categorisation regime;
    - how the client categorisation regime works in relation to very complex products; and
    - the standards that apply when business is done with ECPs.

Issues and feedback

Knowledge and experience

32. Under MiFID Annex II.I (clients that are considered to be per se professionals) there are no explicit tests of the knowledge and experience. By virtue of the sort of business they do or their

size, entities are deemed to possess the knowledge and experience to make their own investment decisions.

33. This broad brush approach to client categorisation might mean that some clients do not get the protections they need because they might not have the knowledge and experience to enable them to properly assess the risks of the transactions they undertake. One way of moving away from such a broad brush approach would be to require investment firms to assess the knowledge and experience of more clients before they could be considered to be professionals. This might be particularly important in relation to unregulated undertakings that currently qualify to be considered as professionals simply by virtue of their size.

34. CESR does not consider that it is appropriate that investment firms be required to assess the knowledge and experience of some per se professional clients, not least because this would not be a proportionate response to the Commission's concerns. This proposal is likely to affect only a small number of clients, so any costs are very likely to outweigh any benefits.

Complex products

35. In addition to the numerous weaknesses in the process of securitisation that have been highlighted by the crisis and from which many institutional investors worldwide (and their underlying retail clients) have suffered, a number of cases of alleged mis-selling of complex derivative products to local authorities in Europe have been brought to public attention by the press. Moreover, anecdotal evidence suggests that corporate clients have also fallen victim to similar practices in the marketing of complex derivatives. In the US, local authorities have lost considerable sums in purported "hedging" transactions. Several enquiries are underway into whether investment firms have misled institutional investors in complex securities (such as asset-backed securities), and one case of civil fraud has recently been brought by the SEC against a major investment bank involved in the structuring and sale of collateralised debt obligations (CDOs) to large institutions.

36. These cases appear to show that clients presumed to be sophisticated and capable of looking after their own interests do not always understand the risks involved in complex instruments. They also appear to show that serious failings by investment firms (inadequate disclosures, unsuitable products) occur in the professional markets for some OTC derivatives and certain other complex products. This is not surprising given the considerable information asymmetries and conflicts of interest in these markets, not to mention the profitability of such complex products for investment firms.

37. However, CESR recognises that some clients need to use potentially complex OTC derivatives in order to hedge precisely the specific and bespoke financial risks they may otherwise face. The risk management practices of those clients may be robust and the hedging activity undertaken should bring benefits in overall risk reduction. Any change in client categorisation should neither discourage nor impede that risk management activity.

38. The relationship between intermediaries and clients asking for financial instruments suitable for their hedging needs will likely amount to investment advice[4] since it will include the provision of personal recommendations from the intermediary. In this case, a suitability assessment is needed and the ECP status is not available under the current legal framework. Nevertheless, in those cases where investment advice is not provided, it is necessary to consider whether it would be desirable and feasible to change the way MiFID's client categorisation rules work for a set of highly complex products (such as asset-backed securities and non-standard OTC derivatives).

[4] CESR's Q&A on investment advice (CESR/10-293) made clear that knowledge about an individual's desire for protection against certain risks was information about a person's circumstances. Consideration of a person's circumstances is one of the elements that determine whether a communication constitutes investment advice.

CESR considered several possible approaches to changing the client categorisation rules; inter alia:

- to say that ECP status is not available for transactions in highly complex products;
- to define a “super ECP” status subject to stricter requirements (for example, large financial institutions instead of all regulated financial institutions) for highly complex products;
- to require undertakings - either all or some, such as non financial undertakings - to request to be considered as ECPs and then requiring firms to consider whether they have the expertise, experience and knowledge to enter into transactions in highly complex products (when such transactions are contemplated) without relying on the investment firm to act on their behalf;
- to require firms that know or have reason to know that an investor classified as an ECP is unlikely to be able to properly assess the risks of a particular instrument or transaction, to treat that investor as a professional client for the relevant transaction; this would require firms to do a minimum amount of ‘know your customer’ (KYC) (experience, knowledge and expertise) when they envisage highly complex transactions with ECPs.

39. CESR does not believe that the client categorisation rules need to be changed in relation to OTC derivatives or complex products. In particular, CESR does not believe, and the overwhelming majority of respondents to the CP agreed, that new concepts of “super ECP” or “highly complex products” are appropriate, not least because these concepts are not only difficult to define, but also because any resultant definitions are likely to very quickly lose their relevance over time, and will therefore lead to legal uncertainty. CESR believes (and this was supported by many respondents) that client categorisation should not be based on products or their relative complexity.

40. Furthermore, in practice, the unavailability of the ECP categorisation for certain products could potentially lead to the untenable scenario where banks, for example, are not an ECP when trading some complex products, some of which they may originate.

Standards applying to business done with ECPs

41. As a result of Article 24(1), when a client does business as an ECP the protections in Article 19 do not apply, and an investment firm is not under a specific obligation to act “… in accordance with the best interests of the client.”

42. It makes sense that investment firms are not under an obligation to act in accordance with the best interests of the client when dealing with ECPs. The conduct of business obligations are turned off for such transactions because the ECPs are deemed to be able to look after their own interests. However, the standards that do apply to business that investment firms conduct with ECPs are opaque.

43. It is clear that the conflicts of interest rules apply to such dealings (Article 24 of MiFID does not disapply these rules to dealings with ECPs). Moreover, for market transparency and integrity purposes, Article 25 of MiFID also says that competent authorities have 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.” This provision does not limit competent authorities’ regulatory obligations, but is not matched by a specific obligation on firms in relation to dealings with ECPs.

44. Given that ECPs are deemed to be able to look after their own interests, there should be no need to have a long list of standards applying to business done with ECPs. However, CESR believes

that it would be helpful to clarify[5] that, irrespective of the kind of client they are dealing with, investment firms have to:

- act honestly, fairly and professionally; and
- communicate with ECPs in a way that is fair, clear and not misleading.

45. These standards are consistent with the way in which firms already seek to act in the marketplace.

[5] For example, through CESR/ESMA guidance.

COMMITTEE OF EUROPEAN SECURITIES REGULATORS

Date: October 2010
Ref.: CESR/10-1254

CESR's Responses to Questions 1-14 and 19 of the European Commission Request for Additional Information in Relation to the Review of MiFID

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Executive Summary

CESR provides factual information to Questions 2, 3, 5, 7 and 14 of the Commission request for additional information where it was requested to provide data about EEA regulators' experience on the pre-trade transparency requirements for RMs and MTFs (Table 1 of Annex II of the MiFID Implementing Regulation (EC) No 1287/2006 of 10 August 2010; standard market sizes (Table 3 of Annex II of MiFID Implementing Regulation No 1287/2006); depositary receipts, exchange traded funds, preference shares and certificates; trading activity involving systematic internalisers and sources of pre- and post-trade information (in particular, through electronic systems) for corporate bonds, structured finance products, CDS, interest rate derivatives, equity derivatives, foreign exchange derivatives and commodity derivatives.

Additionally, in responding to Questions 4, 6, 8, 9 and 10, CESR provides complementary information to the one already published in CESR's Technical Advice in the Context of the MiFID Review, Equity Markets (Ref. CESR/10-802) and Non-Equity Markets Transparency (Ref. CESR/10-799) in relation to the following topics: supervisory experience as regards the eventual problems in relation to the definition of a liquid share (Article 22 of the MiFID Implementing Regulation No 1287/2006); organisational requirements for regulated markets and MTFs; transparency for corporate bonds, structured finance products, CDS, and derivatives (and in particular on pre-trade transparency).

CESR also provides its policy views on the following questions on transaction and position reporting and position limits:

Q11(a) How to arrange the flow of information on transaction and position reporting

CESR suggests defining a new position reporting regime through trade repositories (TRs), as foreseen by EMIR, and in the MiFID review recognising TRs as reporting mechanisms through which investment firms will be able to fulfil their transaction reporting obligations, to the extent that TRs will be able to record all the necessary fields to comply with the transaction reporting obligation.

In line with the EMIR proposal, position reporting will be conducted through TRs and, when they will not be able to record the details of the contracts, directly to regulators. CESR will soon start the necessary work for the definition of the technical standards in this respect, in particular for the identification of the relevant fields in both cases.

Q11(b):Other purposes of transaction and position reporting apart from detecting and pursuing cases of market abuse

There are a number of additional purposes of how information on transaction and position reporting might be used. They include among others monitoring compliance with general MiFID provisions, detecting possible risks for market integrity and stability, identifying the relevant contracts for the purpose of the clearing obligation, identifying the systemically relevant counterparties, enforcing the clearing obligation and gathering intelligence on the new market trends.

Q11(c): CESR members' experiences with transaction reporting arrangements

CESR members expressed general satisfaction with the local arrangements put in place in each jurisdiction. Therefore, no major concerns or proposals for amendments were made.

Q12(a): Existing position reporting arrangements in Members States

Commodity position reporting is currently implemented in the Member States of three CESR members. Relevant obligations arise either from the local legislative provisions or are the result of

historical arrangements.

Q12(b): Position reporting

There is widespread support for a system of position reporting to regulators. Position information is highly valuable for commodities market monitoring and in investigations, because typical abusive behaviour in commodities markets commonly emanates from exploitation of dominant positions. Having a history of how positions have been built up is highly valuable to regulators in understanding market behaviours. It can also be useful for assessing systemic risk and for prudential regulation. Ideally the information should cover exchange and OTC markets, to give a whole market view. Technically, ways to include exchanges, central counterparties and trade repositories in the position reporting system need to be explored. The entry into force of EMIR will indeed improve substantially the information on positions in OTC derivatives.

Q12(c): Breakdown of data by type of trader

There is considerable benefit for regulators receiving this type of information, which can be used to understand financial firms' business models and overall exposures relative to other market users. It could also be used to underpin a system of aggregate open interest reporting to the market, similar to CFTC's Commitment of Trader reports[1].

Q12(d): Position limits

There is little evidence so far to suggest that markets where position limits have operated for the life of the derivative contract have been any less volatile than those which have not. Nor is there sufficient evidence so far that position limits can systematically be used to limit the impact that significant positions may have on the prices markets generate. Accordingly, it remains to be further assessed whether or not position limits are suited to achieving the objectives of reducing volatility or limiting the impact that large positions may have on market prices. The key objectives for financial regulators should therefore remain the maintenance of orderly markets and combating market manipulation. The Commission should in CESR's view focus on analysing whether exchanges/regulators have sufficiently extensive set of powers to manage positions across the entire life of commodity derivatives market contract curves setting up a harmonised set of powers for exchanges/regulators in European legislation and considering whether there is a need for further harmonisation in the way those powers are actually implemented across EU commodity derivatives markets.

