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British Bankers Association (BBA)
Bond Market Association (BMA)
Futures and Options Association (FOA)
International Capital Market Association (ICMA)
International Swaps and Derivatives Association (ISDA)
London Investment Banking Association (LIBA)

Response to FSA Consultation Paper 06/14: Implementing MIFID for Firms and Markets

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We do not comment on Chapters 2, 6, or 11.

Summary of key points

This response sets out the comments of AFB, BBA, BMA, FOA, ICMA, ISDA, and LIBA on CP06/14. We very much welcome the efforts which FSA has made to seek our comments in meetings during the course of the consultation period, and the indications it has given that it will consider seriously the points we have made. We ask FSA to continue these discussions as it prepares the final Handbook provisions. We draw FSA's attention in particular to the following key points.

1. Transaction reporting (Chapter 17):

- a. FSA should avoid additional requirements beyond what MIFID prescribes, in particular in several areas of the transaction reporting proposals: additional fields; additional categories; specification of new standards. FSA's proposals will not in many cases help to achieve its objective to improve its ability to monitor market abuse, while being costly for firms to implement.
- b. It is evident from the CBA that FSA has underestimated the scope of work required by firms to implement MIFID transaction reporting requirements, in particular the super-equivalent suggested additional requirements.
- c. There is a need for objectivity in the specification of data to be reported, so that it is clear to firms exactly what they need to do to comply.
- d. FSA should take account of how its transposition of transaction reporting provisions relates to the approach of other regulators across the EEA through CESR.
- e. Taking account of CESR's work on a consistent pan-European approach, FSA's requirements for transaction reporting need to be both clear and definitive by 31st January 2007, as firms will need the full nine month period allotted in which to implement them by the due date.

2. Level 2 Regulation (Chapters 1, 14-16)

There is a need to switch on discretionary provisions in the Level 2 Regulation through explicit FSA rules, e.g. waivers from pre- and post-trade transparency; definition of "liquid shares". Firms should also be able to rely on the Handbook as a complete statement of the obligations that FSA will enforce, including those deriving from the Level 2 Regulation.

3. Permission notices (Chapter 3)

FSA should take a pragmatic and active approach to updating firms' permission notices.

4. Branches (Chapters 5, 16, 17)

There is a need for appropriate allocation of responsibility for services and transactions undertaken by a branch to the host (branch) State competent authority.

5. Principles (Chapter 8)

Changes to the Principles should be explicit, not done through an "EU law override".

6. Client assets (Chapter 10)

We generally welcome FSA's overall approach to implementing MIFID's client assets provisions, but further technical changes are needed to ensure that professional clients are not constrained in the use of their assets, in particular relating to:

- a. ensuring that the exclusion from client money of arrangements where the firm receives full title operates as FSA intends;
- b. limitation of the application of client money rules to affiliates' money.

7. RSPs (Chapter 14)

There is a need for appropriate treatment of RSPs and other forms of exchange-related RFQ systems for the purpose of determining whether they are systematic internalisers (SIs) or covered by the negotiated trade exemption.

8. Systematic internalisers (Chapter 16)

We generally welcome FSA's intelligent copy-out approach to the provisions on systematic internalisers (SIs) and its proposed reliance on firms to self-assess, but it is important to interpret the elements of the definition correctly, and to apply them cumulatively as MIFID prescribes. We also think that exchange-traded fund products should not be considered as "liquid shares" for the purposes of the SI provisions.

9. Trade reporting (Chapters 14, 16):

- a. "Technically possible" delays for reporting portfolio transactions need to take account of the risk attached to the portfolio as a whole, and the deterioration of price that would result from premature disclosure of large portfolios.
- b. FSA should include additional guidance on the application of trade reporting rules to investment managers, consistent with guidance for transaction reporting.
- c. There is a range of practical implications of FSA's Trade Data Monitor proposals which need to be carefully considered, and which support FSA's decision to follow a cautious, guidance-oriented approach.

10. Market transparency (Chapters 14 – 16)

There is a need to consider the practical implications of CESR's consultation on publication and consolidation of MIFID market transparency, and the effect of any CESR or FSA guidance that may emerge from it on firms' ability to design trade reporting systems with a clear knowledge on 31st January 2007 of what regulatory requirements and expectations are.

CHAPTER 1: OVERVIEW

Legal architecture

FSA is not proposing to incorporate Level 2 Regulation provisions in FSA rules, instead printing them in the Handbook with “EU” status, though it may provide guidance on them. The “EU” approach does not seem to work when the Level 2 Regulation gives discretion to FSA or where FSA needs to exercise a discretion that the Regulation provides for the discretion to take effect. In these cases, “EU” provisions should be supplemented with “R”s to give effect to FSA’s discretion. For example:

- (a) MAR 5.9.6EU and MAR 7.2.6EU need to be supplemented with “R”s to implement delayed reporting of large trades effectively.
- (b) In MAR 6.8.5EU, FSA needs to specify by “R” in paragraph 1 that both (a) and (b) apply.
- (c) MAR 5.7.6G, MAR 5.7.7EU, and MAR 5.7.8EU seem to be a weak means to implement waivers from on-exchange pre-trade transparency. FSA should specify by “R” that “The waiver applies...”

It follows that it is not strictly true, as paragraph 1.33 says, that “the Level 2 Regulation applies to firms directly so no waivers will be available from its requirements”. On the contrary, the Level 2 Regulation specifically contemplates the application of the optional waivers that it contains.

As reflected in Footnote 8, as a legal matter, FSA may be under an obligation not to purport that the Handbook is a comprehensive statement of obligations under EU legislation. However, given that:

- (a) most of the Level 2 Regulation implements details of Level 1 measures which must be transposed into national requirements, in such a way that they cannot realistically be separated;
- (b) only some provisions such as those relating to record-keeping are directly applicable to firms as if they were a Rule; and
- (c) FSA will be enforcing against breaches of those provisions as if they were a Rule,

it would be misleading to say that the Regulation provisions will be directly applicable in a way that means that FSA has no responsibility for them. Given the close intertwining of “R” and “EU” provisions, firms should be entitled to rely on the entirety of the provisions set out in the Handbook as a complete statement of their obligations, and not be required to look elsewhere than the Handbook to ascertain the standards and requirements to which FSA will hold them. FSA should not disclaim responsibility, but should undertake due diligence to ensure that its copied text is accurate and up to date.

CHAPTER 3: SCOPE OF MIFID AND ITS IMPLICATIONS FOR FIRMS

Comments on Chapter 3

Our key comments on this chapter are as follows:

- (1) **Pragmatic and pro-active approach to changes to firms' scope of permission notices.** Whilst we appreciate that FSA is mindful of the difficulties encountered at N2 with respect to the agreement of firms' scope of permission notices, we would urge FSA and HM Treasury to adopt as pragmatic an approach as possible to updating firms' permission notices. In particular, we concur with the use of transitional provisions to update firms' permission notices, without the need for applications for variation of permission, and strongly support the automatic expansion of a firm's permission, in relation to certain specified investments, to reflect the wider scope of MIFID.

We believe that FSA should be pro-active in issuing revised scope of permission notices. FSA is best placed to make judgments on a generic basis of these changes, and they should be applied consistently across the industry. It is, of course, the responsibility of the firm to assess the impact and ensure that the necessary changes are applied. In particular, we would urge FSA to consider the automatic updating of firms' permission notices to reflect changes in relation to the more standard client-type limitations.

- (2) **Fast-track process for variation of permission.** Notwithstanding the above, we believe that FSA should introduce a fast-track variation of permission process, to facilitate cases (which we hope will be few and far between) where firms need to apply for a variation of their Part IV or top-up permission.
- (3) **Expansion of existing categories of derivatives in the RAO.** We commend FSA's efforts to communicate with commodity market participants (for example, through their Commodity Firms Standing Group) but trust that FSA will, where it has discretion to do so, treat this sector in a proportionate manner. In particular, we welcome FSA's helpful policy stance that OTC physical forward transactions intended for delivery should not be caught under MIFID, and we ask FSA to include a statement to this effect in the perimeter guidance.
- (4) **Communication with unauthorised firms.** FSA has explained clearly, in CP06/14, the need for unauthorised firms to consider whether the changes to the scope of UK regulation arising from MIFID will mean that they need to apply for authorisation. We would like to know, however, what steps FSA has taken to communicate this message to the groups of unauthorised firms that are most likely to be affected by the changes (for example, firms trading soft commodities) who might otherwise not read FSA consultation papers. It is our understanding that knowledge of the impact of MIFID might be limited in some sectors and so would encourage FSA to find appropriate channels to deliver suitably targeted communications.

- (5) **Perimeter guidance.** We welcome the helpful and user-friendly draft perimeter guidance addressing issues relating to the scope of MIFID and would urge FSA to encourage its EEA counterparts to consider providing similar guidance on the effect of MIFID on the domestic scope of regulation in other Member States.

Annex 5, Part 5: comments on draft Handbook text

PERG will need to be revised to take account of HM Treasury's revised proposals for amendments to the RAO.

PERG 2.6. A consistent format (including insertion of Regulated Activity Order references) should be used in PERG 2.6.20G(2) ("...but only where they are options in relation to which..."), PERG 2.6.22AG(3) (the drafting of this guidance is in particular need of rewording: "...which:....(3) in relation to which...") and PERG 2.6.33G(3) (...but only where...").

PERG 2.6 should, if possible, be enhanced to reflect the FSA's helpful policy stance (as reflected in Q35 of PERG 13) that OTC physical forward transaction intended for delivery will not be caught under MIFID, despite the use of the word 'forwards' in the Level 1 Directive. As FSA is aware, the FOA has obtained a legal opinion to support this view, copies of which have been provided to both HM Treasury and FSA.

PERG 2.6.20A G. The guidance in PERG 2.6.20A G should be redrafted to improve clarity. For example, the opening "therefore" appears to be superfluous, and the sentence "Where the option in question is one to which 2.6.20(2)G applies, however..." is confusing given that the text immediately above appears to refer to options that "...do not come within PERG 2.6.20G(2) and would otherwise come within PERG 2.6.30G...".

PERG 2.6.20A G. We agree with the last paragraph of PERG 2.6.20A as explaining what HM Treasury means by the words 'in relation to which an investment firm provides or performs investment services or activities on a professional basis' in its proposed implementation.

PERG 2.6.23A G. The last sentence may be misleading where cash and physical settlement are alternatives. FSA should delete it.

CHAPTER 4 : AUTHORISATION

Comments on Chapter 4

Changes to Handbook and application forms. We concur with FSA's view that "relatively few amendments are required" to the Handbook to implement the authorisation provisions in MIFID, although the application packs will be revised to reflect changes introduced by, inter alia, MIFID. We hope that FSA will use the opportunity, notwithstanding the current enhancement of the application packs, to further improve the application forms and their ease of use, including through on-line access.

Delegation. We note and support FSA's decision not to make use of the provisions in MIFID that enable regulators to delegate administrative, preparatory or ancillary tasks relating to the review of the conditions for initial authorisation for firms that only provide investment advice. We believe that delegation of these tasks to a third party would be inappropriate.

Dismantling the Authorisation Manual. Whilst we support FSA's Handbook simplification aims, there is a concern that the dismantling of the Authorisation Manual (AUTH) - which was designed as the central point of reference for firms requiring authorisation for the first time - may make it difficult, once the contents are disseminated (particularly in SUP), for applicants and potential application to identify the rules and guidance appertaining to the authorisation process. That said, we believe that much of the material in AUTH has been of use to firms on an ongoing basis (for example, the perimeter guidance that is now in PERG and the guidance on a firm's permission in AUTH 3); hence, it is entirely logical that the guidance is relocated in SUP.

