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Working document ESC/21/2005
Explanatory note: Principal differences between working document ESC/20/2005
and
the CESR advice, and issues for discussion

1. SCOPE OF THE WORKING DOCUMENT

The purpose of the working document is to prepare for future discussions on the draft Level 2 implementing legislation with respect to four major issues:

- Pre-trade transparency obligations for regulated markets and multilateral trading facilities (MTFs) (Articles 29 and 44).
- Pre-trade transparency obligations for systematic internalisers (Articles 4 and 27).
- Post-trade transparency obligations for regulated markets, MTFs and investment firms (Articles 28, 30 and 45).
- Conditions applicable to the admission of financial instruments to trading on a regulated market (Article 40).

There are also provisions relating to publication of client limit orders (Article 22(2)) and exchange of information relating to calculations relevant to transparency (Article 58).

2. DIFFERENCES BETWEEN THE COMMISSION WORKING DOCUMENT AND CESR'S ADVICE

The draft contained in the Commission working document is largely based on the advice that the Commission received from CESR on 30 April 2005. However we have made some policy adaptations, and some technical modifications and drafting changes in order to transform the advice into a legislative format.

3. OVERALL POLITICAL APPROACH

In dealing with transparency issues we consider that it is important to preserve the guiding principles of the Level 1 text. For this reason, and like CESR, we have generally favoured transparency as an essential means of achieving an adequate price formation process, of ensuring best execution (at least for retail clients) and of providing for a level playing field between the different types of execution venue.

Notwithstanding that, as we understand the scheme of the Directive, transparency cannot be elevated to the single and exclusive means of delivering these objectives in each and

every case. Recognising this, there are elements of the Directive which are designed to encourage firms to put capital at risk that are also necessary to achieve competitive, liquid and efficient markets.

3.1. Policy adaptations

Standard Market Size

To the extent that CESR's proposal left open the determination of classes of shares as well as their Standard Market Size, we consider that this could endanger liquidity provision (since an internaliser would be obliged to incur excessive levels of risk), without adding any substantial improvement in terms of transparency.

In our opinion there should be a limit to the size at which systematic internalisers are obliged to quote. For this purpose, we consider that the Standard Market Size should be capped at €100,000.

3.2. Issues for discussion

Definition of systematic internaliser

The basic criteria for whether a firm is carrying on internalisation on a systematic, frequent and organised basis are set out in Article 6(1), based on CESR's advice.

However, CESR proposed two further indicative numerical criteria for excluding firms from the class of systematic internaliser:

- the ratio of the value of all client orders in shares executed on own account outside the regulated market or MTF to the total value of executed client orders for each share on an yearly basis is less than 15%; and
- the ratio of the value of all client orders in shares executed on own account outside the RM or MTF to the total value of trading in a share on the most liquid market (in the meaning of Article 25) on a yearly basis is less than 0.5%.

We agree with CESR that it is necessary to ensure that there is legal certainty in relation to the “new” concept of a systematic internaliser. However, we have doubts whether including both these quantitative elements in the definition is an appropriate way of achieving that objective. Commission services foresee some difficulties in applying purely indicative criteria in a way which achieves sufficient certainty. We, therefore, would welcome ESC to consider whether:

- the qualitative criteria established in the first part of CESR's advice and reflected in Article 6(1) are workable and sufficient to determine whether or not an internaliser is a “systematic internaliser” for the purposes of the Directive; or
- whether only the first indent above, and not the second, should be included.

Arguably, if it had been the intention at Level 1 to restrict the definition of systematic internaliser by reference to the importance of the internaliser to the overall market or the importance of the internalisation business to its overall business, that would have been clearly stated in the Directive.

Scope of Article 27 - Liquid shares

We consider that the objectives of the Level 1 text may be best served if the business of systematic internalisation is carried on in all European markets in a transparent manner. To this end, it would be necessary to provide that there are liquid shares in all those markets. In order to allow for this, we have provided draft text for discussion (Article 7(1)) which takes a pragmatic approach and provides that, in every market, at least those most traded shares that represent 60% of the overall turnover in that market should be deemed to be liquid. This should allow emerging capital markets to attain an adequate degree of transparency, and to avoid a damaging fragmentation of liquidity between opaque trading venues. It would also assist in levelling the playing field, and thus in promoting competition between regulated markets and internalisers in those markets.

We would be particularly keen to receive feedback on this issue from Member States with smaller financial markets.

Scope of post-trade transparency – share loans

Information on short sales is potentially significant for the market and, if made public, might enable other market users to make better informed investment decisions. Although not a perfect proxy for short selling, information on securities lending may provide valuable information to the market and the investing public. This has proven to be the case in some European jurisdictions that have already opted to increase transparency in respect of share loans.