Q13: Extending the new reporting system to MiFID Article 2(1)(i) and (k) firms

There are in existence already significant alternative reporting methods through which regulators can obtain information on these MiFID exempted firms. These include reporting through regulated intermediaries and reporting of exchange based transactions through market operators. However, extending a new reporting system of transaction and position information to these firms would have the benefits of standardisation of reports and would afford regulators a "whole market" view. In the future, regulators may also receive relevant data on commodities markets positions of firms exempted from MiFID via trade repositories. In view of the fact that EMIR defines non-financial counterparties as those non-covered by MiFID, CRD, Solvency II, etc. it will automatically exclude from the position reporting obligation MiFID exempted firms, with the risk of losing important pieces of information, in particular when contracts are concluded between two exempted firms. Depending on the actual application of the reporting obligation to non-financial firms, which is related to the level of information threshold, regulators will have a more or less 'full picture' of the OTC market.

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[1] For more information on the CFTC's Commitment of Trader (COT) reports see http://www.cftc.gov/marketreports/commitmentsoftraders/index.htm.

Question 1: Please share your supervisory experience as regards any problems with the definition of a transaction for the purpose of Regulation 1287/2006.

See CESR's Technical Advice to the European Commission in the context of the MiFID Review: Transaction Reporting (CESR/10-808).

Question 2: Please share your supervisory experience as regards any problems in relation to Table 1 of Annex II of regulation 1287/2006, defining the information to be made public by MTFs and regulated markets according to Article 17 of the same regulation.

CESR members have not experienced particular difficulties with the application of Table 1 of Annex II in their supervisory practice. The description of the different systems therefore seems to be still valid and the definition of the information to be made public by RMs and MTFs seems to be still adequate.

Question 3: In the context of the work on systematic internalisers currently carried out by CESR, please share your supervisory experience as regards any problems in relation to Table 3 of Annex II of regulation 1287/2006, defining the standard market size.

In order to receive views of market participants on the adequacy of the definition of 'standard market size', CESR included a specific question in this regard in its Consultation Paper on MiFID Equity Markets Review (Ref. CESR/10-394)[2].

The majority of respondents have not experienced any difficulty with this definition. Those respondents who emphasised specific concerns with the definition in Table 3 of Annex II indicated a need to reflect more accurately the rapidly changing trading environment and sizes of transactions. In this respect, it was suggested that the SMS should be assessed on a more frequent basis.

CESR has made the following observations regarding the number of liquid shares, the evolution of the AVT and the allocation of SMS in the AVT buckets included in Table 3 of Annex II over the last three years. The data in table 1 and graph 1 below is based on the data published in the MiFID database on the CESR website[3].

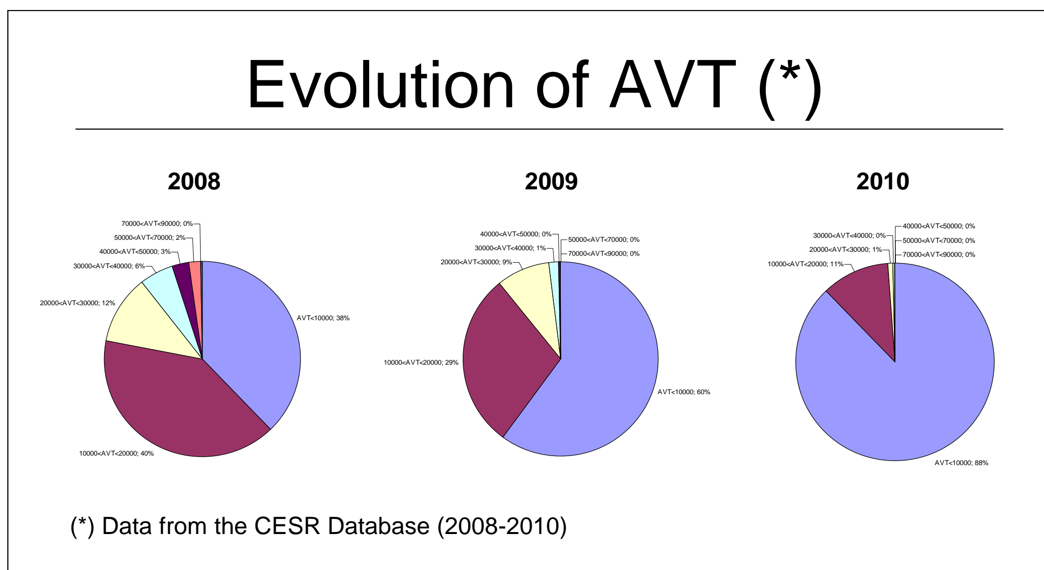
[2] See question 15 of the Consultation Paper – CESR technical advice to the European Commission in the Context of the MiFID Review – Equity Markets, 13 April 2010 (Ref.: CESR/10-394), p.15, available at: http://www.cesr-eu.org/popup2.php?id=6548

[3] See MiFID database at http://mifiddatabase.cesr.eu/.

Table 1: Amount of shares falling in each bucket in Table 3 of Annex II in 2008, 2009 and 2010

Year	Liquid Shares	AVT	AVT<10000	10000<AVT<20000	20000<AVT<30000	30000<AVT<40000	40000<AVT<50000	50000<AVT<70000	70000<AVT<90000
2008	1.004	15.483	38%	40%	12%	6%	3%	2%	0%
2009	742	10.653	60%	29%	9%	1%	0%	0%	0%
2010	732	6.221	88%	11%	1%	0%	0%	0%	0%

Graph 1: Amount of shares falling in each bucket in Table 3 of Annex II in 2008, 2009 and 2010



The Commission may wish to further study this development and the appropriateness of the buckets of the SMS table in the framework of the MiFID review and/or introduce more flexibility in the MiFID Implementing Regulation by allowing ESMA to adjust the SMS table, if necessary, by issuing binding technical standards.

Question 4: In the context of the work on systematic internalisers currently carried out by CESR, please share your supervisory experience as regards any problems in relation to the definition of a liquid share, as set out in Article 22 of Regulation 1287/2006.

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 a regulated market 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.

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.

CESR has not experienced any difficulties with this definition or received complaints that the definition of liquidity itself would be inappropriate for determining liquid shares for the purposes of the systematic internaliser regime. However, CESR considered that the use of discretions by some Member States but not by others may lead to deviations in the determination of a liquid share and may thus influence the scope of application of the SI-regime under Article 27 of MiFID. CESR therefore consulted in its MiFID Equity Markets Review CP[4] on the question whether the discretion should be deleted and, if considered desirable, what the future harmonised criteria for the definition of a liquid share should be used: both criteria (a) and (b) or only one of the two criteria.

Majority of respondents saw advantage in having a unique definition for liquid shares and a broad majority of the respondents preferred to apply both conditions a) and b). As reasons for applying both criteria it was mentioned that volatility and liquidity are not absolute concepts. They rather depend on specific markets and market situations. According to another respondent, any definition based on the average daily number of transactions is so dependent on the trend in frictional costs that setting a threshold based on current market conditions may soon prove to be outdated and irrelevant. The same would apply to average daily turnover.

Since this 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, CESR recommended in its Technical Advice to the European Commission in the Context of the MiFID Review – Equity Markets (Ref. CESR/10-802) that the existing discretion be retained[5].

CESR members have however observed difficulties in limited circumstances with the calculation of the free float in accordance with the requirements in Article 22(4) of the MiFID Implementing Regulation when calculating the free float in line with Article 33(1)(c) of the MiFID Implementing Regulation for purposes of the MiFID database. In particular, the exemption 'unless such a holding is held by a collective investment undertaking or a pension fund' is considered difficult to apply in practice. It could therefore be considered to delete this exemption for practical reasons.

Question 5: In the context of the work currently undertaken by CESR on transparency for instruments similar to shares, please provide information about the number of trades as well as the turnover per Member State for depository receipts, exchange traded funds, preference shares and certificates.

In order to answer this question, CESR has prepared a questionnaire on trading of depositary receipts and 'certificates' to which all CESR members were asked to respond. The results are summarised below and the details for each Member State are provided in Table 2. Please note that the figures provided by Luxemburg, and thus the aggregate calculations on DRs including this data, are confidential information.
The instruments covered by the exercise were those defined in CESR's technical advice on MiFID Equity Markets Review (Ref. CESR/10-802)[6]:

1. Depositary receipts (DRs) are negotiable securities that represent ownership of a given number of a company's shares and can be listed and traded independently from the underlying securities.

[4] See questions 47 to 49 of the Consultation Paper – CESR technical advice to the European Commission in the Context of the MiFID Review – Equity Markets, 13 April 2010 (Ref.: CESR/10-394), p.30 et seq, available at: http://www.cesr-eu.org/popup2.php?id=6548

[5] CESR Technical Advice to the European Commission in the Context of the MiFID Review – Equity Markets, 29 July 2010 (CESR/10-802), p. 38, available at: http://www.cesr-eu.org/popup2.php?id=7004.

[6] For details see http://www.cesr-eu.org/popup2.php?id=7004.

This includes all forms of DRs listed and traded on EU RMs, such as Global Depositary Receipts (GDRs) and American Depositary Receipts (ADRs).

2. '<u>Certificates'</u> are securities issued by a company whose holders 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 MiFID transparency regime.

Since 'certificates' as defined in the CESR advice only exist in certain jurisdictions or are already considered as shares (and included as such in the national transparency regime and the MiFID database), the columns on 'certificates' were only filled by CESR members in whose Member States these instruments exist and are not yet considered to be covered by the MiFID transparency regime.

In order to evaluate the data requested by the Commission on trades and turnover in a meaningful way, CESR also gathered the number of DRs and 'certificates' admitted to trading on RMs in the EEA.

The data covers a time period of Q1 and Q2 2010 as this will provide an idea about the current market structure in the EEA and liquidity of these instruments. Data on the turnover is provided in millions of Euros. The data does not extend to OTC trades of DRs and 'certificates'.

All CESR members answered to CESR's data request on DRs and 'certificates'.

199 DRs are admitted to trading on RMs in 9 jurisdictions[7]. In Q1 and Q2 of 2010 more than 3.5 million transactions took place in DRs on RMs and MTFs in Europe with a turnover of more than 109 billion Euros. In 4 jurisdictions, DRs admitted to trading on a RM are already included in CESR's MiFID Database for shares[8].

In 10 jurisdictions, 'certificates' are admitted to trading on a RM. In 7 jurisdictions these 'certificates' are considered to be shares and are as such already included in the MiFID database. An extension of the MiFID transparency regime to 'certificates' would therefore lead to 370 additional equity-like 'certificates' in the MiFID database. In Q1 and Q2 of 2010, more than 7500 transactions with a turnover of about 525 million Euros were executed on RMs and MTFs in these 370 'certificates'.

[7] Since information provided by the CSSF is not publishable, this information does not include data from Luxemburg.

[8] Luxemburg considers the instruments named as DRs in its jurisdiction as shares and accordingly includes them in CESR's MiFID Database.