We would, therefore, be interested in discussing in more detail, and providing feedback on, FSA's plans for dismantling the Authorisation Manual.

Withdrawal of authorisation. Whilst we largely agree with FSA's proposals, it will be important for FSA to apply them proportionately. For example, FSA should ascertain the firm's intentions before enforcing cancellation if the firm has not traded for six months, and should apply a materiality test to the false statement criterion.

Review of the controllers' regime. We note that both HM Treasury and the European Commission are reviewing provisions relating to controllers, and would welcome simplification of the regime and refocusing on the mischief the regime is designed to guard against, as there is general concern that the costs of the current regime exceed the possible benefits. Each of the Associations will be responding separately to the respective consultations.

Annex 5, Part 6, Annex C: comments on draft Handbook text

SUP 6.3.42G. We note that Article 8 of MIFID Level 1 prescribes circumstances in which a firm's authorisation may be withdrawn. We believe that these powers should apply equally to an FSA authorised and regulated firm's Part IV permission and an incoming EEA firm's top-up permission. The draft text in SUP 6.3.42G should be extended to include specific references to top-up permission.

CHAPTER 5: CROSS-BORDER SERVICES AND THE ESTABLISHMENT OF BRANCHES

The most important issue raised by this chapter is that highlighted in paragraph 5.18 and 5.19 concerning the division of responsibilities between the home and host State in relation to the operations of a branch under article 32(7) MIFID. We are naturally concerned about the practical implications if a branch had to comply with one set of rules when providing services “within” the state in which the branch is located and another when providing services “elsewhere”. We favour an interpretation which treats all the services of the branch as provided “within” the State in which the branch is located, on the basis that:

- (a) Recital 32 of MIFID Level 1 strongly points towards this interpretation of Article 32.7, in that the branch competent authority is better placed than the home State competent authority to monitor and enforce the local rules;
- (b) It minimises the risk of two different sets of rules applying to the operations of a branch;
- (c) It is the approach which is most consistent with the so-called “characteristic performance” test.

There is a need to resolve these issues as a matter of urgency in time for firms to complete their implementation plans.

In any event, Member States could minimise the potential impact on firms by minimising the range of super-equivalent requirements imposed on firms under the articles specified in article 32(7), and the range of divergent interpretations of those provisions. This will assist those firms that choose an approach to implementation based on an aggregation of the most onerous requirements. However, there are some requirements where it would not be possible to adopt such an approach to compliance, such as in relation to transaction reporting, which we discuss in our comments on Chapter 17 below. We encourage FSA to agree an approach with other EEA regulators under which a branch makes its transaction reports to the competent authority in the state in which the branch is located in all cases where any relevant transaction is executed in the branch. However, it should be made clear that, where a branch receives and transmits orders to its head office for execution, the transaction should be regarded as executed in the Member State in which the entity's head office is located for the purposes of transaction and trade reporting and other relevant rules applicable to the execution of transactions.

There is a particular issue relating to client classification. There are a number of different ways in which client classification might work in relation to branches. One possibility is that the home state regime applies for all purposes. Another is that the host state client classification regime applies in relation to those rules which are the responsibility of the branch state supervisor under article 32(7).

This possibility raises additional issues concerning the grandfathering of previous client classifications. For example, a UK firm operating through a branch in Italy may have classified its clients in accordance with the Italian system, which allows firms to treat certain investors as “qualified investors”. To the extent that UK rules apply to the firm's operations (e.g. at the very least in relation to the client assets regime where the distinction between retail and professional investors is important under articles 17(3)(b) and 19(1)(A)), there would seem to be no reason why FSA could not allow

the firm to grandfather its prior classifications under the Italian regime for UK purposes (at least if the Italian authorities allow the grandfathering for the purposes of their implementation of MIFID). Indeed, on an ongoing basis we would expect that FSA should be willing to accept classification done by the branch in accordance with (in this example) the Italian implementation of MIFID as meeting FSA's requirements, even if there are minor differences in approach.

Clearly, this could be a very significant issue for firms from other EEA states with passported branches in the UK. These firms are likely to wish to ensure that their home state regulator recognises (and grandfathers) their prior classifications carried out in accordance with the UK regime (and, possibly, on an ongoing basis any classifications done for the purposes of UK rules to the extent that the client classification system is not entirely a home State matter). The UK's willingness to recognise other state's classifications would be helpful in persuading other Member States on this point.

In addition, there is the issue of the application, in this context, of the provisions of article 24(3). To the extent that home State rules apply to the operations of the branch, it seems likely that those rules should defer to the branch State's rules defining eligible counterparties in relation to counterparties located in the branch State. To the extent that the rules of the branch State apply, then the same result should obtain.

Paragraph 5.5

We believe that the Guidance on passporting is helpful to firms and support its retention, even though it is not mandatory under MIFID. Whilst FSA is committed to copy-out of EU Directives, this approach should not preclude the provision of additional guidance or the retention of existing guidance, where such guidance helps firms understand their obligations. We also believe that the provision of formal guidance by FSA should be through the medium of the Handbook.

Paragraphs 5.11 and 5.20

We note the proposed amendment to FSMA implementing the provisions of articles 31(1) and 32(1) MIFID that state that "ancillary services may only be provided together with an investment service and/or activity" in relation to the provision of cross-border services. We believe that it is important that there is a clear understanding that this provision only means that a firm cannot submit a "notice of intention" in relation to ancillary services alone (i.e. a notice of intention must state an intention to provide at least one specified "core" investment service or activity, as well as one or more ancillary services).

It should not mean that an investment firm must, when exercising its passport rights, restrict its provision of ancillary services to clients to whom it also provides a "core" investment service or activity. For example, a firm may provide dealing services to some clients together with safekeeping/administration (custody) services but may provide custody services to other clients to whom it does not provide dealing services (or indeed any other investment service). This is obviously important in relation to those ancillary services that can be provided to clients who do not receive core services e.g. custody, M&A advisory, investment research, and trading in

commodities (points 1, 3, 5 and 7 of Section C, Annex I MIFID). The more restrictive interpretation would significantly inhibit the effectiveness of cross-border competition, and increase the necessity for “top-up” permissions/licences, which may not always be available in some Member States.

Paragraph 5.12

As FSA will be aware, it is often difficult for firms to determine if a service will be provided on a cross-border basis due to the uncertainties in respect of where an activity or service is deemed to be provided. This is particularly problematic where clients trade online: if they have an Internet link and a laptop, they could use a firm’s services cross-border from any location in the EEA. As discussed above, in respect of services, we favour an interpretation which treats the services as provided “within” the State in which the branch or firm is located and would welcome guidance from FSA that addresses the issues facing firms in an online environment.

Further, given the expansion of the EEA and the increasing mobility of clients (both physically and by virtue of the Internet) we believe that FSA should now encourage notifications from firms to the effect that they may wish to exercise their rights to provide cross-border services to clients located in any one of the other 24 States.

Q1. Do you agree with FSA’s proposals to retain these provisions [information and procedural guidance relating to notifications]?

Yes.

Paragraph 5.29 to 5.32

Following on from the above, we think that it is likely that some firms that need to serve notices of intention in relation to new services (such as commodity derivatives) will wish to refresh their passport notifications completely by serving notifications that cover all the MIFID services/activities they intend to provide in all the countries where they intend to provide those services/activities, as if they were serving a notice of intention for the first time (even if some of the services/activities may benefit from the grandfathering arrangements). This will help the firm if there are countries which take a different view from that described in paragraph 5.29 and also may make changes in activity easier to monitor. It would be helpful if FSA would confirm that it would be willing to accept and deal with those notifications on an expedited basis.

CHAPTER 7: ENFORCEMENT AND REGULATORY COOPERATION

Q3. Do you have any comments regarding the amendments FSA propose to make to ENF and DEC?

In large part we support FSA's proposals on Enforcement. However there are concerns in relation to cross border supervisory co-operation, specifically requests for information from other Member States' regulators.

Our members are comfortable with FSA provisions in relation to Recognised Investment Exchanges (RIEs). FSA's draft text on precautionary powers of intervention and enforcement in the event that a firm breaches MIFID requirements is coherent and positive.

Regarding requests for co-operation and exchange of information, we are concerned that the questions raised by MIFID Level 1 Article 57 have not been sufficiently examined in CP06/14.

Specifically, we would request FSA to clarify whether a Member State regulator other than FSA has a legal right to demand information directly from a firm in relation to its UK operation and activities. If it does, then there would be no difficulty in providing client information because that legal right would override duties of confidentiality owed to firms' clients. Currently firms require that FSA cite the relevant parts of FSMA when seeking information, in order to override their client confidentiality obligations.

The wording of MIFID Level 1, Article 57 is ambiguous and the concern is that providing information to overseas regulators under that Article might not override firms' confidentiality obligations. This would then leave firms vulnerable to a claim from a client. For this reason, it is vital that FSA provides its interpretation of Article 57 in a form which enables firms to rely on it for confidentiality purposes.

The issue is not simply whether the authority receiving the information treats it confidentially. If other Member States' Regulators can ask for information, carry out investigations etc, the rules and laws under which the overseas regulators' activities take place need to be clearly understood by the relevant firm, and this would cover more than obligations of client confidentiality.

Our own view is that if Article 57 does permit direct intervention by other EU regulators this would contradict the approach put in place by CESR and also under the ISD whereby all approaches by member state regulators should be made to the regulator rather than the firm in the State where the operations take place. We consider that Article 57 should be interpreted so as to maintain the current position. We ask FSA to discuss the matter with us if it disagrees with our analysis.

FSA needs to address a number of issues arising out of article 57. The text of this provision states that other Member States regulators can not only ask for information but also carry out 'verification or investigation'. It would be helpful if FSA could clarify the nature and depth of this requirement on firms. For instance if a firm is a member of Euronext does this imply that all the regulators from Member States that

Euronext operates in are able to ask for information and carry out supervision directly? Would other Member States' regulators for instance require information on capital adequacy or systems and controls as part of these potential supervisory powers? Article 57 also talks about on-site visits; this raises the possibility of, for example, multiple regulators doing on site supervision on the same topic – implying a concurrent cost to the firms involved. There needs to be co-ordination so that such visits are handled in a practical and cost efficient way with the maximum of joint work between regulators and the minimum of duplication.

If a firm is a member of a cross-border exchange such as Euronext, Article 57 outlines that Member States' regulators can request information. We suggest that this should mean that firms are only required to provide basic information regarding trading on that exchange (client information, trading volumes etc), but not information on any derivatives based on that instrument but not traded on the exchange, or where a firm is acting as an advisor to the issuer of the instrument, or information such as insider lists.

In the cost-benefit analysis (Annex 2.4) FSA states that it receives 300 inquiries a year from other regulators. However, it is the number of inquiries which FSA sends out to firms which is the critical number for determining the level of burden on firms and total cost industry-wide of responding to these inquiries. For many of the requests that FSA receives, it will presumably send out multiple requests to different firms, so that the number of overseas inquiries received by firms collectively is probably considerably higher, perhaps in the thousands. This makes it even more important that FSA clarifies helpfully what Article 57 means and its implications for firms and FSA itself.