The Commission supports greater disclosure and market transparency in general, seeing it as a key factor in facilitating efficient markets. If some market participants have access to information on short positions and stock borrowing figures, while others do not, those with the information are in a privileged position, and this is not a desirable outcome.

We have therefore included share loans within the scope of the post-trade transparency provisions (Article 12(2)(h)), for the purposes of discussion.

Admission to trading criteria for shares

Also for the purpose of discussion, we have included draft text setting out proposed conditions relating to admission to trading of shares on a regulated market (Article 17(3)). That text is based on the CESR recommendations.

We consider that the Level 1 Directive contains a clear mandate to achieve at the European level a substantial degree of harmonisation of the requirements for admission to trading, and we remain concerned that the wording suggested by CESR may not deliver that result. We would prefer that the substantive policy choices should be clearly made in the Level 2 text, rather than left to the interpretation of the different competent authorities involved in the application of such requirements.

We therefore invite Member States to indicate whether in their views more detailed requirements as to distribution of shares and track record should be laid down.

4. OTHER TECHNICAL MODIFICATIONS AND DRAFTING CHANGES

See Table in Annex.

Annex

CESR Advice	Retained Yes/Mostly/Partly/No	Remarks
Content of the pre-trade transparency	Yes	We redrafted paragraph 5 of the CESR advice in order to introduce greater flexibility and dispel any doubts that the provisions in this article might make it impossible for certain types of established systems to continue their operations.
Exemptions from pre-trade transparency	Yes	<p>We have retained the principles but have simplified the provisions somewhat.</p> <p>We do not think that it is necessary to include in the operative provisions certain details, for example, those included in paragraph 13 of the advice. Some issues of this kind could be included in recitals.</p>
Publication of the pre-trade information	Yes	The pre- and post-trade publication and calculation provisions have been merged. We have left out some parts of the advice that we think repeat Level 1.
Definition of systematic internaliser	Partly	We have left out both quantitative criteria pending further discussion within the ESC.
Liquid shares	Yes	For discussion purposes, we have included text deeming the most liquid shares representing up to 60% of cumulative annual turnover liquid for the purposes of Article 27. This would take into account the different market structures and also to ensure a level playing field between internalisers and regulated markets in Member States where there would be no or only very few Article 27 liquid shares without such a deeming provision. By doing so we also further the flexibility proposed in the CESR advice without greatly expanding the final number of liquid shares.

CESR Advice	Retained Yes/Mostly/Partly/No	Remarks
Calculation of the average size	Yes	
Orders large in scale compared to normal market size	Yes	
Definition of classes	Yes	
Definition of standard market size for each class of shares	Yes	We have limited the standard market size at 100K as we do not see the necessity to have an indefinite number of standard market sizes.
Revision cycles for the allocation of shares to an standard market size group	Yes	
Grouping of shares following first admission to trading on a RM	Yes	We are less concrete in prescribing the way to estimate the standard market size.
Publication of the information	Mostly	We did not include some of the provisions as we think they are more of an explanatory nature and as such should be included in a Recital.
Quotes reflecting market conditions	Yes	
Obligations for systematic internalisers when handling and executing client orders	Yes	

CESR Advice	Retained Yes/Mostly/Partly/No	Remarks
Orders executed large in scale compared with normal market size for the purposes of calculating average trade size for Article 27 shares	Yes	
Client limit orders	Mostly	<p>Our main goal here was to maintain the CESR ‘visibility’ and ‘easy execution’ tests. This is fundamental and we do not feel there is a need for some of the other provisions to be included. We take it for granted that once this test is met, firms will be able to publish the information in venues other than regulated markets or MTFs as well as use other investment firms to transmit such information to the publication venues. We exclude the provisions on quote-driven systems for the same reason.</p> <p>We also don’t feel the need to explicitly state that the obligations in this article don’t release the firm from its best execution obligations as we don’t think it the client limit order provisions could be interpreted in such a way.</p>
Content and publication of post-trade information	Mostly	<p>We have aligned the terminology with the Cooperation and Enforcement text and left out certain fields we thought superfluous. We have also included a publication obligation for loans.</p> <p>Paragraphs 56 and 57 have been redrafted in order to provide for greater clarity.</p>
Approval of deferred publication arrangements for transactions that are large in scale compared with normal market size	Yes	The calculations in paragraph 66 are not based solely on order book data. Similar changes were applied to paragraph 69.

CESR Advice	Retained Yes/Mostly/Partly/No	Remarks
Requirements for instruments to be admitted to trading on a regulated market	Mostly	<p>The money market requirement seems a little too obvious to be included in a piece of legislation. In general, regulated markets should get information on the terms of every instrument, not just money markets, but we believe we can safely assume the regulated markets will do that.</p> <p>We rewrote the UCITS requirements slightly.</p>