Table 2: Number of DRs and certificates, number of trade, turnover

		Depositary Receipts			Certificates		
		Number of Instruments	Trading		Number of Instruments	Trading	
Country	Competent Authority / Country	Total number of instruments admitted to trading on RMs	Number of Transactions (on RM and MTFs)	Turnover (on RM and MTFs)	Total number of instruments admitted to trading on RMs	Number of Transactions (on RM and MTFs)	Turnover (on RM and MTFs)
BELGIUM	CBFA	21	28267	129.516	0	n/a	n/a
BULGARIA	FSC	0	n/a	n/a	0	n/a	n/a
CZECH REPUBLIC	CNB	0	n/a	n/a	0	n/a	n/a
DENMARK	Finanstilsynet	0	n/a	n/a	46	1983	60.113
GERMANY	BaFin	8*	8210	59.450	*	n/a	n/a
ESTONIA	Finants-inspektsioon	0	n/a	n/a	0	n/a	n/a
GREECE	CMC	1	689	0.167	0	n/a	n/a
SPAIN	CNMV	0	n/a	n/a	0	n/a	n/a
FRANCE	AMF	5*	292536	2162.448	*	n/a	n/a
IRELAND	Financial Regulator	0	n/a	n/a	*	n/a	n/a
ICELAND	Financial Supervisory Authority	1	203	0.937	0	n/a	n/a
ITALY	Consob	0	n/a	n/a	*	n/a	n/a
CYPRUS	Cysec	0	n/a	n/a	0	n/a	n/a
LATVIA	FKTK	0	n/a	n/a	0	n/a	n/a
LITHUANIA	Lithuanian Securities Commission	0	n/a	n/a	0	n/a	n/a
LUXEMBURG	CSSF***						
HUNGARY	PSZAF	0	n/a	n/a	1	2	0.016
MALTA	MFSA	0	n/a	n/a	0	n/a	n/a
NETHER-LANDS	AFM	0	n/a	n/a	*	n/a	n/a
NORWAY	Finanstilsynet	0	n/a	n/a	0	n/a	n/a
AUSTRIA	FMA	1	5094	18.478	323	5552	465.741
POLAND	FSA	0	n/a	n/a	*	n/a	n/a
PORTUGAL	CMVM	0	n/a	n/a	*	n/a	n/a
ROMANIA	CNVM	0	n/a	n/a	0	n/a	n/a
SLOVENIA	Securities Market Agency	0	n/a	n/a	0	n/a	n/a
SLOVAK REPUBLIK	National Bank of Slovakia	0	n/a	n/a	0	n/a	n/a
FINLAND	Fin FSA	1	124321	1295.400	0	n/a	n/a
SWEDEN	Finansinspektio nen	12*	1099806	9708.000	0	n/a	n/a

UK	FSA	149	2031153	95 704.117	0	n/a	n/a

* DRs or 'certificates' (as defined in CESR's advice) admitted to trading on a RM in these jurisdictions are already included in CESR's MiFID database for shares.

*** The information provided by CSSF is not publishable.

CESR referred to Spanish 'participationes preferentes' only in the questions on transparency of equity-like products in the Consultation Paper on MiFID Equity Market Review and has proposed in its final advice on non-equity transparency to include Spanish 'participationes preferentes' in the post-trade transparency regime for corporate bonds due to their special structure and secondary trading in Spain. A common definition of 'preference shares' has therefore not been developed. Since the term 'preference shares' is interpreted very differently in various Member States and it is difficult to exactly define which instruments would be similar to the Spanish 'participationes preferentes', it seems to be of limited value to collect data about instruments which are not considered as equity-like and not clearly defined. Against this background, CESR will not answer the question regarding 'preference shares' and has also not collected data on Spanish 'participationes preferentes' at this stage.

As regards Exchange Traded Funds (ETFs), i.e. open-ended funds which are admitted to trading on RMs and enable investors to gain exposure to equity and fixed income, there is quite a lot of information on the number of ETFs and turnover on the most important trading venues for ETFs publicly available. Since the number of ETFs admitted to trading on a RM is very large, the collection on trades and turnover including all OTC trading of ETFs by CESR members could have been very burdensome. However, the additional value to publicly available information would be limited. CESR will therefore answer the questions on ETFs on the basis of and with reference to publicly available data.

At the end of Q2 2010 the European ETF industry had 961 ETFs with 2,979 listings, assets of US$ 218,0 Bn, from 35 providers on 18 exchanges. Since the beginning of 2010, the number of ETFs increased by 16,3 % with 135 new ETFs launched. The top 100 ETFs, out of 961, account for 67,2 % of European ETF assets under management (AUM). Since the beginning of the year, the average daily trading volume in US dollars increased by 14,8 % to US$ 2,6 Bn[9].

Blackrock[10], for example, provides a list of ETF listings by exchange in Europe (as at the end of May 2010) which includes data on 'number of primary ETFs', 'number of ETFs', 'AUM' and '20 day ADV'[11], a full list of ETFs listed in Europe[12] and figures on turnover in ETFs on each European exchange (and the reported OTC trades) and the respective market share of these venues (or of the reported OTC trades)[13]. According to this data, the total turnover on all European exchanges and the reported OTC trades in January 2010 was EUR 40,924.6m, the average daily turnover being EUR 2,048.4m[14].

Exchanges like the London Stock Exchange also publish monthly statistics on turnover and/or trades in ETFs on their exchanges[15]. Yearly statistics on turnover in each ETF listed on the exchange are also often provided by exchanges such as Deutsche Börse[16].

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9 Blackrock, ETF Landscape, Industry Highlights (end of Q2 2010), p.7.

10 For all reports by Blackrock see http://uk.ishares.com/en/pc/about/etf-landscape/publications?pt=false.

11 See Blackrock, ETF Landscape, Global Handbook (Q2 2010), p. 31.

12 See Blackrock, ETF Landscape, Global Handbook (Q2 2010), p. 32 -113.

13 See Blackrock, ETF Landscape, Celebrating 10 Years of ETFs in Europe, (April 2010), p.22.

14 See Blackrock, ETF Landscape, Celebrating 10 Years of ETFs in Europe, (April 2010), p.22.

15 For the June 2010 statistics of the LSE see http://www.londonstockexchange.com/statistics/specialist-issues/etfs-etps/jun-10.pdf; for June 2010 statistics of Deutsche Börse see http://deutsche-boerse.com/dbag/dispatch/en/notescontent/gdb_navigation/trading/60_downloads/200_statistics/500_monthly_comparison_etf/INTEGRATE/xtf_statistic?notesDoc=/maincontent/KIR+XTF+Monatsvergleich&expand=1 and http://deutsche-boerse.com/INTERNET/EXCHANGE/zpd.nsf/KIR+Web+Publikationen+E/CPOL-87ZCQM/$FILE/XTF_Q2_2010_e_v1.pdf?OpenElement.

Question 6: In relation to CESR work to identify possible differences in organisational requirements between regulated markets and MTFs, please provide details of any differences that are identified.

While the MiFID's organisational provisions governing RMs and MTFs are to a large extent similar, RMs have raised concerns in the past that they are subject to more stringent – and costly – regulatory requirements than their MTF competitors.

CESR has therefore analysed the details of the respective requirements in MiFID and identified one key difference between requirements for RMs and MTFs operated by investment firms, which may be a potential source of unlevel playing field. The concept of "proportionate approach"[17] is laid down in organisational requirements applicable to MTFs and the discretion that may be attached to such test of "proportionality" by competent authorities may lead to less stringent requirements for new MTFs. To provide more clarity that RMs and MTFs should be subject to the same organisational requirements as regards the operation of their trading platform, CESR recommended in its Technical Advice on MiFID Equity Markets Review[18] an extension of requirements for RMs under Article 39(a) to (c) of MiFID to investment firms or market operators operating an MTF.

Apart from this difference in requirements, there are also other organisational requirements in MiFID which differ:

- MTFs operated by investment firms or market operators are covered by Article 14 of MiFID and have to comply with organisational requirements for investment firms under Article 13 of MiFID in addition to specific requirements in Article 14. Article 13 of MiFID sets out very detailed organisational requirements for investment firms further specified in chapter II of the MiFID Implementing Directive. At the face of it, these requirements are far more detailed than Article 39 of MiFID which is laying down organisational requirements for RMs. However, not all organisational requirements for investment firms in the MiFID Implementing Regulation are relevant for the operation of an MTF since they rather govern the relationship between the investment firm and its clients. Comparing the requirements is also difficult because the Implementing Directive allows for a certain calibration of the requirements depending on the 'nature, scale and complexity of the business of the firm and the nature and range of investment services and activities'.
- One obvious example for organisational requirements relevant for MTFs are outsourcing requirements in Article 13(5) of MiFID and Articles 13 to 15 of the MiFID Implementing Directive. There are no such requirements for RMs in Article 39 of MiFID although in practice national requirements for outsourcing by RMs exist.

It could therefore be considered to establish a set of the same formal organisational requirements for RMs and MTFs, be they operated by investment firms or market operators (e.g. by developing Level 2 measures under Article 39 of MiFID which would be suitable for operators of RMs and MTFs).

Where an investment firm operates an MTF and provides additional investment services, conflicts of interest may arise between the function of operating the MTF and the provision of other investment services. Investment firms therefore may require additional organisational requirements to address any issues that may arise from this specific situation (for example through appropriate governance

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16 See Deutsche Börse Group, Factbook 2009, p. 15 to 20 at http://deutsche-boerse.com/INTERNET/IP/ip_stats.nsf/(KIR+Factbook+Kassamarkt+E)/407B2EB81C10C693C12577270052CF51/$FILE/Factbook_2009_e.pdf?OpenElement

17 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.

18 See CESR Technical Advice to the European Commission in the Context of the MiFID Review – Equity Markets, 29 July 2010 (CESR/10-802), p. 34, available at: http://www.cesr-eu.org/popup2.php?id=7004

structures and conflicts of interest policies) when implementing organisational requirements in practice.

Question 7: In the context of the work currently carried out by CESR to review systematic internaliser requirements, please provide figures for the total trading activity currently involving systematic internalisers. If any changes to the definition of a systematic internaliser are proposed, please provide estimates of the additional trading that would be covered as a result of the changes.

In order to answer the Commission's question on figures for the total trading activity currently involving SIs, CESR members have addressed all investment firms currently operating as systematic internalisers (SIs) which are included in the MiFID database[19] to provide with the following data concerning Q1 and Q2 2010: number of shares included in the investment firms' systematic internalisation service in Q1 and Q2 2010, number of shares traded at least once in the respective time periods, the aggregate number of trades executed in these shares and the aggregate value of these trades, the value of trades of a size below Standard Market Size (as defined in table 3 of Annex II of the MiFID Implementing Regulation) executed under their SI services as a percentage of the total value of trades executed under their SI services in shares admitted to trading on a RM in the EEA, the proportion of SI service in shares admitted to trading on a RM in the EEA provided to retail clients, in terms of the percentage of retail clients in comparison to all clients and value of trading with retail clients in comparison to value of trading with all clients and the value of trades executed under their SI services as a percentage of the total trading in shares admitted to trading on an EEA regulated market executed to satisfy client orders, whether over-the-counter, on a regulated market or on an MTF.