Furthermore, it is not clear whether FSA's 25 hours estimate (paragraph 4.14) of the time firms typically allocate to dealing with a request of average complexity is accurate. For example whilst FSA only refers to the compliance department of a typical firm, such enquiries often also place considerable demands on the time of other departments such as trading, IT and operations. It would appear that this additional time has not been factored in. It also highlights the need to focus on how many inquiries banks - as opposed to FSA - actually receive.

Given that, as described above, total costs across the industry can spiral quickly, it is critical that FSA performs a rigorous assessment of each request, facilitated by strong and effective communications with the overseas regulator, to ensure that:

- (a) the objective of the enquiry is understood and deemed justified;
- (b) the information request is properly focused on obtaining only that information which is most relevant and that will most readily assist the requesting regulator to carry out its stated objectives;
- (c) a decision is made, based in the above, as to whether the inquiry should or should not be forwarded to FSA regulated firms;
- (d) the nature of the inquiry and the data being requested is unambiguous and proportionate; and
- (e) given the above, the scope of the data request merits the resultant costs to firms.

Sometimes it appears that FSA undertakes very little review of overseas requests before passing them on. From the firms' perspective, it is the work which FSA does at this stage of the process which is critical to ensuring that FSA provides a good service to firms and other regulators. As an indicator of this aspect, it would be helpful to know what proportion of requests FSA does not pass on to firms.

However, it is also important for FSA review its procedures to minimise the time between its receipt of the request and its transmission to firms and, similarly, the time between receipt of the response and sending it out to the requesting regulator. As an indicator of this aspect, it would be helpful to know how much time FSA spends processing incoming requests and outgoing responses.

Firms would request that FSA continues to improve its administrative arrangements for managing other Member States' requests for information, for example to minimise delays in passing on requests, and to pass on explanatory material that is necessary to understand the request. Given the increasing number of requests that are envisaged from November 2007, FSA should: consider the resources required to handle requests quickly; scope requests so that they are appropriate for the UK market; and provide sufficient supporting data to the firm to clarify the request.

CHAPTER 8: PRINCIPLES FOR BUSINESS

Q4. Do you agree with FSA's proposed approach to ensuring that the application of the Principles for Businesses is consistent with MIFID requirements?

No, we do not agree with FSA's proposed approach on the application of high level principles. Given the changes in customer classification that will be brought in by MIFID, which are specifically highlighted for firms' consideration in the FSA CP, it is vital that the Principles themselves, as well as to whom and when they apply, are clear to firms.

FSA's proposed approach of general amendment to PRIN3, outlining that principles do not apply where the UK would breach MIFID obligations, is not practicable. The implementation of MIFID high level requirements should be done by amending the Principles themselves where necessary, not by an "EU override". The Principles are the driving force behind FSA work. Every enforcement action has one or more Principles supporting it. Given that FSA has on occasions enforced against firms based purely on Principles rather than specific rules, firms need to have a clear indication of the standards that FSA expects.

The FSA principle-based approach requires firms to use the Principles as a reference point when they are unsure how to act. In carrying out supervision FSA wants to know how firms apply the Principles to their business. The centrality of the Principles to FSA's work and regulation in the UK as a whole requires that they must be clear and unambiguous.

It is unhelpful to use the "unless in breach of EU law" approach - firms must be clear what the principles are. For example, on conflicts, this would imply replacing all references to "customer" with "client" (as MIFID applies the detail of the conflict management procedures to 'client' relationships with counterparties).

FSA should amend the Principles so that they are consistent with MIFID high level standards but still remain a coherent and complete stand alone document.

CHAPTERS 9 and 10: CLIENT ASSETS

We welcome the fact that FSA has consulted on client asset rules now, to maximise the consultation time available to the industry.

Comments on Chapter 10

10.3. The flexibility to allow firms to apply MIFID rules for non-MIFID business as well (plus flexibility for non-MIFID assets) is welcome. We believe that large firms will wish to opt in to operate a single platform. However, firms should be able to apply MIFID rules for classes of business (i.e. not all or nothing), either through rules or by waiver. This flexibility will be an important complement to the ability to opt in to other MIFID rules where similar issues may arise. It may be particularly important for smaller or specialist firms.

To avoid administrative inconvenience and expense, FSA should also enable UK branches of non-EEA firms to opt to apply MIFID rules. Because CASS 6 and 7 apply only to “MIFID investment firms”, which do not include a UK branch of a non-EEA firm, such branches would remain subject to existing CASS 2 and 4. However, an EEA firm in the same group will be subject to CASS 6 and 7 for MIFID business and CASS 2 and 4 for non-MIFID business and, in respect of the non-MIFID business, may under CASS 6.1.17 and 7.1.3 opt to hold money and assets solely under the new MIFID rules. A non-EEA firm’s London branch in the same group would not be able so to elect because, under CASS 6.1.17 and 7.1.3, it does not hold any MIFID money or assets, which is a requirement for the opt- in under those rules. It could be extremely inconvenient practically if the group has to operate two regimes, and there does not seem to be any policy reason why such an election should not be allowed to a non-MIFID firm.

10.11 – 10.16. We acknowledge FSA’s judgement that retaining the professional opt-out is not compatible with MIFID segregation requirements, and that FSA is not proposing to carry the opt-out forward. FSA proposes to rely on exclusions from the definition of client assets instead: e.g. title transfer collateral (but not unlimited) by analogy with Level 1 Recital 27. We note that FSA expects exclusions to allow “many existing arrangements” to continue, subject to proper documentation and good faith, “even when they relate to future or prospective obligations”. We also note that the exclusions are constrained by the RAO exemption from accepting deposits: ‘in the course of or for the purpose of carrying on certain regulated activities’. In this context, it will be important to interpret future or prospective obligations broadly enough to enable firms, for example, to retain profits from the liquidation of a client’s position to cover a liability that may arise in the future, without falling outside the RAO exemption from accepting deposits.

We broadly welcome FSA’s proposed approach, which would enable firms not to treat as client money any situation where the client gives full title to funds to the firm, where the firm receives title to the money for the specified purpose. The approach would not prevent firms and clients from agreeing client money protection if the client wants it, in effect by agreeing that the funds should belong to the client and be segregated on receipt. We note that arrangements agreed with professional clients are not constrained by the more restrictive approach in 7.2.7G.

However, we would like to propose the following amendments to the draft Handbook text in order to give full effect to the policy intention:

- (a) We suggest that the title of 7.2.3R should delete the word “collateral” (to reflect the broader nature of the exemption), or be changed to “Transfer of ownership as security” to reflect the original wording of MIFID Level 1 Recital 27, and the introductory words to 7.2.5G should refer to “arrangement under which the firm receives full title” (or “full ownership”) rather than “effective title transfer arrangement”.
- (b) There is also a need to limit 7.1.12G to circumstances where the firm provides MIFID investment or ancillary services to an affiliated company (so that the affiliated company is a client as defined in MIFID), in order to avoid limitations on the ability of affiliates to deposit money. FSA should link CASS 7.1.12G more explicitly to CASS 4.1.18R, as CASS 7.1.12G does. It would not be inconsistent with the MIFID Level 2 legislation to reflect the existing provisions of 4.1.18R in the new CASS 7. This would not be an opt out but merely a statement that money received from affiliates will not be client money except in the circumstances set out in the current wording. It would also avoid the cost to firms of identifying whether a move away from the CASS 4.1.18R approach meant that any currently excluded balances would need to be newly treated as client money.
- (c) There is a need for a flexible approach to the interpretation of “no longer than necessary” in 7.2.7G(3) so that, for example, firms do not need to return to client money or withdraw from client money on a daily basis due to fluctuations in margin requirement. Clients often keep a small amount of cash margin with firms in excess of collateral requirements to give them a cushion or flexibility to open new positions or increase exposure at short notice. It will be important for firms to be able to keep this money unsegregated, and treat cash margin as “no longer required” only when it significantly exceeds current requirements, or when the account is closed.
- (d) There is a need for a flexible approach to the interpretation of ‘reasonable link’ in 7.2.7G(4) so that retail clients (especially those which cannot opt up: see our more detailed comments under Q5 below) are not unduly constrained in providing funds for prospective obligations.
- (e) FSA should ensure that 7.2.3R covers cases where a firm holds client securities which generate coupon, dividends, etc. and title to those funds is transferred to the firm with the client's consent for the specified purpose, by referring to cases “Where full ownership of a client's money is transferred”, rather than “Where a client transfers full ownership”.

The definition of “client” needs to be brought into line with MIFID.

We also concur with, and welcome, FSA’s view that it is not intended that money transferred by the firm to third parties such as exchanges and clearing houses is “subject to the full MIFID segregation requirements...” We would welcome,

therefore, rules that set out when money ceases to be client money on the transfer of client funds to a third party, which are similar to FSA's existing rules. In this regard, we would suggest that 7.4.11 is made subject to the provisions of CASS 7.5.2R. (which mirrors the qualification which already exists in CASS 4.3.34 R).

Q5. Are there any current arrangements that might not be covered by the proposed carve-out under Recitals 26 and 27?

Subject to our comments above, we believe that, in many cases, the proposed carve out will enable current arrangements within the wholesale markets to continue. However, we have identified two areas where further guidance may be necessary to maintain the status quo:

- (a) "Trapped" institutional/expert retail clients. As FSA is aware, given the possible recategorisation under MIFID of many intermediate customers as retail customers, any restricted application of absolute title-transfer for retail clients as a whole is likely to have a significant impact on the way in which many firms finance and manage their business. This is particularly so for firms trading CFDs with unregulated institutional clients and high-net-worth 'expert' individuals, categorised as intermediate customers, that have opted out of client money protection under the current rules.

In the cost benefit analysis, FSA states that: "The CASS regime did not allow opt outs for private clients. Wholesale clients are more involved in the market, are in a better position to take account of any risks, and understand the implications of not being protected by the rules better than private clients. The MIFID exclusion does not take into consideration client classification, so there is some risk that firms may begin to exclude retail customers. This risk should be mitigated by the Article 19(1) requirements of firms to act, inter alia, in the best interests of the clients." (Annex 2, paragraph 5.16). It is our understanding that this statement, and others in the CP, refers to the exclusion from segregation of the funds of private clients that are currently segregated and not to the continued exclusion from segregation of the free funds of intermediate customers (the 'base case' referred to in paragraph 5.13 of Annex 2).

We refer FSA to the comments made by BMA, ICMA, ISDA, and LIBA in response to FSA's August 2006 informal discussion paper on client classification about the need for an approach that enables as many current intermediate customers as possible to choose to be professional clients. To the extent that this is not possible, though, it will be important for FSA to include guidance to achieve the same effect for the remaining balance of current intermediate customers (especially as the CBA is based on the assumption that the status quo continues). We would also be happy to work with the FSA to produce more detailed industry guidance for firms in respect of the steps they could take when assessing whether to enter into full title transfer arrangements with non-segregated clients that are recategorised as retail clients.

- (b) Calculation of the margined transaction requirement. Concerns have also been raised, in particular by LME members, with respect to the calculation of the

margined transactions requirement, in particular whether full-title transfer arrangements can cover clients' equity balances. In sum, if a client has entered into a full title transfer arrangement with the firm - and, as a result, their margin monies are outside the definition of client money - would the firm still have to calculate an equity balance in respect of the client's positions?

It is our understanding that the guidance relating to the calculation of an equity balance does not come into effect unless the client's funds are segregated (i.e. the FSA is not intending to require firms to segregate a part of a transaction) and we would welcome guidance to this effect from the FSA. We would also be happy to work with the FSA to produce industry guidance in this complex area.

Q6. Would these arrangements have any unintended consequences that FSA would need to consider in its overall implementation of the Directive e.g. impact on repapering or firm permissions/requirements?

Repapering would be required. Firms are currently examining what changes to the form of wording might be needed e.g. in respect of client documentation in respect of any transfer of ownership /right to hypothecate. We may need to discuss aspects of this repapering with FSA in more detail. Whether there would be unintended consequences would depend heavily on whether FSA accommodated the concerns above.

Q7. Do you agree with FSA's proposals that will allow firms to hold excess commission outside MIFID's requirements for the safeguarding and administration of client money?

Yes, on a permissive basis. But there should be the ability to agree not to treat excess commission as client money as long as reasonably necessary. The ability to do so should not be time-limited as in 7.2.13G. It is important not to blur the boundary between client money and commissions.

Q7 and Q8. We do not comment on these questions.

10.23: FSA proposes a principle-based approach to stock-lending involving private customers' custody investments, with guidance expecting the firm to ensure that relevant collateral is provided by borrower.

Q10. In the absence of this rule, in what circumstances would you undertake stocklending activities for a retail client without ensuring that relevant client collateral were provided by the borrower to protect the client's rights?

The current rule (CASS 2.5.8 R) creates practical issues in a number of circumstances where it is customary to borrow securities without collateral e.g. in the context of Greenshoes or convertibles where selling/principal shareholders lend securities to a global coordinator/lead manager to facilitate settlement of the transaction on closing or settlement of related hedging short sales, and the rule appears to apply even if the firm is the borrower of the securities (i.e. the firm is not acting as an agent). In future, many more clients may be private customers, depending on how FSA approaches the transposition of MIFID Annex II. Borrowing

securities without collateral from retail clients does create credit risk for the client and it is possible to see where this might be considered inappropriate in the context of an agent or custodian. However, where selling or principal shareholders are lending shares to provide hedging on a convertible bond deal or to cover settlement of over-allotment options in an IPO, those shareholders have significant vested interest in the success of the relevant transaction and make an informed risk-reward decision, and not providing collateral for such loans is consistent with longstanding market practice. Rather than proscribing mandatory provision of collateral the rules should remain silent and leave the terms of the bargain between the client and the firm, subject at all times to the firm's duty to treat clients fairly in the circumstances. Alternatively, the existing language should be qualified as being relevant to agency only transactions. More generally, since providing collateral will affect the cost of the stocklending arrangement, and there are other areas of the new provisions where retail clients are not prevented from taking on higher degrees of risk, there should be scope for a retail client to make an informed decision as to whether they want the borrower to provide collateral. FSA should therefore not interpret CASS 6.4.3G as requiring collateral to be provided.

10.24. FSA proposes a more general requirement than at present for reconciliations "as often as necessary", and to carry forward the existing annual requirement for audit of systems and controls.

Q11. Will your firm make use of this flexibility or will you continue to reconcile under current timescales?

Investment banks typically reconcile daily, so the greater flexibility is not expected to have any practical effect. The flexibility may be more relevant for smaller firms.

There may be more concerns about auditors' wish to use consistent formats for external audits. FSA should ensure that imposition of standard methodologies by auditors does not undermine the methodological flexibility introduced by the new rules.

10.25. FSA proposes a copy-out approach for Money Market Funds, and notes COB and CASS 6 implications. It is important that restrictions on the use of MMFs for client money purposes do not constrain the flexibility for firms to use them as client investments with client consent, as many money market funds may not meet overly stringent criteria.

Q12. Will your firm use MMFs for the segregation of client money?

This is a question for individual firms to answer. We also have the following observations:

- (a) It is not clear if the assessment of whether an MMF is suitable involves using a long or short term rating. In order for this new provision to be meaningful, firms will need to be able to access funds with high short term ratings. If firms are restricted to using long term ratings (AAA) they believe that there are so few funds with this rating that it would not be worthwhile using MMFs to segregate client money.

- (b) Notwithstanding the above, some firms are sceptical about whether MMFs will be able to achieve any significant returns with money flowing backwards and forwards on a daily basis and given the limited criteria available. As an investment option they are seen as a poor comparison to the US model that allows investment in government debt etc.

As noted in our comments on paragraph 10.25, it is also essential that the constraints on MMFs' use to segregate client money do not also constrain their use as client investments.

10.26. For unregulated custodians, FSA proposes a copy-out (no use of unregulated custodians in countries where they are regulated; use of unregulated custodians in other countries only where necessary or with professional client permission), with no discretion for derogation.

Q13. Will FSA's proposals affect arrangements that firms currently have with unregulated custodians?

We do not think that the requirement will significantly affect firms' current arrangements, although it will be important to interpret this provision, so that it does not impose an absolute obligation to use "state-approved" custodians if to do so would not be in the client's best interests.

10.27 FSA proposes to carry forward rules on client money received in foreign currency.

Q14: In the absence of this rule, would you pass on currency exposure to relevant clients?

We believe that some firms would continue to do this.

10.29. We note that FSA is liaising with the Commodity Futures Trading Commission (CFTC) "to determine if any change will be needed to" the CFTC Part 30 Exemption Order following the implementation of MIFID. Members of the London Metals Exchange (LME) are concerned about how the proposed changes to the client money rules will affect this exemption and whether the bond arrangement is likely to continue in its present form (notwithstanding the customers being non-EEA). We note that this issue will be "covered later in the year" but would urge FSA to share its current thinking in this area with the industry as early as possible.

Comments on Annex 2.5: Cost-Benefit Analysis

5.9 – 5.24. FSA estimates that 20% of 50 – 75 firms’ professional clients currently opt out, and states that it is not certain that the same population of firms and clients will fall under the exemptions under MIFID. FSA assumes for the CBA no change, with the only economic change being the cost of transition from one type of exclusion to another. Provided that FSA amends and interprets the new requirements as set out in our comments above, we consider that this is a reasonable assumption.

FSA assumes costs arising from repapering at £50,000 per firm, and legal advice at £125,000 to 250,000 per firm. FSA estimates legal costs to affected clients at £3.5 million to £6 million. FSA assumes these are overestimates. FSA expects costs to be reduced by trade associations’ industry standards for documentation. It is difficult to estimate repapering costs, since they will form part of a broader repapering exercise. It is also difficult to quantify the cost of managing the repapering process. Many agreements in this area would be individually negotiated with the client, so any repapering would be very time-intensive. The business area most likely to be affected by repapering is prime brokerage, where we do not expect that there would be a significant reduction as a result of trade association industry standard documents, because agreements tend to vary from firm to firm, and in many cases are tailored to the client.

FSA estimates the cost to firms of inability to maintain the existing opt out as £40 per client per year. Given the “no change” assumption, FSA’s analysis assumes that there will be no economic cost to clients of not being able to avail themselves of the more efficient use of their money that the opt-out provides. Provided that FSA amends and interprets the new requirements as set out in our comments above, we consider that this is a reasonable assumption. FSA should note however that the funding cost to clients of any loss of the ability to have their money excluded could be very significant indeed. For example, at present firms do not segregate affiliates’ balances as client money unless they are held by the affiliate on behalf of an underlying client: any change to this position would impose funding costs on the group.

As clients will have a right to oppose the placement of their funds in qualifying MMFs, it appears that firms will, pre-investment in the MMF, have to maintain two separate pools of money to avoid breaching the client money rules and to be able to demonstrate compliance i.e:

1. segregated clients who will allow money to be invested in an MMF;
2. segregated clients who will not allow money to be invested in an MMF

If this is the case, there will increased administration and additional costs to firms, which will undermine FSA’s cost benefit analysis.

Comments on Annex 5, part 3: draft Handbook text

CASS 1.2.10R – 1.2.13R It seems unnecessarily restrictive to require firms to keep segregated MIFID and non-MIFID investments separate. We are not convinced by FSA’s justification. Segregation would not affect the legal position. We consider that the effect of such a requirement would be to force firms to opt in non-MIFID business, and to deny firms flexibility.

CASS 6.1.10G. See our comments under paragraph 10.11 – 10.16 above and on the CBA. 7.1.12G should be limited to circumstances where the firm provides MIFID services to an affiliated company, in order to avoid limitations on the ability of affiliates to deposit money.

CASS 6.4.4R(2). FSA should interpret this provision flexibly so that firms need measure only the aggregate amounts used, and whether they correspond to the aggregate assets of clients that have given consent.

CASS 6.4.5R: Wrongly refers to 6.4 rather than 6.4.4.

CASS 7.1.12G. See our comments under paragraph 10.11 – 10.16 above and on the CBA. 7.1.12G should be limited to circumstances where the firm provides MIFID investment services to an affiliated company, in order to avoid limitations on the ability of affiliates to deposit money.

CASS 7.2.3R – 7.2.5G: See our comments under paragraph 10.11 – 10.16 above and on the CBA. 7.2.3G should delete the word “collateral” (to reflect the broader nature of the exemption)), or the title should be changed to “Transfer of ownership as security”, and the introductory words to 7.2.5G should refer to “arrangement under which the firm receives full title” rather than “effective title transfer arrangement”. 7.2.3R should also referring to cases “Where full ownership of a client’s money is transferred”, rather than “Where a client transfers full ownership”.

CASS 7.2.13G. See our comments on Q7 above. FSA should additionally provide guidance that rebates need not be treated as client money “until such time as is agreed between the parties”.

CASS 7.4.5R. It is ambiguous whether this provision relates to a specific fund, or to funds in general. “Qualifying money market fund” is defined, following MIFID, as one that invests in “high quality” instruments, i.e. those awarded the highest available credit rating by each competent rating agency that has rated that instrument. The need to check all rating agencies to ensure that an instruments was AAA would be very burdensome. It is therefore particularly important to ensure that 7.4.5R does not prevent firm from using funds for clients generally: see our comments under paragraph 10.25 above.

CHAPTER 12: PRUDENTIAL ISSUES FOR COMMODITY FIRMS AND OTHER NON-ISD FIRMS

Comments on Chapter 12

The joint associations welcome the publication of the promised Handbook changes for commodities firms and other non-ISD firms anticipated in CP06/10, and note that FSA is not seeking comments on the decision to maintain the current regime for those firms in this CP.

Comments on Annex 5, Part 7: draft Handbook text

IPRU(INV) 3-1D G. The table in 3-1D G on the applicability of provisions on *large exposure* and concentration risk covers the applicability of BIPRU 10 and IPRU(INV) 3 rules for *energy market participants, oil market participants* and *securities and futures firms*. Per this table, TP16 is not applicable for firms which are not either energy or oil market participants, yet TP16 is potentially applicable to all *exempt BIPRU commodities firms* (3-1B R), which includes *metal market participants* in addition to energy and oil market participants. We recommend that the table be updated in this regard.

IPRU(INV) 3-41(9)(a). The valuation rule requires that a position must be valued at its close out price, stating “a long position shall be valued at current bid price and a short position at current offer price”. This is inconsistent with the GENPRU 1.3.19R requirement that “a *firm* must use mark to market in order to measure the value of the investments and positions” where GENPRU 1.3.21R further requires that “when marking to market, a *firm* must use the more prudent side of bid/offer unless the *firm* is a significant market maker in a particular position type and it can close out at the mid-market price” Will 3-41(9)(a) be updated, or will firms be given the option to choose the rule and notify FSA accordingly?