At the time of preparing this response, there are 12 registered SIs. According to the data provided by their competent authorities, the total number of shares traded under the SI services was 2547 (which may include the same shares trades by different investment firms), which were almost all traded at least once during the second quarter of 2010. When attention is paid to the number of trades executed, a significant increase can be noticed from Q1 to Q2 2010, reaching an aggregated number of 2,823,681 transactions with a total value of more than 83 billion Euros in the second quarter.

The number of shares for which the SI service is provided by a particular investment firm ranges from 1 to 683, but the majority of the firms provide this service for more than 400 shares. In the majority of firms the number of shares has remained stable or slightly decreased from the first to the second quarter 2010.

The number of trades executed under this service in Q2 2010 ranges from 1285 to more than 1,500,000 transactions. There is not a clear pattern in this regard from Q1 to Q2 2010, since a small majority of firms experiment an increase in the number of transactions, whilst many others see these transactions reduced.

The value of these transactions shows significant differences between firms ranging from 7 million Euros to more than 13 billion Euros in Q2 2010.

Regarding the percentage of trades below standard market size in relation to the firms' total SI trading activity in Q2 2010, the responses range from 2.9% to 69%. The majority of responses received indicate that these trades represent between 14% and 48% of the total SI trading activity. It is important to highlight that only two firms report a significant increase of them, for the others it remains flat or they report a small decrease.

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[19] See the list of systematic internalisers in the EEA at: http://mifiddatabase.cesr.eu/Index.aspx?sectionlinks_id=16&language=0&pageName=MiFIDSystematicSearch&subsection_id=0

Retail investors hardly make use of this service according to the information provided except in three cases where retail clients represent the main group of clients. The outcome of the survey on the percentage of retail business relative to total SI business shows exactly the same results.

CESR asked investment firms providing this service about the value of trades executed under their SI services as a percentage of their total trading in shares admitted to trading on an EEA regulated market executed to satisfy client orders, whether over-the-counter, on a regulated market or on an MTF. Only four firms informed of a percentage above 10%, reaching 32% in the highest case.

Taking into account that CESR has not proposed significant changes to the definition of systematic internaliser[20] and that the answer to the second part of the question would require estimating the impact of the proposed measures on investment firms' behaviour, it does not seem to be necessary to answer this part of the question.

Question 8: How does CESR envisage achieving further transparency in line with its recommendations in the CESR report on Transparency of Corporate Bond, Structured Finance Products and Credit Derivative Markets?

Please see CESR's Report on Transparency of corporate bond, structured finance product and credit derivatives markets (Ref. CESR/09-348) and CESR Technical Advice to the European Commission in the Context of the MiFID Review: Non-Equity Markets Transparency (Ref. CESR/10-799) (from now on, the Technical Advice).

For example

Question 8(a): Should the requirements apply by financial instrument regardless of where the trade is executed (regulated market, MTF, systematic internaliser, or OTC) based on qualitative and/or on quantitative grounds? Qualitative criteria could include, for example, whether a bond has been issued with a prospectus, or whether a derivative is clearable. Quantitative criteria could include, for example, bonds with a certain issue size, or instruments with an average daily turnover above a certain threshold

In developing the advice provided in CESR Report on Non-Equity Markets Transparency (Ref. CESR/09-348), the Technical Advice clarifies that the proposed post-trade transparency regime should be applicable to corporate and public bonds for which a prospectus has been published (i.e. including all corporate and public bonds admitted to trading on a regulated market) or which are admitted to trading on an MTF, regardless where the trade has been executed: on a regulated market, an MTF or by investment firms trading OTC. The calibration of the proposed post-trade transparency regimes for corporate and public bonds is based on quantitative criteria, i.e. average transaction size.

In relation to structured finance products (ABS and CDOs), CESR Report on Non-Equity Markets Transparency (Ref. CESR/09-348) proposed a phased approach so that the regime would gradually apply to all ABS and CDOs commonly considered as standardised. This proposal has been developed in the Technical Advice, explaining that in this context "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 an MTF. The proposed post-trade transparency regime should be applicable to these instruments regardless

[20] See paragraph 90 of the CESR Technical Advice to the European Commission in the Context of the MiFID Review – Equity Markets, 29 July 2010 (CESR/10-802), p. 20, available at: http://www.cesr-eu.org/popup2.php?id=7004

whether the trade has been executed on a regulated market, an MTF or by investment firms trading OTC. The calibration of the regime is based on the rating of these instruments.

For CDS, in its previous report (Ref. CESR/09-348), CESR was of the view that a post-trade transparency regime should cover all CDS contracts which are eligible for clearing by a central counterparty due to their level of standardisation. The Technical Advice differentiates between single-name, index and sovereign CDS but keeps the same approach. The proposed post-trade transparency regime should be applicable to these instruments regardless whether the trade has been executed on a regulated market, an MTF or by investment firms trading OTC. The calibration for the proposed post-trade transparency regime is based on transaction size.
In relation to derivatives, CESR has made a generic recommendation for a harmonised post-trade transparency regime that has to be further developed.

Question 8(b): Should the requirements apply by trading venue (regulated market, MTF, systematic internaliser) to any financial instruments traded on these venues or only to those financial instruments fulfilling certain qualitative or quantitative criteria as specified under (a) above? If so, should separate requirements apply to OTC trades as well?

Please see the response above.

Question 9: Pre-trade transparency not being considered in CESR's report on Transparency of Corporate Bond, Structured Finance Products and Credit Derivative Markets, please assess whether there is any evidence of a failure in the level of pre-trade transparency available in these markets? Do all potential participants have access to pre-trade information on even grounds, for example in the case of retail investors in relation to non-equity products made available to them?

As indicated in paragraphs 18 and 19 of the Technical Advice, it can be said that 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.

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[21].

Question 10: Considering recommendations from the G20, and the Commission Communication on Ensuring efficient, safe and sound derivatives markets , and notwithstanding CESR's advice regarding energy derivatives, please assess whether similar or other shortcomings in the level of post-trade and/or pre-trade transparency arise for derivatives not covered by CESR's report on Transparency of Corporate Bond, Structured Finance Products and Credit Derivative Markets (interest rate derivatives, FX derivatives, equity derivatives, commodity derivatives).

As appears in paragraphs 22 and 24 of the Technical Advice, in relation to pre-trade transparency of all the instruments analysed (including interest rate derivatives, FX derivatives, equity derivatives

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

and commodity 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.

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.

Regarding post-trade transparency, CESR recognises in paragraphs 125 and 126 of the Technical Advice that the analysis undertaken is still in an early phase, given the heterogeneity of all the OTC derivative segments covered. 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 supporting more resilient and transparent markets in general. CESR therefore recommends that a harmonised post-trade transparency regime for these assets should be further developed.

Question 11: In view of CESR's work on transaction reporting of OTC derivatives and on trade repositories (TRs), please assess:

Question 11(a): how best to arrange the flow of information to be provided by investment firms to regulators for transaction and position reporting purposes? Please consider the objective of minimizing any double reporting for investment firms:

The Commission consultation paper on Derivatives and Market infrastructures released on 14 June 2010 was used as a starting point for CESR's response. Having analysed the proposal of the Commission on a Regulation on OTC derivatives, CCPs and trade repositories (previously known as EMIR), CESR noticed no major change in respect of position and transaction reporting. However, any fundamental changes to the proposal in the course of the negotiation process may affect the premises of this analysis and would require changes to CESR answers and advice. The content of this answer should, therefore, be read with this caveat.

Differences between transaction and position reporting

Transaction reporting obligations provide for reporting of individual transactions on specific financial instruments. Position reporting, on the other hand, aims at providing information on the economic exposure of an investor or counterparty to a specific derivative instrument, an underlying instrument, an underlying issuer of financial instruments and/or a counterparty at a specific moment of time (date).

There are several differences between transactions in OTC derivatives and the resulting positions that may merit different solutions for the purpose of reporting to regulators.

Transaction reporting is a "flow variable", while position reporting is a "stock variable". Reporting transactions to regulators for the purpose of market abuse detection has to be a daily flow of information and delays must be avoided at all costs.

Transaction reporting for market abuse surveillance purposes has been identified as a need by regulators well before the financial markets crisis started. Transactions in OTC derivatives are already reported in some EU Member States (at least UK, Spain and Ireland), where this information plays a fundamental role in market monitoring. Many other Member States have plans to introduce transaction reporting on OTC derivatives in the short term (coming months) under recital 45 of MiFID. However, the development of a regulatory position reporting to monitor systemic risk and improve prudential supervision has been a clear consequence of the crisis. The calendar for the adoption of such a regime will be subject to the adoption and implementation of EMIR. Furthermore, there is also a non-legislative initiative that is sponsoring the creation of TRs in the context of the commitments of some ISDA dealers. This project is clearly aligned with the purpose of EMIR and highly valuable at the moment, but its current progress and scope is not as developed as MiFID transaction reporting for market abuse surveillance purposes.

Transaction reporting has been of interest mainly for securities regulators, namely for supervision of conduct of business rules and, in particular, market abuse. Position reporting, on the contrary, has so far been mainly an objective for prudential/systemic supervision (both insurance and banking supervision), especially to detect concentration of systemic risk and prevent possible complications. Position reporting may become of increased interest for securities regulators (e.g. in the context of the introduction of measures to ban and/or disclose short selling transactions, to monitor open interest positions in one specific underlying instrument or issuer, or to enforce new provisions arising from EMIR), and also transaction reporting of increased interest for prudential regulators; however, the two data flows are likely to remain complementary to one another, with differences and overlaps. In addition, the expected level of detail of the data (granularity) may be different for prudential and securities regulators.

Currently, the information gathered and stored by existing TRs is different from the information necessary for supervision of compliance with MiFID and MAD provisions. Although no details are final yet, it is probable that TRs will host in the future information on foreign underlying instruments that are not admitted to trading on EU regulated markets (i.e. an equity swap position on IBM shares or a CDS transaction on US government bonds), as well as categories of derivatives that are of less interest for securities regulators (interest rate or currency derivatives). Besides this, some information that is essential to calculate positions accurately (e.g. exercises of options) and has to be sent to TRs is of little or no use for market surveillance and does not need to be included in transaction reporting.

In addition, the scope of application of MiFID and EMIR will probably be different. MiFID provisions apply solely to financial intermediaries (investment firms) that are the only ones authorised to arrange transactions on OTC derivatives on a professional basis. EMIR, on the contrary, may end up having a more ample scope, engulfing positions held not only by intermediaries but also by investors (hedge funds, insurance companies), for obvious reasons linked to prudential supervision.

Overarching principles for any reporting mechanism

Any regime for position and transaction reporting of OTC derivatives should be guided by some basic principles:

a. Unconditional and quick access to data should be guaranteed to the regulators wherever the TRs are located;

b. Information received by regulators should be in a specific unified format, to be defined pursuant to the provisions of MiFID/EMIR;

c. Data quality should be paramount, since it impacts the quality and accuracy of supervision;

d. Duplication of reporting obligations for firms or investors should be avoided;

e. Extending transaction reporting to OTC derivatives is urgent (and the work to achieve that is much more advanced than the work on position reporting).