CHAPTERS 13, 14, 15, 16: RMs, MTFs, INVESTMENT FIRMS TRADING OUTSIDE A RM OR MTF

Comments on the Chapters 13 - 16

Chapter 13: Introduction

13.4. We welcome FSA's commitment to intelligent copy out of the provisions on RMs, MTFs, and investment firms' transparency. See our comments under Chapter 1 above and Chapter 16 below on FSA's approach to the direct effect of the Level 2 Regulation, and the need to do more than merely to copy it "for ease of reference".

13.8. FSA states that HMT will not propose transparency requirements beyond MIFID shares. But FSA proposes to retain existing guidance on transparency for non-equity RMs and MTFs. See our comments on this issue under paragraph 15.6 below.

13.10; 13.13. Regarding FSA's statement that "In principle, choice of means by which firms trade report creates a risk of fragmentation of post-trade data", see our comments under Chapter 16 below.

Chapter 14: RMs/RIEs

14.3. We welcome FSA's overall approach to impose minimum change.

14.24 (footnote 221). "Shares" should be interpreted in a way consistent with the way the scope of the relevant provisions were understood throughout the legislative process. In particular, it was never contemplated that fund products should fall under MIFID Level 1 Article 27 as Footnote 221 suggests. Fund products belong to a different asset class from cash equities, regardless of how the particular fund is set up. Exchange Traded Funds, typically index-tracker products which are continually created and redeemed by authorised participants, are traded in a very different way from cash equities. These products have never been contemplated to form part of the specific pre-trade transparency regime for shares, and the measures for assessing the liquidity of shares (Article 22 of the MIFID Level 2 Regulation) would not really be relevant for such fund products. FSA should therefore make clear that ETFs should not be regarded as 'liquid shares' for the purposes of the SI provisions.

14.27. FSA states that HMT is to include FSMA provisions allowing FSA to grant waivers from RM pre-trade transparency. FSA proposes to clarify that existing REC guidance does not apply to shares. See also our comments elsewhere in this response about the need for FSA to give effect to waivers from other requirements in addition to on-exchange pre-trade transparency.

Q26. Do you agree that FSA should use its power to waive from pre-trade transparency requirements: crossing systems that meet MIFID conditions; systems that formalise negotiated transactions and meet MIFID conditions; management systems operated by RIEs that meet MIFID conditions; and/or transactions which are large in scale according to thresholds outlined in Table 2 at the end of Part III?

Yes, we strongly endorse FSA's granting these waivers. But see also our comments on the interpretation of the second category under 14.32 - 14.36 below.

14.32 - 14.36; 14.48: FSA proposes an interpretation of Level 2 Regulation Recital 14 under which RSPs and firms operating other RFQ models might not be able to fall within the negotiated trade exemption from pre-trade transparency because they do not expose their quotes publicly, and that RIEs might need to impose additional quote display facilities if Recital 14 prevents the application of a negotiated trade waiver. FSA states that the firms concerned might need either to post a firm quote on-exchange (14.35) executing transactions as agent on-exchange, or conduct the trades off-exchange, in which case pre-trade transparency requirements might apply (14.36). In the latter case, it is important not to exclude the possibility that pre-trade transparency requirements do not apply. See also our comments below on FSA's CBA assumptions in this area.

It is helpful that RIEs are providing RSPs and firms operating other RFQ models with facilities to quote on-exchange in order to provide unequivocal certainty that the transactions are carried out in an environment of on-exchange pre-trade transparency within which they are able to price-improve. But it is also important not to assume that such firms are either necessarily SIs, or to interpret Recital 14 broadly so that such firms automatically fall outside the negotiated trade exemption where the activity is carried out on-exchange.

RSPs' activity does not necessarily represent systematic internaliser activity, since in order to be so, it would need to satisfy all of the elements of organised, frequent and systematic dealing on own account by executing client orders outside a RM or MTF. Even though their RFQ activity is not specifically governed by rules set by the exchange, RSPs do operate under constraints which are specifically established by reference to what happens on-exchange, in particular as regards price. They are an established mechanism to save costs and enable quick execution of certificated securities for retail investors, in a role which provides a substitute for on-exchange market making, and subject to constraints that would not apply if they were operating outside an exchange-related environment. They effectively act as intermediaries between the retail brokers and their clients to whom they provide liquidity and LSE, reflected in the fact that they quote at or within the best bid and offer on the exchange. They thus do not necessarily fulfil all of the conditions attaching for being a SI, in particular because they are not acting in a systematic and organised way outside a RM or MTF (indeed, some would argue they are not doing so outside a RM or MTF at all), any more than other types of non-systematic internalisation (including transactions carried out on an OTC basis under Recital 53) which involve intermediation between the client and an RM or MTF, rather than a separate 'quasi-exchange' functionality.

The intention of Recital 14 was to prevent RMs from establishing arrangements to enable SIs operating outside an exchange environment to avoid SI obligations, not to impose new restrictions on activities that facilitate the interaction between investors and the exchange.

14.26. FSA explains the first type of waiver as applying to 'crossing systems' that fulfil the requirements of Level 2 Regulation Article 18.1(a). Article 18.1(a) itself

refers to ‘systems’ based on a trading methodology that fulfils those requirements. Since ‘crossing systems’ is neither a defined term nor mentioned in the legislation, FSA should make clear that it does not imply a limitation of the types of system for which the relevant waiver will be available.

14.30. It is helpful that FSA expects RIEs to inform FSA whether they intend to use waivers and whether they attach any more onerous conditions to them.

14. 42. FSA should encourage UK RMs not to introduce higher thresholds and shorter delays, and work with other Member States to encourage the same approach in other jurisdictions. This is an area where pan-EEA harmonisation will be an important gain, which is critical if firms are to operate on a level playing field, and if the regime is to encourage data consolidation and avoid issues relating to determining in which jurisdiction a trade is executed.

Q27. Do you agree that FSA should use its power to permit RMs to provide a block trade facility?

Yes.

Q28. Do you see the need for additional guidance on post-trade transparency requirements to implement MIFID?

No.

Chapter 15: MTFs

15.3 – 15.6. FSA states that MIFID requirements formalise and “to some extent expand” existing ATS guidance, but the provisions will now be framed as rules. FSA intends to retain variations of permission for MTF operators that operate a primary market in shares.

FSA also proposes to retain guidance on its “expectation” that MTFs will maintain existing post-trade transparency in non-equities and pre- and post-trade transparency in non-RM-traded equities. As a general principle, under the better regulation approach, we would argue that the mere possibility that there may be a market failure is not sufficient justification for imposing provisions which are superequivalent to the specific requirements of MIFID. We recognise that Recital 46 empowers Member States to extend transparency requirements beyond shares, although it is also important not to prejudge future reviews of the application of transparency requirements beyond shares. If FSA does retain this guidance, it will be important to retain flexibility for different business models, to minimise additional conditions or “expectations”, and to ensure that provisions which are couched as guidance do not introduce rule-type requirements.

Q29. Do you agree that FSA should use its powers to waive from pre-trade transparency requirements: crossing systems that meet MIFID conditions; systems that formalise negotiated transactions and meet MIFID conditions; management systems operated by RIEs that meet MIFID conditions; and/or transactions which are large in scale according to thresholds outlined in Table 2 at the end of Part III?

Yes.

Q30. Do you agree that FSA should use its powers to waive the post-trade transparency requirements for transactions which are large in scale according to the conditions outlined in Table 3 at the end of Part III?

Yes.

A public list of ATSS is not currently maintained. FSA's discussion in the CBA implies that it expects the population of MTFs to be the same as existing ATSS, and in due course the list of MTFs will be published. It would therefore help firms to assess what types of system will fall within the MTF definition if FSA were to publish now the list of entities that currently have ATS status and will be MTFs. It would also be helpful if FSA could confirm that the internal crossing of client orders where the client has not exercised any form of discretion on the way the order is handled does not constitute the operation of a MTF. In addition, we think that it is important that the FSA confirms that, in a situation where a client of an investment firm merely selects an internal crossing facility as the destination for their order, but where they are not able to view other participating interests in that system, this would not constitute being a member of or participant in an MTF, and that systems that operate on this basis do not themselves constitute an MTF. Given that the purpose of the MTF regime is to make transparent price-forming liquidity pools, and to ensure that such markets are orderly and fair for all participants, it is hard to see how a system can accurately be described as a "market", nor as having "participants", when the clients' "participation" cannot involve any real time reaction to others' buying and selling interests within the system. It is worth noting that some of the MTF requirements applicable to operators, for example those governing access for participants and monitoring for potential market abuse, seem inconsistent and inappropriate for such a model: firms would be required to monitor for market abuse in a system that clients cannot abuse given that they are not real "participants" in the sense normally associated with a "market".

Chapter 16. Investment firms trading outside a RM or MTF

16.1 FSA says that "a consistent transparency regime is essential to ensure that the price discovery mechanism is not undermined by the fragmentation of liquidity". This statement is not reflected in the text of MIFID, and is an over-interpretation of its background. A one-size-fits-all approach to transparency is not appropriate and too prescriptive. It would be more accurate to say that "an appropriate transparency regime is essential..." Prices in different markets may not be comparable, especially on a pan-EEA basis, because they depend on other variables such as clearing and settlement structures which are not consistent between different markets. Where structural differences (such as different clearing and settlement costs) cause prices not to be comparable, fragmentation is a rational outcome as there is effectively more than one market. Any attempt to consolidate such non-fungible prices would be at best useless and at worst misleading. Consistency of the transparency regime thus would not necessarily remove fragmentation of liquidity unless different markets were to be heavily constrained in their structures in a way that would harm market users by limiting innovation. Although liquidity may be fragmented, and may become more

fragmented, there are already several systems whose function is to aggregate and publish pre- and post-trade data derived primarily, but not exclusively, from exchanges around the world. It is thus important not to over-emphasise the fragmentation of liquidity, and not to use it as a justification for excessive prescription of post-trade transparency structures, especially since MIFID will increase post-trade transparency in EEA markets overall.

16.2. FSA identifies “OTC” as meaning “outside RMs and MTFs”. We encourage FSA not to use terms loosely that have a defined meaning within MIFID. It is important to avoid confusion and achieve comparability with MIFID’s narrower interpretation of “OTC” business as used in Level 1 Recital 53, which however, as discussed below, includes business carried out in accordance with the examples set out in Recital 53, but also extends to other types of non-systematic internalisation activities as well. See also our comments on paragraphs 16.6, 16.12, and 16.14.

16.5. We welcome FSA’s intention not to extend investment firms’ transparency requirements beyond shares admitted to trading on a RM. However, we do not think that there is a need in this context to refer to possible amendments as a result of the Commission’s forthcoming review.

16.6. It is important to be clear that retail investors do not typically have a complete picture of trading opportunities: their brokers do. The question is whether professionals have enough information. Disclosed prices will not necessarily provide information about the price that an investor would have got.

FSA states that “Firms dealing on own account *exclusively* in the wholesale markets, *and* in wholesale market sizes will not be subject to the SI pre trade transparency obligation.” While this is strictly speaking correct, the Level 2 Regulation does not use the word “exclusively” and does not make the requirement cumulative by adding the word “and”. Moreover, SMS, above which all transactions are exempt from SI obligations, may not amount to ‘wholesale market sizes’ in any sense of the word. Furthermore, such a limited interpretation would not be consistent with the much broader range of types of business that the Level 2 Regulation carves out. We assume that such a limitation is not FSA’s intention, but FSA should be more disciplined and accurate in how it words such interpretative summaries. See also our similar comments on paragraphs 16.2, 16.12, and 16.14.

It is also important to be clear that the types of firm that FSA lists (dealing on own account exclusively in wholesale markets and wholesale market size) are not by any means the only ones that will not be subject to SI obligations when dealing on own account. FSA itself (paragraph 16.11) recognises a type of dealing on own account which will not be subject to systematic internalisation obligations, but there will be others.

Systematic Internalisers

16.9. We welcome FSA’s proposed intelligent copy out, but see also our comments under Chapter 1 on the legal architecture of “EU” provisions. We welcome FSA’s intention “to work closely with stakeholders to implement the new SI regime in as

proportionate a way as possible”. We also welcome the fact that FSA is not proposing any additional guidance relating to SIs or to impose additional rules.

16.11. We agree with the exclusion of matched back to back trades from dealing on own account. While it may be the case that a firm that enters into a position to execute a client order is dealing on own account as well as executing an order on behalf of a client, the firm is not necessarily acting as an SI in doing so. In the particular example that FSA gives, where the firm hedges its exposure by taking a corresponding position in the market, the fact that the firm is intermediating between the client and the market means that the activity might well be effectively conducted on-exchange and therefore not satisfy the “outside a RM or MTF” element of the SI definition. As regards the situation which FSA describes where a firm enters into a position to execute a client order, it will be important to distinguish, as FSA did in its August 2006 informal discussion paper on client categorisation under MIFID between dealing on own account which is a service provided to a client, and dealing on own account which is an activity. Only where the firm is acting in an agency capacity or in contractual circumstances which are akin to an agency obligation should the presumption that dealing on own account is an investment activity be overturned.

16.12. FSA treats the elements of the Level 2 “organised, systematic and frequent” definition as examples, or options. This is an incorrect interpretation of the Regulation, under which all of the criteria must apply for a firm to be acting as a SI. MAR 6.3.1EU 1, copying out MIFID Level 2 Regulation Article 21.1, is very clear that a firm “...shall be treated as a systematic internaliser if it meets the following criteria...” (i.e. all of the criteria). It is very important to be clear that all of the criteria must apply, so that the definition does not apply more widely than the EU legislation intended. This would mean that if any of the criteria was not satisfied (for example, if the activity did not have a material commercial role, or was not conducted in accordance with non-discretionary procedures), the activity would not be systematic internalisation. We ask FSA to discuss the matter further with us if it thinks that our interpretation is incorrect.

16.13. Subject to appropriate interpretation (see 16.12 above) we welcome FSA’s proposal for no additional guidance on the interpretation of the definition of SI, and the self-assessment approach.

16.14. It is important to be clear that Level 1 Recital 53 is an *example* of OTC business, and does not describe it exclusively. It is therefore important for FSA to transcribe Recital 53 into its rules, as well as to reproduce the corresponding Level 2 provisions. See our comments on 6.3.1EU3 below.

16.16. FSA proposes to require firms to notify FSA in writing by 1st December 2007 if the firm is a SI. We presume that the one month delay is to enable SIs to finalise their systems and arrangements before making a formal notification. It will be important to ensure that, where MIFID imposes obligations on third parties in relation to SIs, those obligations apply only once a SI is entered on a public list.

We think additional guidance by FSA would be useful on the interpretation of the third and fourth sub-paragraph of MIFID Level 1 Article 27. 3, which state that transactions need to be executed at the quoted price (subject to certain qualifications).

We suggest that FSA should clarify that this refers to the time the relevant SI function of a firm has received an order. In a situation where a separate sales function is housed in the same legal entity as the SI function, a different interpretation according to the time the sales function received an order would be unworkable. This is because usually the price will have moved in the time needed to transmit the order to the SI function. The SI provisions were not intended to force firms to execute orders at such outdated prices or to force them to separate the SI function into separate legal entities.

16.17ff. See our comments under paragraph 14.24 (footnote 221) above on the need to exclude Exchange-Traded funds

Q31. Do you see the need for additional guidance to clarify the definition of SIs?

No.

Q32. Do you see the need for additional guidance to clarify the meaning of dealing on own account?

We do not see the need for additional guidance. However, we refer to our analysis under paragraph 16.11 above of how the status of dealing on own account should be interpreted.

16.17 – 16.19. We welcome FSA’s proposed broadly flexible approach to SI quoting obligations.

FSA proposes to measure “close to comparable quotes” by reference to the LSE order book. It will be important to give firms as much flexibility as possible in the interpretation of “close to”, and not to tie closeness too particularly to a single market, to ensure that that market cannot be “gamed”.

16.20. We welcome FSA’s proposal to apply both MIFID conditions to the definition of “liquid shares”. FSA will need to give effect to this decision in a Rule.

16.24. FSA should not imply that a firm can be an SI in non-equity products. Although the definition of “SI” does not refer to shares, the operative provisions of Article 27 do. It is important not to pre-judge the MIFID Level 1 Article 65.1 review.

16.28. We welcome FSA’s helpful statement that introducing brokers can aggregate orders to obtain price improvement, and that this benefit can be taken into account as a criterion for best execution.

16.29. It is important for FSA to leave flexibility for the market to determine what amounts to a “complex order”. FSA should therefore avoid over-prescriptive guidance on this point.

16.31. FSA’s explanation is helpful as far as it goes, but the only example it gives of conditions other than current market price is VWAP, which is still price-focused. FSA should make clear that any order that is not either a straightforward market order or an immediately executable limit order, including through non-price conditions

(such as all or none, or minimum percentage to be executed), constitutes an order that is subject to conditions other than price.

16.39. See our comments on MAR6.13.1R below. FSA should articulate more clearly MIFID Level 1 Recital 50, which cites as examples of Article 27.5 the possibility of SIs giving access to their quotes only to professional clients, or only to retail clients, or to both. It should also be possible for firms not to make their quotes available to ECPs under Article 27.5.

16.40. We welcome FSA's helpful intention to rely on firms to self-assess and report back on SI status, combined with FSA's openness to discuss with firms the implications of particular business models. To ensure that the requirement is not too burdensome, it should be clear that the requirement is to notify FSA only of the fact that they are a SI, not which shares the status applies to.

Post-Trade Reporting

16.42. We welcome FSA's proposed intelligent copy out of post-trade transparency provisions, but see our comments under Chapter 1 on the legal architecture of "EU" provisions.

In one other area we see a significant need for FSA to provide guidance to provide clarity on which trades need to be reported by whom. FSA should provide similar guidance on the circumstances in which investment managers should be seen to "conclude" a transaction under MIFID Level 1 Article 28, as it does in the draft guidance SUP 17.2.2 G for "executing" a transaction under MIFID Level 1 Article 25.3 (transaction reporting). The fact that, for example, the German language version of MIFID uses the same expression for what reads as "executing" and "concluding" respectively in the English version points to both expressions meaning the same. Draft SUP 17.2.2 G makes clear that investment managers who place an order through an executing broker would not be seen as executing a transaction themselves. We agree with this conclusion and would like to see the same clarification for MIFID Level 1 Article 28. Any different conclusion would lead to uncertainties on which party has to report, as the reporting rules in MIFID Level 2 Regulation Article 27.4 assume clarity between the parties as to whether each party has a reporting obligation. Without such guidance it would be difficult for brokerage firms to ascertain whether a particular investment manager has a reporting obligation, which would depend on their local regulatory status and in particular on whether they are an "investment firm".

16.45. It is important to be clear that firms are required to make public only the information that is specified in MIFID, not additional information that may be specified by RMs' reporting rules.

16.49. FSA's statement that "in most cases the [trade reporting] obligation will likely fall on the seller" seems to ignore the ability of parties to agree who reports, and the reality that in practice buy side firms are likely to agree (for example through an accepted course of action) that the broker-dealer will report the trade.

Q33. Do you see the need for additional guidance to clarify responsibility for publication and to avoid duplication of trade reports? If so, please indicate what in your view this should be and the basis for your recommendation.

Guidance would be helpful on the circumstances in which investment managers should be seen to “conclude” a transaction for trade reporting purposes, similar to the draft guidance SUP 17.2.2 G on “executing” a transaction for transaction reporting purposes. See our detailed comments under paragraph 16.42 above. See also our comments on paragraph 16.49 above.

However, we note that in its 20th October 2006 consultation “Publication and Consolidation of MIFID Market Transparency”, CESR proposes considerably more detailed options to avoid duplication of trade reports: allowing publication only through one channel; unique trade identifiers; trade reports timed to the millisecond; or a combination of these three. The systems and cost implications of these proposals appear to be significant. It is not clear what the status of any guidance that CESR produces on this point would be, when it would become operational, or how FSA would build CESR’s apparently quite specific proposals into the Handbook. Given FSA’s commitment to giving firms nine months in which to come into compliance with requirements which are definitely determined as at 31st January 2007, it will be important for firms to know when CESR plans to finalise its policy on this point (we note that CESR’s final MIFID Level 3 Work Programme states that the work will be finished in Q1 2007), when or if FSA would plan to transpose it into the Handbook, and what form such provisions would take, given the importance of not imposing superequivalent requirements, and taking into account the formal status of FSA Guidance. We presume that it would not be possible to do this until after 31st January 2007. Bearing in mind the interaction between firms’ trade reporting and transaction reporting mechanisms, it will be necessary to avoid substantial last minute system changes, or further substantial system changes after October 2007 (see also our more general comments on the interaction between CP06/14 and CESR’s consultation below, and our comments on Chapter 17 below).

16.50. The provisions on timing of trade reports of portfolio transactions need to be interpreted as broadly as possible, with “as close to real time as technically possible” taking account of the need for firms to be able to take account of the risk attached to the size of the portfolio as a whole. Technical possibility relates not just to the physical process of disaggregating a portfolio in order to allocate prices to particular shares, but also to the ability of firms to provide good prices for portfolios on a risk basis when they do not know, before the transaction is concluded, what the portfolio contains and how they may need to hedge the position. Programme trades are typically priced on-risk, with a commitment to improve on the price where possible. This means that all the necessary contractual elements of the trade are not determined until just before allocation to the client. It should therefore be clear that the “close to real time” condition, for a programme trade, does not start to run until that moment.

Q34. Do you agree that FSA should use its power to permit firms trading OTC to be entitled to defer publication for transactions large in size?

Yes. The same delays should be available as for trades on RMs and MTFs. There should also be appropriate treatment of portfolio transactions as described under paragraph 16.50 above. FSA should give effect to this decision through a Rule.

Trade Data Monitors (TDMs)

We recognise FSA's desire to help resolve the challenges for firms to ensure under Level 2 Regulation Article 32 that arrangements for making trade reports public satisfy requirements relating to reliability, error control and correction, and facilitation of consolidation. As users of market information, our Members support FSA's concern to ensure the accuracy of data for users. But, as FSA also recognises, there is a need to take account of the fact that the more complex the systems, the more timing of data becomes an issue. It is also important to ensure that, where data are not comparable, consolidation does not give a false impression that they are. We therefore welcome FSA's decision to work through more adaptable mechanisms than Rules. But there are still a large number of practical questions to which FSA's TDM proposals give rise.