In any case, with respect to the second principle, it is assumed that fields and specifications to report transactions (or positions) in OTC derivatives will be pre-defined, based on the work done so far by CESR and on the basis of the technical standards to be developed by ESMA in cooperation with EBA/EIOPA. Therefore, the data that competent authorities will receive will be harmonised and exactly the same no matter how reporting is to be organised. It is also important to stress the need for maximum convergence between standards and formats for reporting to TRs and those used to report transactions to competent authorities under MiFID. Avoiding differences to the maximum extent possible will mean lower compliance costs and more robust information in both.

In order to meet the above overarching principles, CESR has CESR analysed and consulted on (Ref. CESR/10-809) two possible regimes and has now identified a preferred solution. The first possible regime was to establish a single reporting regime for both transaction and position reporting on OTC derivatives, based on reporting through TRs. In this option, both regulated entities and investors subject to EMIR would report transactions in OTC derivatives to TRs (either directly or through authorised reporting mechanisms (ARMs) or CCPs), which would then, together with other information, report positions periodically to relevant regulators (probably prudential ones) and transactions daily to securities regulators. This system, when enacted, would substitute and abolish the MiFID reporting regime for OTC derivatives (but not for the other types of financial instruments). However, due to numerous disadvantages[22], and on the basis of the responses received in the public consultation, CESR has discarded it.

CESR preferred solution for organisation of position and transaction reports on OTC derivatives

CESR suggests defining a new position reporting regime through TRs and, once TRs are fully established, allowing MiFID firms to fulfil their transaction reporting obligations through reporting via TRs.

This system is based on the assumption that all persons not exempted from EMIR (including MiFID-authorised firms) would have to report transactions on OTC derivatives to TRs after these will have been established, registered (or recognised for those not located in the EU[23]) and their regulatory regime defined.

This proposal, however, contemplates that investment firms would retain the possibility of complying with their transaction reporting obligations with respect to OTC derivatives under MiFID provisions. This implies that transaction reports could be sent directly to the relevant competent authorities, together with all the other transaction reports provided following MiFID requirements.

Investment firms reporting their transactions to a TR, supporting MiFID standards, would be exempted from direct reporting *ab initio* (not case by case) when they communicate to the competent authority their decision to report their OTC derivatives transactions through a TR. Therefore, the MiFID regime would apply to reporting obligations but these could be dealt with by TRs for the account of investment firms in order to avoid duplication.

Concisely, as long as EMIR has not been finalised and implemented, OTC derivatives transactions would be reported under MiFID rules, where applicable. When EMIR comes into force and TRs have been registered and start to operate, these transactions could be reported through TRs to relevant

[22] Two different types of information; Multiplication of the possible reporting channels by each investment firm; Potential risk arising from market power of TRs (that come close to natural monopolies); Different timelines between OTC derivatives transaction reporting and EMIR, etc.

[23] When referring to TRs, no distinction is being made between EU or non-EU repositories as long as they are registered or recognised under the EMIR regime.

competent authorities, but complying with MiFID obligations. In other words, TRs (and ARMs[24] and CCPs) would be recognised as a valid third party reporting mechanism under Article 25(5) of MiFID.

Firms obliged under MiFID to report transactions would be responsible for i) informing their competent authority of the channel they intend to use to report each class of OTC transactions (directly, through a specific TR, through a CCP or otherwise) and ii) establishing the necessary arrangements with any third party to ensure that those transactions will reach the competent authority within predefined time and the required format. TRs (and ARMs and CCPs) will, of course, need to have an updated list of which members are relying on them for fulfilling MiFID transaction reporting obligations to each member's competent authority.

In line with the EMIR proposal, position reporting will be conducted through TRs and, when they will not be able to record the details of the contracts, directly to regulators. CESR will soon start the necessary work for the definition of the technical standards in this respect, in particular for the identification of the relevant fields in both cases.

The advantages of this solution include:

a. Compatibility with existing systems and no risk to impede the immediate extension of the MiFID regime to OTC derivatives. CESR members could continue working on transaction reporting of OTC derivatives irrespective of when EMIR comes into force.

b. Avoiding double reporting obligations.

c. The possibility for investment firms to comply with MiFID provisions to report transactions by relying on TRs (and/or CCPs).

d. Information from TRs could be distributed and shared through TREM, seamlessly (same files, timing and rules, system operated by ESMA) with all other transaction reporting information, allowing easy integration in market surveillance systems.

e. Minimum implementation work or no work at all if the exemption of direct reporting when using the TRs would be enshrined into the MiFID Implementing Regulation.

In all likelihood, if the TRs' system for transaction and position reporting on OTC derivatives proved to be more efficient, most - if not all - of the transaction flow would come in the future through centralised facilities like TRs (or CCPs/ARMs).

An important issue with regards to this model relates to the authority to which reports should be transmitted by TRs acting as reporting channels. Under the current MiFID framework, a third party reporting mechanism has to report to the investment firm's competent authority. When TRs or CCPs are recognised as reporting channels under Article 25 of MiFID they will have to send the transactions of each member that is relying on the TR/CCP for fulfilling its MiFID transaction reporting obligations to that member's competent authority. This will imply establishing connections with different competent authorities. CESR has discussed the possibility of allowing a single reporting point for TRs (for instance, their own competent authority if they are EU-based or ESMA) and a subsequent circulation from that single point to the relevant national competent authorities. However, a consensus on whether that single reporting point should be allowed could not be reached. It should, however, be noted that under EMIR the relevant competent authorities (e.g for banks and insurance companies) will need to receive the position reports directly from TRs and ESMA would need to share with other authorities the information held by TRs that is relevant for the exercise of their duties.

[24] When referring to TRs for reporting purposes in the following sections, reference is also made to CCPs for trades cleared through them and to ARMs.

CESR proposal to extend the scope of transaction reporting obligations

Recital 45 of MiFID provides discretion for Member States to apply transaction reporting obligations enshrined in Article 25(3) to financial instruments that are not admitted to trading on a regulated market. There are two clear extensions that some Member States have adopted or are considering on the basis of the experience after MiFID came into effect: 1) extending reporting obligations to transactions in financial instruments admitted to trading only on MTFs (but not on regulated markets) and 2) extending reporting obligations to transactions on certain OTC derivatives.

Extension to the instruments admitted to trading only on MTFs

There are several reasons for engulfing financial instruments admitted to trading only on MTFs within the transaction reporting obligations. According to Recital 6 of MiFID, definitions of regulated markets and MTFs should be introduced and closely aligned with each other to reflect the fact that they represent the same organised trading functionality.

Regarding the Market Abuse Directive (MAD), the European Commission has recently consulted[25] on extending the scope of MAD to cover instruments which are admitted to trading and/or traded on an MTF but not on a regulated market. Since the MiFID transaction reporting regime is one of the main supervisory tools for market abuse purposes, it is therefore essential for this regime to cover all transactions that could potentially constitute market abuse, including the ones on instruments admitted to trading only on MTFs.

Transparency mechanisms, financial product innovations and the general impact of events in globalised markets and platforms all call for the need of competent authorities to have regular information about the trades on financial instruments admitted to trading only on MTFs. If MTFs develop (some are doing so already now) their role as alternative markets for different types of issuers (mid and small caps, for instance), this would also be a good reason to introduce transaction reporting requirements for transactions made in financial instruments admitted to trading only on these trading venues.

Therefore, a common effort has to be done in order to ensure the capability of competent authorities to have information on instruments admitted to trading only on MTFs and to have the appropriate tools to correctly apply policies to prevent market abuse. CESR considers that this should be done through MiFID, and not by extending nationally the obligations on the basis of recital 45 of MiFID.

Extension to some OTC derivatives

On the matter of OTC derivatives, in order to enhance competent authorities' ability to detect suspicious activity and maintain the integrity of their markets, CESR members have decided to exchange transaction reports on some OTC derivatives. CESR is currently working on harmonising the technical standards on the collection and exchange of transaction reports to include OTC derivatives whose value is derived from instruments admitted to trading on a regulated market or an MTF. The relevant consultation paper (Ref. CESR/09-768) and feedback statement to it (Ref. CESR/09-987) can be found on CESR website.

Recent events in financial markets have shown the clear need of having information about trades on OTC derivatives, both for market surveillance and investor protection purposes.

Financial derivative products typically traded OTC, like CDS, OTC options or total return swaps, have proved to play a very important role in recent market situations where strong volatility movements have finally affected all sectors, countries and types of investments.

[25] http://ec.europa.eu/internal_market/consultations/2010/mad_en.htm

Moreover, competent authorities have noted that, due to financial product innovations, there is a range of OTC financial instruments that mirror instruments admitted to trading on regulated markets or MTFs that can affect prices on regulated markets and MTFs and that can equally be used for the purpose of market abuse, which are now out of the scope of the transaction reporting exchange mechanism.

As long as OTC financial instruments can mirror products admitted to trading on regulated markets or MTFs, the price and volatility relationship between them is direct and unavoidable, and has to be considered when conducting market abuse investigations. Some OTC derivatives have reached such a high degree of popularity and trading activity that they can perfectly influence (not only follow) the price evolution of the traded underlying they are related to.

Transaction reporting of OTC derivatives would meet the requirements expressed by G20[26] to improve the regulation, functioning and transparency of financial and commodity markets to address excessive price volatility.

It is also true that the increasing importance and size of OTC markets makes fully understandable that the competent authorities need to have information about the trades in OTC derivatives. According to recent BIS statistics[27], total notional amounts outstanding of OTC derivatives reached $615 trillion by the end of December 2009, which means a 12% increase compared to December 2008 data.

Competent authorities need to enhance their ability to detect suspicious activities and to maintain the integrity of their markets, and those objectives can only be achieved by collecting and exchanging specific information about trades executed on both regulated markets, MTFs and OTC.

Some regulators are already collecting information about trades on OTC derivatives whose underlyings are instruments admitted to trading on regulated markets. According to the feedback received from those regulators, this has been a very useful tool to improve their market surveillance activities and to monitor possible market abuse situations.

Since the main reason for the extension of the reporting obligations is the possibility to use an OTC derivative as a substitute to a "traditional" security, the basic criteria to define the scope of the extension would be whether the value of the OTC derivative depends on the performance of a financial instrument that is admitted to trading on a regulated market (or an MTF) or on the credit risk of a single issuer of such financial instruments. Therefore, credit derivatives on baskets or indexes, with no exposure to an individual issuer in particular, would be excluded from the reporting regime.