16.54ff. FSA is concerned about trade data fragmentation as a result of the new rules, so it is proposing a framework for consolidation and a mechanism that would "offer some comfort" that firms comply with MIFID, in the form of new guidance setting out "minimum standards" for trade reporting mechanisms, covering: a verification mechanism which is independent of the trading process; consistent and structured data formats based on industry standards; accessibility by automated electronic means in machine-readable format; and instructions on how users can access information.

FSA suggests that market forces will not deliver data consolidation on their own, and that there are significant obstacles and insufficient incentives. FSA states that it "would be taking a risk if we were to wait for market data to fragment." As a matter of general principle, we observe that making regulatory recommendations on the basis of a "potential market failure" is not compatible with FSA's principle of not regulating unless there is a demonstrable market failure and the proposed solution is the most effective and efficient response to that failure.

We agree with FSA that there is a need for a "balance between competition and comprehensive, timely, reliable information", and to encourage private sector involvement and minimise regulatory involvement. We therefore welcome FSA's decision not to impose Rules on firms when they execute away from a RM or MTF, although even if it develops guidance in this area, FSA should bear in mind that MIFID Level 2 Regulation Article 32 itself imposes an obligation on firms to ensure the information is reliable, facilitates consolidation, and is available on a reasonable and non-discriminatory commercial basis. Given:

- (a) that reporting through a TDM will not absolve firms of these responsibilities (paragraph 16.73);
- (b) the choice of reporting mechanism that MIFID provides;
- (c) the fact that using a TDM would simply reduce due diligence and provide "some certainty and comfort" that firms comply, and that TDMs would not be responsible for monitoring firms' compliance, doing no more than monitoring for potential errors and reporting discrepancies to the firm:

careful consideration is needed as to whether a TDM regime would add enough value to be useful and commercially viable. It is further necessary to take account of the following considerations:

- i. Even though FSA proposes a voluntary TDM scheme, there is no specific sanction in MIFID for it.
- ii. It will be important not to impede firms' ability to publish fast and accurate prices by introducing an unnecessary additional processing stage into the publication of transactions. This is a point which is likely to be relevant in the context of CESR's 20th October 2006 consultation: "Publication and Consolidation of MIFID Market Transparency".
- iii. Firms already have a significant commercial and regulatory incentive to publish trade data fast and reliably, and they devote considerable resources to doing so.
- iv. Any TDM scheme would need to operate on a pan-EEA basis in order to achieve the objectives which FSA sets for it, and it would be necessary for FSA to accept that trade reports made through TDM equivalents in other countries have the same validity as those made through UK TDMs. It would also be necessary to ensure that EEA regulators do not mandate the use of any particular TDMs. The issues for TDMs are in some ways similar to those for ARMs for transaction reporting (though less problematic given the voluntary nature of TDMs), and there is also a similar issue relating to the timing of FSA's work vis a vis CESR's work on trade data consolidation. See also our detailed comments below on the interaction between FSA's and CESR's consultations on this area. FSA states that it will take into account CESR's Level 3 work in finalising the guidance, although it is not clear how CESR's timetable will square with FSA's, or what process it would follow to take account of CESR proposals which appear to go into considerably more detail than FSA's.
- v. There will be strong commercial incentives to publish information in a consolidatable format where consolidation provides value added information.
- vi. The Commission is due to report under MIFID Level 1 Article 65.4 by November 2008 on the state of removal of obstacles to the consolidation of trade information.

16.81 and 16.82. FSA states that it does not intend to regulate TDM fees, but "they must adopt a transparent, non-discriminatory pricing policy". FSA also proposes to extend non-discrimination provisions to TDMs, with no exclusive arrangements. As became clear at the useful discussion at the 6th October seminar on this topic, it will be important to consider, in a voluntary regime relating to entities over which FSA would have no formal authority, what would be the effect of imposing such restrictions. Any regime of pricing constraints imposed by FSA on TDMs would need to avoid indirectly regulating how firms can charge for proprietary trade information.

16.83. The comparison with PIPs, in the context of a requirement for TDMs to report to FSA verifying that they comply with service criteria, does not take account of the fact that PIPs report seven times a year, whereas TDMs would need to report tens or perhaps hundreds of thousands of trades.

16.84: FSA answers the perception that TDM proposals would establish differences in MIFID transparency between Member States by saying that the proposals are “in harmony with what Commission had intended with its draft implementing legislation, and would not disadvantage competitiveness of UK firms”. See our comments above on the interaction with other EEA States’ proposals. Any such programme would need to be done on a pan-EEA basis given the interconnectedness of EEA markets. Although the Commission’s intention in draft implementing legislation would not on its own be a valid basis for imposing obligations, we agree that, because the TDM scheme would be voluntary, it would not disadvantage the competitiveness of UK firms.

16.85 – 16.87: FSA says that it proposes TDMs to deal with “what FSA believes may be a significant potential market failure”. As noted above, we do not think that a potential market failure on its own is a valid reason to regulate under the better regulation approach. Nevertheless, given its essentially voluntary nature, and our interest as market users in the reliability of trade data, we are happy for FSA to proceed with the proposed TDM regime, provided that in developing it FSA takes into account the considerations and concerns that we have identified above. We think that FSA is right to have rejected the alternative routes of encouraging firms to continue to publish to existing trade reporting entities, or providing a consolidated tape in its own capacity.

Q35. Do these standards achieve FSA’s stated objective?

An additional independent error checking process may not be consistent with the drive to streamline and speed up trade reporting. The primary obligation is to ensure that the trade report is reliable: FSA should be careful not to prescribe in detail how that reliability is achieved. We agree that consistency of formats and data accessibility are essential elements of trade reporting. These are factors which both the requirements under the Directive and commercial factors will encourage.

Q36. Do you agree that the proposed approach would contribute to consolidation of equity trade data post-MIFID?

We do not think that it is possible to predict. See our comments above on the strong commercial and regulatory pressures towards consolidation. In the pan-EEA context, it is important to note that only a subset of equities will have cross-border interest. A large number, probably at least a majority, due to many factors will only be of interest locally or regionally.

Q37. Do you agree that the TDM framework would help to maintain high quality trade data?

See our comments above on the fact that regulatory obligations to maintain the quality of trade data remain regardless of whether a TDM is used.

Q38. Do you agree that TDMs should not be able to provide trade information exclusively to one data consolidator and that doing so may present unacceptable risks to consolidation?

See our comments on paragraphs 16.81 and 16.82 above. It will be very important to avoid indirectly regulating how firms can charge for proprietary trade information.

Q39. Would it be preferable for all information published by a TDM to be in a standard data format to facilitate its consolidation with similar data from other sources?

See our comments above on the strong commercial and regulatory pressures towards consolidatability.

Q40. During our pre-consultation, many market participants indicated that the TDM approach would not be appropriate for pre-trade information. Do you believe there is a need for a framework for the consolidation of pre-trade transparency information in the UK? If so, would the TDM model be an appropriate framework?

There is no market failure need or justification for a TDM framework for pre-trade information. Market forces already ensure that information is available to those who need it, and will continue to do so.

Q41. Do you agree that the TDM service criteria will ensure TDMs deliver a high quality service and provide comfort to firms that they would comply with the relevant MIFID obligations when they use a TDM?

While the proposed TDM service criteria do not seem inappropriate, it is too early to tell whether they will ensure that they deliver a high quality service, and whether they will provide compliance comfort to firms. Since under FSA's proposals the use of a TDM will not provide a safe harbour, whether TDMs can provide comfort to firms will depend on how FSA enforces MIFID Level 2 Regulation Articles 32(a) and (b)

Q42. What is the preferred option? Please outline reasons.

Q43. Should FSA publish the annual reports it receives from TDMs on its website?

Q44. Would this make it easier for firms to compare which TDM they would like to use?

At this stage we do not have any strong views on these questions.

Comments on the interaction between CP06/14 and CESR's 20th October 2006 consultation: "Publication and Consolidation of MIFID Market Transparency"

On 20th October 2006 CESR published its consultation paper: "Publication and Consolidation of MIFID Market Transparency". In that paper, CESR proposes a considerable range of possible CESR guidance, which points towards the possibility of important controls on how firms might satisfy MIFID requirements on reliability, consolidatability, and availability of pre- and post-trade transparency information. We comment under Q33 above on some of the implications of CESR's consultation for FSA's CP06/14 proposals on avoiding duplication of trade reports. Other areas where CESR's consultation goes into more detail than CP06/14 seem to be:

- (a) Contingency arrangements to cover publication and data quality monitoring;
- (b) Whether it is necessary and reasonable to require firms to 'push' transparency information out to anyone who wants it via a feed;
- (c) Specification of the time of execution of a transaction;
- (d) Bundling of transparency information with other services;
- (e) Announcements relating to "unknown" proprietary mechanisms;
- (f) Publication formats and standards;
- (g) Amendments to published data.

The greater detail of CESR's consultation in these areas, in particular (b), (f), and (g), and the avoidance of duplicate trades, all of which have significant system implications, raises a number of questions more generally:

- i. What will be the status of CESR guidance, and how will CESR expect its members to implement it?
- ii. Will FSA implement it? How would FSA deal with issues such as any competitive implications of CESR's suggested asymmetrical treatment of incumbents and new entrants as regards formats and standards?
- iii. What process will FSA use to transpose any CESR guidance that emerges from the consultation into the Handbook?
- iv. On what timescale will any CESR guidance emerge and be incorporated into the Handbook?
- v. How will FSA conduct cost-benefit analysis as part of this process?
- vi. How will the timing of any further guidance affect the timing of firms' design of systems that integrate trade reporting and transaction reporting obligations, bearing in mind the need for firms to know at 31st January 2007 how the requirements will be interpreted, if they are to be able to make the necessary system changes in time for a 1st November 2007 implementation date, and that adjusting one element of a system to take account of a new interpretation may affect the integrity of the whole system development process?
- vii. On what timescale would any additional interpretations or expectations apply?

We may need to comment to FSA further on these points in the light of our more detailed consideration of CESR's consultation paper.

Comments on Annex 2.7 – 12: Cost-Benefit Analysis

Markets - introduction

As a general comment on the CBA, we observe that costs may be higher than FSA expects, depending on the complexity of the changes involved.

7.17. FSA states that over 90% of retail order flow is largely outside SETS and conducted through RSPs. FSA argues that RSP trades are “on-exchange” solely by virtue of obligation to report trades on exchange. See our comments on paragraphs 14.32 to 14.36 of CP06/14 above: although it is true that the conduct of RSPs’ business is not governed by LSE rules other than the requirement to report trades on-exchange, it does not therefore follow that RSP business is necessarily off-exchange for the purposes of the definition of SI activity.

CBA – Pre-trade transparency

8.5. FSA asserts it will not be possible for firms to execute certain types of transaction without pre-trade transparency, and that this may affect RFQ services. See our comments on paragraphs 14.32 to 14.36 of CP06/14 above, and on paragraph 8.10 of this CBA below. It is important not to assume, because RFQ business is not covered by MIFID on-exchange pre-trade transparency provisions, that it is therefore necessarily either systematic internalisation or excluded from the possibility of falling under a negotiated trade exemption. Whether an activity is or would be systematic internalisation, and whether it is therefore subject to a quoting obligation or excluded from the negotiated trade exemption, should be determined on the merits of the activity itself, not according to whether or not on-exchange pre-trade transparency rules apply.