CESR proposes that the European Commission extends, through a change in Article 25 of MiFID, the scope of transaction reporting obligations to financial instruments that are admitted to trading only on MTFs and to OTC derivatives whose value depends on the performance of a financial instrument that is admitted to trading on a regulated market (or an MTF) or on the credit risk of a single issuer of such financial instruments. In the OTC derivatives case, CESR strongly recommends that the exact scope of the instruments would not be exhaustively set out in the Level 1 text but could be further specified through binding technical standards to be developed by ESMA[28]. This seems essential in order to ensure that the scope of the reporting obligation can be more easily adjusted to respond to the innovations in the market without the need to revisit the Directive every

[26] http://www.g20.org/Documents/pittsburgh_progress_report_250909.pdf

[27] Source: *OTC derivatives market activity in the second half of 2009, Monetary and Economic Department, May 2010, www.bis.org*

[28] The OTC derivatives initially subject to the reporting obligations would include those covered in section D of CESR's feedback statement on the consultation on "Classification and identification of OTC derivative instruments for the purpose of the exchange of transaction reports among CESR Members" (CESR/09-987).

time a new, significant instrument emerges in the EU market or an existing, non-covered instrument acquires a significant supervisory relevance.

Recital 45 of MiFID could be retained in order to have the ability to require data at national level on other financial instruments that may become widespread in the future and that would need to be included in the transaction reporting regime, but not on an EU wide basis.

Question 11(b): Apart from detecting and pursuing cases of market abuse, what other purposes does transaction reporting have? What purposes does position reporting have?

Information derived from the transaction reports can also be used for the purposes of:

a. monitoring the compliance with the disclosure requirements of persons' discharging managerial responsibilities and shareholders' disclosure rules requirements;

b. determining the minimum price in take-over bids;

c. assessing the order execution policy;

d. ensuring firms are not undertaking transactions in financial instruments they do not have permission to trade; and

e. monitoring compliance with general MiFID provisions.

Information derived from the position reporting can, inter alia, serve the purposes of:

a. evaluating the counterparty risks and assessing the risk profile of investment firms;

b. calculating positions for standardised OTC derivatives and detecting possible risks for market integrity and stability;

c. identifying the relevant contracts for the purpose of the clearing obligation;

d. identifying the systemically relevant counterparties;

e. enforcing the clearing obligation

f. gathering intelligence on the new market trends;

g. providing transparency to the market; and

h. conducting economic analysis.

Question 11(c): What are the experiences of CESR with transaction reporting by regulated markets, MTFs or trade-matching or reporting systems by pursuant to article 25(5) MiFID?

Different reporting options were chosen by Member States when implementing MiFID transaction reporting provisions. Though it would be difficult to identify a particular preferred reporting channel, CESR members expressed general satisfaction with the local choices (whether reporting through the regulated market, MTF, reporting system or firms themselves) and did not have any major concerns.

Question 12: In light of the G20 endorsement of the IOSCO recommendations regarding commodity derivative markets, the increased participation of financial participants as an alleged possible factor influencing the price of physical commodity markets via the respective derivative markets, and the recent volatility in these markets:

Question 12(a): Please provide us with an overview of existing position reporting arrangements in the different Member States. Do these arrangements arise from national legislation or are these initiatives undertaken together with derivative exchanges?

Position reporting arrangements in different Member States

Specific arrangements on commodity derivatives position reporting currently exist in three Member States.

In the first case, the positions on commodity derivatives are reported directly to the competent authority (CA) by the clearing house of the regulated market where the transactions took place (transactions are reported directly by the market operator of the commodity derivatives regulated market). The positions reported are those of the members of the clearing house and are segregated according to three types of account i.e. for own account, for client accounts and "market maker".

In accordance with its rules, the clearing house monitors the open interest of its members and can take action in case position limits (specific to each derivative contract) are exceeded. This provides thus a first level of supervision of systemic risk (and delivery risk for commodities) even though limited to the clearing house members' level.

It should be pointed out though, in the current situation, this CA does not receive information about the positions of the final beneficial owners of the traded contracts or about any positions held on the spot markets. Neither are OTC transactions on commodity derivatives or aggregated positions taking these transactions into account available.

In this case, the existing arrangements are the result of historical arrangements.

In the second case, positions in relation to commodity derivatives are disclosed to the CA in monthly reports submitted by investment firms monthly. The information is being provided in accordance with the domestic law.

In the third case, the commodity derivative exchanges provide regular position reports to the CA on either daily or weekly basis. Primary responsibility for monitoring and reviewing positions lies with the regulated markets but the CA undertakes a secondary review of the information and engages with the regulated markets as appropriate. There are no specific legislative provisions for submission of this particular information, however, general provisions on co-operation/provision of information can be applied.

Position reporting arrangements in the US[29]

In the US, the CFTC collects – in accordance with the respective CFTC Regulations – market data and position information from exchanges, clearing members, future commission merchants (FCMs) and traders. Exchanges must provide the CFTC with confidential information on the aggregate positions and trading activity for each of their clearing members, in addition to providing public data on trading volume, open contracts, futures delivery notices, exchanges of futures for cash, and prices. Each day, exchanges report each clearing member's open long and short positions, purchases and sales, exchanges of futures for cash, and futures delivery notices for the previous trading day. This data is reported separately by proprietary and customer accounts by futures month, and for options by puts and calls, expiration date and strike price.

[29] http://www.cftc.gov/IndustryOversight/MarketSurveillance/LargeTraderReportingProgram/index.htm

The CFTC uses data like this to identify large cleared positions in single markets or across many markets and exchanges, to audit large trader reports, and to resolve any account aggregation issue.

Clearing member data, however, do not directly identify the beneficial owners of positions. The aggregate customer position reported for a clearing member could represent either a single trader or numerous traders. The data does also not reveal a circumstance where a single trader controls substantial portions of the customer positions with more than one clearing member, and therefore, could control a substantial portion of the market. To assess individual trader's activities and potential market power, the CFTC has established a large trader reporting system (LTRS). This is also used to enforce position limits.

Under the CFTC's large trader reporting system, clearing members, FCMs, and foreign brokers (i.e. 'reporting firms') file daily reports with the CFTC. The reports show futures and option positions of traders with positions at or above specific reporting levels as set by the CFTC. If, at the daily market close, a reporting firm has a trader with a position at or above the CFTC's reporting level in any single futures or option expiration month, the firm reports that trader's entire position in all futures and options expiration months in that commodity, regardless of size.

Since traders frequently carry futures positions through more than one broker and control or have a financial interest in more than one account, the CFTC routinely collects information that enables it to aggregate related accounts. This enables the CFTC to make an assessment of a trader's potential market impact and a trader's compliance with position limits.

Aggregate data (without identifying any individual reportable trader) concerning reported positions are published by the CFTC in its weekly Commitments of Traders reports. The CFTC may also issue a special call to a reporting firm or a trader to investigate a threat of a market manipulation or other market disorder. The special call is designed to gain additional information about a firm's traders and/or about a participant's trading and delivery activity, including information on persons who control or have a financial interest in the account. The special call may also request information about positions and transactions in the underlying commodity.

Question 12(b): In your view what are the benefits in terms of regulatory oversight (*of positions*)?

There is widespread support for a system of position reporting to regulators. Position reporting is of value in preventing, detecting and enforcing against market abuse. In commodity derivative markets the investigations undertaken to date indicate that abusive behaviour often comes about as a result of attempted market squeezes, e.g. where a participant attempts to corner a market by building up a dominant position which distorts the price formation and prejudices other participants ability to trade out of their own positions. To the market supervisor, having information which shows how the suspected abuser's position has changed over the preceding period will be highly informative in seeking to understand the behaviour.

Position information can also be of use in seeking to protect market integrity and stability. For example, at times of high market volatility, being able to look at positions in the market and identify whether any particular trader or group/type of trader's behaviour can be attributed as being influential in bringing about that market behaviour will be of use because of the value of being able to see how positions have changed over time.

It is important to have both transaction and position reports since, in an investigation, the investigator will always look at the relevant individual trades of the associated parties at the time of the suspected abusive behaviour. Given the complex nature of these markets, transaction records alone are unlikely to explain the trading patterns.

The other potential use of position information from commodity derivative markets is for prudential regulation. Position information is of use to the firm supervisor in assessing a firm's exposures and its compliance with capital adequacy requirements.

Position information is of use when looking systemically at the exposures of a group of firms of a particular type, or of some or all of the firms within a particular market. Aggregating the information on the positions of the individual firms will show the total exposure of the group and this can be used to assess whether that presents an unacceptable risk, either to that sector of firms, or to the market in which the positions are held.

To get a true picture of the nature of a position held by a participant the supervisors/investigators need ideally to be able to see the participants' exchange, OTC and physical market positions. For example, a participant may appear to have an unnaturally large position on an exchange in a particular commodity. If this however can be seen as a natural hedge for an offsetting OTC or physical position then it may demonstrate that the large or dominant position is in fact acceptable and not abusive.

Similarly, for capital adequacy/prudential assessment, systemic reporting of a firm's positions on all markets will be of value. For instance, should a supervisor give more attention to a firm which it sees has fifty per cent of the total exposures in one particular market, or to another firm which has a thirty per cent exposure in five related markets? Having wide-ranging reports on firms' positions would be beneficial in deciding how to prioritise supervisory effort.

An additional possible benefit of requiring commodity derivative position reporting to regulators would be that it would likely introduce highly useful standardisation of the content and format of position reports which current reporting through market operators, all of whom have their own systems, does not provide. Standardisation of position reporting may also be fostered by potential future requirements for trade repositories to provide information to regulators.

Regulators receiving position reports themselves would have an ability to make potentially more exacting checks on how market operators are fulfilling their domestic obligation to collect and act on position information from their participant firms in the interests of ensuring their facilities are not used for abusive activity[30].

The downsides for regulators to receiving position information appear limited. There is a challenge for regulators in receiving significant amounts of additional information, which they will need to be appropriately resourced to review. The mere collection of information is useless if the information cannot be properly processed and effectively used. Another drawback is the likely cost of implementation and review, both for firms and for regulators.

Creating a dual system where regulators are effectively obliged to duplicate the exchange's monitoring role at some level, because of the information they receive, may frustrate the initial objectives of the framework MiFID has created. In many Member States market operators were made front line regulators. It could therefore be argued that this kind of supervisory system intended that the pool of specialised market monitoring and supervising resource was designed to coalesce at market operator level. Creating similar obligations for regulators may create risk from lack of clarity over split responsibilities.

When creating a system of position reports to regulators, the use of existing sources of position information of exchanges (RMs, MTFs and other spot exchanges), central counterparties and trade repositories should be explored to avoid frustration of firms by requirements to report to multiple entities/regulators, In evaluating technical possibilities it also needs to be taken into account that some of these entities may be located outside the EEA.

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[30] For more information on the position management approach currently applied in some Member States see also the answer to question 12(d) below.

Question 12(c): Would data by type of trade (e.g. commercials, investment firms, fund managers, etc) be of further use? How?

It would be useful for a number of purposes to have this type of information.

The information would be useful for understanding the risk profile and business models of regulated financial firms, which could provide valuable information on their overall exposure and systemic risks posed relative to other market users.

Information of this type would also be of value because it could be used to provide additional transparency to the markets. This could come about if the data were used, as has been recommended by IOSCO's Commodity Markets Task Force, to underpin the publication of aggregated open interest reports similar to the CFTC's Commitment of Trader reports, which have been published for US markets for many years. These reports provide information on how the break-down of open interest between participant type changes over time[31]. Many stakeholders, including analysts in particular, value this type of information for attempting to explain price movements and other market behaviours to constituents who, unlike regulators, do not have the complete underlying information set.

When considering Commitment of Trader style reporting, the classification of participants requires careful examination however. There are certain participants which are not easy to categorise, and by the same token others which may fall into more than one group because they trade for more than one purpose. Clearly the primary objective is to get the most meaningful classifications. The reports will have most value if they can present an international picture for markets which are international, i.e. wider than a single continent.

The downsides to receiving and publishing information of this type are few. Again, one of the most obvious downsides to consider is clearly that this would represent an additional cost to the market and to regulators..

Question 12(d): What regulatory purposes could a system of position limits best serve?

Purpose of position limits

Position limits are used to serve different purposes in commodities markets.

Anti-manipulation

Position limits have been used by certain exchanges, primarily in the United States, as a tool for preventing abusive squeezes in a commodity derivatives market as it approaches physical delivery. Limits are applied most typically to positions in the final three pre-expiry days of the contract to prevent any participant or any group of participants building up a dominant position from which to effect a market squeeze, typically manifested as an undesirable price movement. They may be viewed as primarily effective for physically settled contracts where supply of the underlying deliverable is finite.

Preventing large concentrations and or "excessive speculation"

The CFTC has recently consulted[32] on a new system of position limits for energy market derivative contracts which would apply throughout the lifetime of a derivatives contract. The Proposed Rule

[31] See also the description in the answer to question 12(a) above.

[32] On 18 August 2010, the CFTC has withdrawn its proposals on 'Federal Speculative Position Limits for Referenced Energy Contracts and associate Regulations' as it plans to issue a notice of rulemaking proposing position limits for regulated exempted commodities contracts, including energy commodity contracts, as directed by the recently enacted Dodd-Frank-Act.

would allow the CFTC to directly impose position limits for futures and option contracts in energy commodities, in particular limits for futures and option contracts in four energy commodities traded on NYMEX and ICE. The proposed position limits are intended to reduce the market concentration of large market participants to ensure they do not disrupt the price discovery or liquidity of the markets. They may also be interpreted as being aimed to prevent any market participant or class of participants from building up positions during the contract which would represent an over-concentration. Commentators have opined that the rationale for these proposals is to establish a regime to combat the believed effect of passive long-only market participants, which may build up significant positions which, whilst not manipulative of themselves, cause an undesirable price movement. These positions are typically considered as speculative and as such, limits on them may be used to counter "excessive speculation".

Whilst "excessive speculation" is an undefined term, its origins are linked to price movements in onion derivatives which led to its incorporation in US legislation and to its combat being included in the CFTC's objectives. Indeed these events, which date back to the 1930s, led to the introduction of position limits for physically delivered contracts[33]. The current CFTC consultation has followed a period of significant volatility and extreme price movements in energy derivatives markets, most notably oil.

It is important to note that in both of the above position limits applications, a system of exemptions to allow legitimate hedging of physical positions, is applied. The Proposed Rule suggests to establish a uniform process for the CFTC to grant swap dealers limited risk management exemptions for swap transactions instead of the bona fide hedging transaction exemption that they currently obtain through the exchanges.

Current EU position

European legislation has to date charged European exchanges and regulators with, amongst others, the objective to combat market abuse. There has not to date been any European legislation in this area which obliges European financial services regulators and or market operators to combat excessive speculation.

Certain European exchanges employ position limits in the traditional manner as anti manipulation tools, although this is not mandated in European legislation. Market operators are however charged with an obligation for ongoing monitoring of their markets to prevent, detect and – in some jurisdictions – enforce against market manipulation. This obligation applies to the entirety of the contract's life. Market operators commonly monitor positions on a real time or daily basis and take action over any position of concern. This action can include consultation with the participant and/or with regulatory authorities. Market operators can often also use their powers to either force the participant to reduce the position or to reduce it unilaterally if the participant is unable or unwilling to do so. In many jurisdictions, regulatory authorities can order the exchange to take action if they consider this necessary. This approach may be termed "position management". However, there are no harmonised requirements in EEA legislation regulating this kind of position management.

The case for position limits

The potential benefits and drawbacks set out below apply in the context of employing position limits to prevent market manipulation and to ensure orderly markets.

Benefits of employing position limits

Potential benefits of position limits may include:

[33] Note that position limits were never intended to apply to cash settled contracts, of which there are many in EEA markets.

- Position limits can be employed as a part of a set of tools to combat abusive/manipulative strategies.
- In contrast to a position management approach, position limits are more transparent and could give market participants a level of certainty. Once set, compliance becomes objective (setting aside the potential impact of decisions on exemptions).
- Formal exemptions may be granted, giving the market monitor/regulator clarity over how an exempted participant may behave in the market.
- Position limits may be to limit the exposure of a certain type of participant to prevent it/the group taking on an unacceptable exposure, i.e. one which it cannot sustain.
- Given the certainty of published, hard limits, they may improve the public's confidence in the functioning of markets which determine the price of many key consumables.
- A system of position limits for Europe could mirror arrangements for US markets, aligning regulatory approaches in what are in many cases global markets.

Drawbacks of employing position limits

Potential drawbacks of position limits may include:

- A published limit is inflexible and can only be reviewed after due process has been followed. This may result in an inappropriate limit for prevailing market circumstances (since each contract month can be different).
- The limit may be seen as subjective or arbitrary and as such may damage market confidence.
- Limits typically apply to all or all of a certain class of market participant. This may be inappropriate since different position sizes may be acceptable for different participants. "One size does not fit all".
- They may be used as a 'decoy' by participants which hold positions that are not suitable for the particular participant or market, but which do not breach the limit. For example, a fund which has no capacity to take delivery sitting on a position which is just below the position limit but may result in a failed delivery if not reduced prior to expiry.
- Limits may provide 'false comfort' since there are likely to be market attempts to circumvent them, e.g. underlying investment interest may be divided amongst numerous market participants to mask what would otherwise be a limit-breaching position.
- If limits are too tight, they may impact liquidity and/or volatility, thereby damaging market confidence.
- A system of position limits inevitably requires that exemptions are granted. These may not be understood by alternative market participants and create uncertainty or damage market confidence.
- The granting of exemptions is subjective. Certain participants have hedging and speculative elements to their trading book and yet to date exemptions have covered the whole of the book.

CESR position regarding a regulatory regime for position limits

The key objectives for financial regulators should remain the maintenance of orderly markets and combating market manipulation.

Accordingly, regulators should have a complete set of tools to ensure markets are orderly and that manipulation is deterred. On the basis of the discussion in the Stakeholders' Workshop[34], CESR considers that stakeholders share this objective. It recommends therefore that the key issue the

[34] For details see Annex II below.

Commission should focus on analysing whether exchanges/regulators sufficiently extensive set of powers to manage positions across the entire life of commodity derivatives market contract curves setting up a harmonised set of powers for exchanges/regulators in European legislation and considering whether there is a need for further harmonisation in the way those powers are actually implemented across EU commodity derivatives markets. When pursuing a position management approach, greater clarity should be given about position management by publishing guidance on what measures are typically taken into account when making decisions on how positions are managed.

Position limits may appropriately sit within that set of tools but they do not appear to be the answer to ensuring orderly markets and an effective safeguard against manipulation in their own right. A wider review of regulators' powers to maintain orderly markets and combat manipulation would be more appropriate.

It is key that MiFID and MAD regimes give all regulators a set of comprehensive information to detect manipulation and appropriate powers to combat it. In accordance with the IOSCO recommendations, regulators (and exchanges where appropriate) need clear and unambiguous authorities which give them access to a full set of information on positions held across exchange and OTC markets as well as powers to access information on physical positions where this is required[35].

There is little evidence so far to suggest that markets where position limits have operated for the life of the derivative contract have been any less volatile than those which have not. Nor is there sufficient evidence so far that position limits can systematically be used to limit the impact that significant positions may have on the prices markets generate. Accordingly, it remains to be further assessed whether or not position limits are suited to achieving the objectives of reducing volatility or limiting the impact that large positions may have on market prices and the Commission may reconsider this based on further market development.

Question 13: Against this backdrop, and its earlier advice concerning Article 2(1)(i) and (k) of MiFID notwithstanding, please assess whether market oversight could be impaired if exempted firms do not fall under the scope of possible future reporting requirements to trade repositories and/or regulators?

Exclusion of any class of market participant from reporting obligations at first glance impairs regulators having a set of information which gives them a "whole market" view, which is valuable for market surveillance and enforcement. However, it is important to assess the significance of the gap in the picture given to regulators and whether this can be mitigated from other sources.

Records of positions and trading of a firm are important to the market monitor or regulator and these will always be consulted when examining a particular course of conduct[36]. However, if the information is available to regulators otherwise than through the direct reporting they receive then the risk arising from the apparently incomplete view may be mitigated. For commodity derivatives traded on exchange, transaction reporting is already operational through market operators reporting to their regulators in various jurisdictions. In their advice of October 2008, CESR/CEBS[37] noted that arrangements where regulated markets provide transaction reports in relation to commodity derivatives to their home Member State competent authorities continue to provide a satisfactory solution.

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[35] See also answer to question 12(b) above.

[36] See also CESR/ERGEG advice to the European Commission in the context of the Third energy package (Ref.; CESR/08-998) regarding record keeping of trades in electricity and gas contracts, available http://www.cesr.eu/popup2.php?id=5478. .

[37] CESR/CEBS's technical advice to the European Commission on the review of commodities business (Ref. CESR/08-752), 15 October 2008, available at: http://www.cesr.eu/popup2.php?id=5306.

Further, in the UK, MiFID exempt firms are subject to domestic regulation and accordingly their trading records may be accessed by the UK FSA. These alternative routes to the information provide a significant mitigation of the risk of an incomplete view.

However, it should be noted that a complete unified transaction reporting system direct to regulators would bring benefits of standardisation of the reports and immediacy which the alternative routes referred to cannot provide. It would also align MiFID with MAD for commodities derivatives markets, which would appear to be the logical position.

As outlined under questions 12(b) and (c) above, a position reporting system which provides a whole view of the market would also have many benefits. It needs to be further explored how trading platforms, central counterparties and trade repositories may be involved in this kind of reporting to regulators taking into account that some of these may be located outside the EEA. Considering that EMIR relies on MiFID definitions of investment firms, MiFID exempted firms will be out of the scope of EMIR, unless they are above the identified threshold. The problem, therefore, is that transactions between two exempted firms will not be captured by EMIR provisions, leaving a possible substantial part of the trading activity undetected.. Depending on the actual application of the reporting obligation to non-financial firms, which is related to the level of information threshold, regulators will have a more or less 'full picture' of the OTC market. Some potential gaps could also be mitigated by a system of large trader reports[38].

Drawbacks to extending reporting requirements to MiFID exempt firms clearly include costs to firms and regulators of the additional reporting. Also (and again as noted by CESR/CEBS[39] and as discussed above under question 12(b)) for trading platforms, creating wholesale reporting to regulators potentially undermines the role of exchanges as front line regulators of their own markets.

Question 14: In the context of the CESR work on post-trade transparency in corporate bonds, structured finance products and credit derivative markets, could CESR provide us with any relevant information collected on the level of the de facto existing trade transparency including any description of existing sources of pre- and post-trade information, mostly through electronic systems?

In order to respond to this question, CESR included the following question in the Consultation Paper on the Technical Advice to the European Commission in the Context of the MiFID Review – Non-equity Markets Transparency (Ref.: CESR/10-510)[40].

"On the basis of your experience, could you please describe the sources of pre- and post-trade information that you use in your regular activity for each of the instruments within the scope of this consultation paper: a) corporate bonds, b) structured finance products (ABS and CDOs), c) CDS, d) interest rate derivatives, e) equity derivatives, f) foreign exchange derivatives, e) commodity derivatives?"

As a general comment it is important to note that no responses to this question were received from retail investors. The majority of responses received were sent from buy-side and sell-side firms, execution venues and investment banks.

[38] See description of the CFTC's large trader report system under Questions 12(a) above.

[39] See footnote above.

[40] Consultation Paper on the Technical Advice to the European Commission in the Context of the MiFID Review – Non-equity Transparency (Ref.: CESR/10-510), 7 May 2010, p. 5, available at http://www.cesr-eu.org/popup2.php?id=6629.

Pre-trade transparency

Some responses identified sources of pre-trade transparency information without stating the asset classes covered by the source, such as:

- Pools of liquidity or alternative trading systems where pre-trade transparency is available;
- Bespoke in-house software that aggregates market data and indications of interest from liquidity providers and agency brokers; and
- Instruments traded on regulated markets that are subject to pre-trade transparency.

BONDS: Respondents were able to identify a significant number of sources of pre-trade transparency for bonds. These include dealer runs, parsing services, indices providers, price aggregators, electronic services, bids wanted in competition (BWIC) and offers wanted in competition (OWIC). In particular, one respondent noted the pre-trade transparency regime of Borsa Italiana and ExtraMOT for Italian bonds (although this respondent also noted that the Italian bond market was quite a liquid market before pre-trade transparency had been introduced). Some respondents also referred to the Order Book for Retail Bonds (ORB) launched in February 2010 by the London Stock Exchange as an example of where pre-trade transparency for some corporate bonds is available.

STRUCTURED FINANCE PRODUCTS: Sources of pre-trade transparency for these products include Bloomberg screens, dealer runs, internal pricing and valuation groups (where rating reports, prospectuses, independent research related to the security in question are analysed), third party data providers, model providers and BWIC and OWIC.

CDS: Sources of pre-trade transparency for these products include dealer runs (which although not firm quotes as they have to be followed by a request for quote (RFQ), some respondents noted the commercial incentive to stand behind the quotes reported), parsing services, BWIC, OWIC, single dealer screens/electronic services, commercial vendors, end of the day marks for clearing eligible contracts provided by CCPs and pre-trade transparency provided by electronic execution platforms. In particular, one participant underlined that it used as a form of pre-trade transparency an analysis of the average bid-ask spread, the number of investment banks that provide regular pricing and the frequency of quoted pricing as a proxy for liquidity.

INTEREST RATE DERIVATIVES: Sources of pre-trade transparency for these products include live trading platforms such as Bloomberg (on which the possibility of direct client access was highlighted by one respondent) and TradeWeb, proprietary systems/spreadsheets from Bloomberg and Reuters; single-dealer pricing and execution screens. Some responses considered as useful for pre-trade transparency information inter-dealer trades, which are widely reported to the market where trade data is not deemed sensitive and dealer information on client positions provided as part of the service, end-of-day price data and mark to market position revaluations available to clients via CCPs.

EQUITY DERIVATIVES: Sources of pre-trade transparency for these products include the information provided by public screen prices available for listed equity products supplemented by requests for quotes from dealers and voice prices upon request. For equity swaps and other delta 1 products sources of pre-trade transparency include the price of the underlying jointly with the price of the ‘financial service’ offered by dealers and brokers when offering these products. One respondent noted that for bespoke and structured products there is no pre-trade transparency since these instruments do not exist prior to a request to create the particular derivative. A particular case was noted of the order book operated by EDX London, where market makers offer a transparent pre-trade price for exchange traded instruments. Another response focused on the absolute lack of pre-trade transparency based on the need for secrecy.

FOREX DERIVATIVES: One response included a general remark to explain that even for highly bespoke products, what is readily available is information on key inputs such as spot and forward rates and volatilities. Therefore, that respondent clarified that information currently available was

more relevant for (short dated) spot and forward FX market, rather than options or long-dated currency swaps. Another response informed that given the highly bespoke nature of FX options (variable strike prices, barrier levels, maturity dates, and so on) there are not generally any direct price comparisons available, although clients have access to the necessary pricing inputs (spot rates, forward rates, etc.). The pre-trade transparency sources reported were broker screens (such as electronic quotation services and electronic indication services), data available from the exchanges, electronic crossing networks, aggregators acting as a principal, direct contact with banks and market makers and data providers.

COMMODITY DERIVATIVES: Several respondents noted that most OTC derivatives are by definition not transparent, since in practice quotes are obtained from 2 or 3 counterparties. If quotes were obtained from more counterparties, there would be a risk of front-running by some of those counterparties. In these cases, the risk is borne by the counterparty that wins the trade and then has to unwind the risk. The reported sources of pre-trade transparency are inter-dealer brokers, electronic exchanges, electronic broker platforms, voice brokerage systems and Reuters and Bloomberg platforms.

Post-trade transparency

CORPORATE BONDS: Some reported sources of post-trade transparency included information provided by regulated markets (and in particular LSE's ORD system), Xtrakter through its TRAX OTC trade matching, Bloomberg, Bondscape or the ICMA initiative. One participant underlined that there is a lack of reliable data identifying realised transactions and a lack of reporting of this data no matter how unreliable it may be. This respondent therefore proposed to create a "reference price" based on market prices which would be useful for issuers who are considering tapping the market. For covered bonds, one respondent clarified that there is no post-trade transparency and for government bonds, there are only subscription services for all prints on an electronic system.

STRUCTURED FINANCE PRODUCTS: Sources of post-trade transparency for these products include Xtrakter (through its service Xbis), e-trading platforms, index providers and post-trade valuations.

CDS: The main sources reported were DTCC Trade Information Warehouse (TIW) and valuations provided by dealers to clients as part of their client service. Some respondents believed that also CCPs will provide post-trade transparency once OTC clearing via CCPs is implemented. One response differentiated between post-trade transparency for end-of-day prices (for which the sources were CMA, Markit, Creditex) and size disclosure (for which the main sources were DTCC or RFQHub).

INTEREST RATE DERIVATIVES: Respondents receive post-trade information from regulated markets, Markit Wire, OTC trade repositories, the information provided about inter-dealer trades which are widely reported to other market makers (unless they may affect liquidity). Regarding future developments, it was considered that CCPs should provide access to end-of-day prices and daily mark to market revaluations. One respondent noted a virtual lack of post-trade transparency apart from discussions in the market place, but also indicated that most trades were too bespoke to be of any comparable value.

EQUITY DERIVATIVES: Two respondents considered that there is no post-trade transparency on OTC trading in this asset class. Two other responses named as sources of post-trade transparency information discussions with dealers, brokers and clients and data from equity derivatives traded on regulated markets.

FOREX DERIVATIVES: broker screens, market data providers and exchanges were reported as sources of post-trade information to the FX market. FX dealers have embraced post-trade transparency through increased reporting via CLS since 2002, covering up to 70% of the daily

transaction volume in the FX market. Some participants use bespoke in-house software in order to aggregate market data and Indications of Interest from liquidity providers and agency brokers.

COMMODITY DERIVATIVES: Respondents noted using sources such as clearing house data (including CMV Clearport or ICEClear), information from electronic confirmation and matching platforms or the monthly "special call" report to CFTC. Some responses focused on the lack of post-trade transparency in the OTC space.

Question 19: "Professional clients per se" (Annex II.I of MiFID) and eligible counterparties (Article 24 MiFID) include a number of entities presenting differences in their nature, their size and the complexity of their business (for instance, small and big financial entities providing different types of activities; different categories of "institutional investors", municipalities and other public bodies). In the perspective of further calibrating the treatment of clients:

Q19(a): Please share your supervisory experience and data related to problems encountered in the provision of investment services to professional clients or eligible counterparties. This includes any alleged miss-selling which may have involved public local authorities (e.g. municipalities), small and medium undertakings, institutional investors (e.g. pension funds), or small credit institutions. We ask CESR to provide details about the kind of entities and products concerned;

Q19(b) Please consider possible technical criteria to further distinguish within the current broad categories of clients ("other authorised or regulated financial institutions", "locals", "other institutional investors" (Annex II.I(1)(c), (h), (i) of MiFID), public bodies managing public debt (see Article 24(2) and Annex II.I(3) of MiFID).

See CESR's Technical Advice to the European Commission in the context of the MiFID Review: Client Categorisation (CESR/10-1040).

ANNEX I: Discussion at the Stakeholders' Workshop

Discussion at the Stakeholders' Workshop

A wide range of views and points were raised by stakeholders at the workshop including those set out below.

Comments on operation of position limits

- Whilst position limits have worked for managing final delivery risk for physically delivered contracts, stakeholders would prefer the flexibility of the position management approach with 'accountability' of market participants and ad hoc requests about their OTC positions to continue since this has worked better than limits.

- The availability of exemptions is essential for legitimate hedging business. However, it is difficult to judge when legitimate hedging becomes speculative. Exemptions introduce subjectivity. Authority for granting exemptions should remain with exchanges which have the experience to decide what is appropriate. Concerns about the subjectivity of position management could be addressed by regulators/exchanges publishing guidance on the factors taken into account.

Position limits to combat volatility reduce "speculation"

- Position limits over the lifetime of the contract curve would be likely to restrict markets, damage liquidity and in turn lead to higher volatility.

- Markets rely on a full range of participants to function. For every hedger, a corresponding "risk buyer" is required. Financial and investor participants play a vital role in this respect, as well as their traditional role as liquidity providers.

- There is little evidence which suggests that markets where position limits have operated for the life of the contract (e.g. US agricultural markets) have been less volatile than markets where position limits have not operated. As a tool, it is questionable whether they achieve the aim.

- Care is needed when assessing "large positions". For example, an apparently large financial position may simply be off-setting an underlying physical position of a participant which in reality has a flat book. It becomes more and more difficult to determine which market player is a 'speculator' since traditional categories of market participants (e.g. producer, financial) are blurring.

- Position limits are likely to result in positions becoming split across risk aggregators, i.e. to lead to a market with a greater number of small participants which are likely to be less well capitalised than larger aggregators and to increase systemic risk.

Combating manipulation

- Stakeholders agreed that combating manipulation is an essential part in maintaining market confidence and agree that regulators should have a complete set of information covering exchange and OTC markets and appropriate powers to deal with manipulative practices.