8.10. FSA estimates that 15% of equity trades (less than 5% by value) would ‘potentially’ not be able to benefit from pre-trade waivers. Without sight of the data on which FSA bases this estimate, it is difficult to assess its accuracy or discuss its substance. However, as explained in our comments on paragraphs 14.32 to 14.36 of CP06/14 and paragraph 8.5 of this CBA above, it is important not to interpret the Directive’s requirements too restrictively.

8.11. FSA’s assessment of the impact of MIFID on RSPs appears to rely on an assumption that RSP activity would be subject to pre-trade transparency requirements. As explained in our comments on paragraphs 14.32 to 14.36 of CP06/14 and paragraph 8.5 and 8.10 of this CBA above, FSA should not assume that this is necessarily the case.

8.16. In the second bullet FSA says that the main cost of being an SI should be the cost of publishing quotes. But other important cost elements will include the cost of capital commitment, risk control, and commitment of staff. In the third bullet: FSA estimates a total cost of £7 million in exchange fees if OTC trades are put on the order book, plus ‘transfer from firms to other market participants’ as a result of benefits of internalisation foregone. The accuracy of these cost estimates appears to depend partly on the assumptions that underlie paragraphs 8.5 and 8.10. To the extent that

those assumptions are not fulfilled it may be that the costs of change will be less than FSA estimates.

8.17-8.18. FSA says there is a wide range of estimates of cost of 'becoming pre-trade transparent'. This may partly represent uncertainties of interpretation, and partly different commercial responses that firms may adopt.

8.19. FSA's estimate of 15 to 20 firms affected, with £20-40 million one-off costs, and £8-20 million annual costs, begs the question on "business that will need to adjust" to the SI regime. FSA should not assume that RSPs would become SIs or otherwise need to become pre-trade transparent.

8.26 We note FSA's conclusion that MIFID pre-trade transparency requirements will result in higher trading costs for investors. It is therefore particularly important not to impose them where MIFID does not require them.

CBA – Post-trade transparency

9.13 – 9.14. FSA expects exchanges to bear most costs (which will be significant) of switching to the new block trade regime. It expects firms' costs to be less substantial, and ongoing costs to be negligible. This analysis focuses on the UK position: firms' costs relating to non-UK shares may be more substantial.

9.16. FSA expects increased cost for firms from more rapid publication of portfolio trades. In order to minimise that cost, we urge FSA to approach portfolio trades as set out in our comments on paragraph 16.50 of CP06/14 above.

Q57. The majority of this analysis was undertaken on the basis of the 6 February text of the Level 2 Implementing Regulation. Some changes have been made with the publication of the agreed ESC text in June. What, in your view, are the material implications, if any, of the Level 2 text changes for our CBA on post-trade transparency?

FSA's analysis is notable for:

- (a) not focusing (except in the academic studies section) on the costs to clients of limitations on delayed reporting; and
- (b) measuring impacts only against current LSE rules.

Changes to Level 2 involving longer delays were intended to diminish the impact on clients of short delays, across the EEA as a whole. They are therefore likely to be beneficial, but the impact needs to be kept under review as provided for in the Level 2 Regulation.

CBA – Post-trade publication by investment firms

10.8 – 10.19. FSA analyses the benefits of competition in trade data publication against the costs of fragmentation and the risks to data consolidation and integrity of greater competition. FSA concludes that the impact of publication obligations will depend on whether trade data are consolidated, and how. FSA estimates cost savings from competition, but costs from risk of data fragmentation. We think that competition is likely to reduce the costs in the medium to long term. The new

competition in trade data publication should see a significant reduction in costs, while the costs of any greater data fragmentation (which is yet to be seen) would be more than compensated by the ability of data aggregators and consolidators to do their job. See our comments on the TDM section of CP06/14 above.

10.22 – 10.29. FSA says that the CBA of TDMs is contingent on industry participation in the scheme. It remains to be seen how firms will respond to the TDM regime. Since the decision to become a TDM will be a voluntary act, and the decision to use it will also be voluntary, is CBA relevant in this context?

CBA - MTFs

11.1 – 11.24. We note that FSA's CBA of MTF trading process requirements implies a correspondence between the existing ATS population and future MTFs. FSA estimates a cost of £27,500 per MTF, with benefits unlikely to be material given existing commercial incentives, and a possible increase in barriers to entry. FSA expects limited benefit from the extension of CAD capital requirements to MTF operators, with additional capital cost at €125,000 – 200,000 per year for affected MTFs. It identifies a risk that some MTFs will exit, and of barriers to entry, leading to reduction in numbers of trading venues. FSA's overall assessment is that there will be no benefits, but significant costs, risking reduced competition. We agree with FSA that there is likely to be an increase in barriers to entry. We note that MTFs, but not RMs, will be subject to CAD requirements, which is likely to be a further barrier to entry in a business which under the MIFID scheme is intended to compete with RMs.

CBA – Wider Market Impact

12.3 FSA does not expect the market effects of MIFID to be substantial, given that existing competition and existing rules address market failures. We welcome FSA's expectation that new regulatory requirements will not impinge on markets.

12.4 – 12.5. FSA expects little increased competition between RMs, though MIFID may put downward pressure on RMs' charges. We agree.

12.7. FSA identifies a possibility of more competition from MTFs and SIs. FSA expects more competitive opportunities, but increased costs, for MTFs. We agree.

12.9. – 12.13. FSA says that the effects of the transparency regime are ambiguous: increased incentives to trade are likely to represent a transfer between participants, not an incremental benefit, with possible decrease in liquidity provision. FSA thinks aggregate spreads across all trading activity are unlikely to be affected. FSA expects limited impact from SIs because of limited retail involvement. FSA expects limited impact from longer delays in reporting block trades because "information leaks out anyway". FSA expects no reduction in provision of risk capital, though "the pattern of its deployment may change". We agree with the last point. In practice we think that firms are more likely to provide more liquidity to more liquid shares (which do not really need the increase) than to mid-cap and less liquid shares (the market in which may suffer accordingly). Where regulatory burdens impinge, firms may be less likely to commit capital for the execution of the orders of certain customers.

12.18. FSA says it does not know the aggregate effect of the markets provisions, but “expects firms to optimise their response”. It expects shifts in where shares are traded because of regulatory restrictions, but no overall effect on the amount of trading or total welfare in the market. “There may be a transfer of welfare from more informed to less informed participants in this market.” We think that this prediction is likely to be accurate. A transfer of welfare from, for example, large institutional investors managing the funds of a very large number of individuals to smaller fund managers may not be beneficial to investors generally.

Comments on Annex 5, Part 2: draft Handbook text

MAR 5 - MTFs

MAR 5.3.2G-5.3.6G. Provisions on transparency in non-admitted shares, and admitted non-shares, are retained. See our comments on 5.3.2G under paragraphs 15.3 – 15.6 above.

MAR 5.7.6G. This provision should be a rule, not guidance, to give proper and binding effect to the implementation of MIFID Level 1 Article 29(2) and FSA's authorisation of waivers of transparency under the Level 2 Regulation as set out in MAR 5.7.7 and 5.7.8.

MAR 5.8.4G. Guidance states that information made public "should" conform to a consistent and structured format based on industry standards, accessible by automated means in machine readable way; facilitate consolidation, and be accompanied by instructions. We note CESR's recognition in its 20th October 2006 Consultation Paper "Publication and Consolidation of MIFID Market Transparency" that the process of doing so may vary between different trading venues.

MAR 5.9.3EU 1(a). FSA should insert cross-references within MAR, rather than to the Level 2 Regulation.

MAR 5.9.4EU 3. This provision needs to be interpreted to take account of the risk attached to a portfolio trade: see our comments on paragraph 16.50 above.

MAR 5.9.6EU. As it stands (in "copy out"), this provision says "deferred publication...may be authorised", but does not say by whom. FSA should insert an "intelligent copy out" Rule which gives effect to the waiver by saying "publication...may be deferred". 5.9.7R on its own is not sufficient to give effect to the waiver. As a separate point, FSA should apply 5.9.7R in the context of 5.7.7EU, so that approvals are granted in an equal manner.

MAR 6 - SIs

MAR 6.3.1EU 3. FSA copies MIFID Level 2 Regulation Article 21(3), but not Level 1 Recital 53 (which says that the characteristics of transactions carried out on an OTC basis include the criteria specified in Level 2 Article 21(3)). FSA should incorporate Level 1 Recital 53 as a Rule, in order to give full effect to the exclusion from SI obligations.

MAR 6.8.5EU 1. In order to provide certainty as to its intended policy, FSA should specify by Rule that it will apply both conditions to the determination of 'liquid shares'.

MAR 6.9.4EU; MAR 6.9.5EU; MAR 6.11.2EU; MAR 6.14.3EU. These provisions should cross-refer to the relevant references in MAR, not to Articles in the Regulation or Directive.

MAR 6.9.6G. FSA should not specify that it would be reasonable for SIs to include a verification process independent of the trading process, systematically and in real time. MAR 6.9.5EU is sufficient to set out SIs' obligations.

MAR 6.9.7G. FSA should not specify by Guidance that SI quotes "should" conform to a consistent and structured format based on industry standards, accessible by automated means in machine readable way; facilitate consolidation, and be accompanied by instructions. MAR 6.9.5EU is sufficient to specify firms' obligations. We note that CESR's 20th October 2006 consultation paper proposes such guidance. However, superequivalent requirements should not be introduced through guidance, and furthermore it will be important to interpret and apply any guidance on this matter in a way that does not constrain SI's ability to control who has access to their quotes.

MAR 6.12.1R(1). FSA wrongly copies out the directive, which specifies only one quote (in relation to a specific share).

MAR 6.13.1R. Should specify more clearly that a SI can decide to give access only to retail clients or only to professional clients.

MAR 6.14.1R; MAR 6.14.2R. These Rules should not be linked to Recital 50 provisions: FSA should delete "within the categories of retail and professional clients".

MAR 7 – Trade reporting

MAR 7.1.4G. See our comments under Chapter 5 above on the need to treat all services provided by a branch to be subject to branch State rules.

MAR 7.2.6EU. Transposing the Level 2 Regulation as "EU" rather than "R" does not work. As it stands (in "copy out"), it says "deferred publication...may be authorised", but does not specify by whom. What is needed is an "intelligent copy out" Rule which gives effect to the waiver by providing that "publication...may be deferred".

MAR 7.2.6EU; MAR 7.2.15G. These provisions should cross-refer within MAR rather than to Articles of the Level 2 Regulation.

MAR 7.2.8EU. "As close to real time as possible" needs to be interpreted to take account of the risk attached to a portfolio trade. See our comments on paragraph 16.50 above.

MAR 7.2.10EU. FSA should reproduce the definition of "trading day" in the Handbook.

MAR 7.2.13G. FSA should not specify by guidance that it would be reasonable for firms to include a verification process independent of the trading process, systematically and in real time, for the purposes of trade reporting. MAR 7.2.12EU(a) is sufficient to specify firms' obligations.

MAR 7.2.14G. FSA should not specify by guidance that information made public “should” conform to a consistent and structured format based on industry standards, accessible by automated means in machine readable way; facilitate consolidation, and be accompanied by instructions. MAR 7.2.12EU(b) is sufficient to specify firms’ obligations.

MAR 7.2.16G. It is not appropriate for FSA to “encourage” firms by Guidance to use an approved TDM. Given that TDMs are intended to be a voluntary scheme, there should be no implication that FSA will enforce Level 2 Regulation Articles 32(a) and (b) more aggressively if firms do not follow the TDM route.

CHAPTER 17: TRANSACTION REPORTING

General comments

(1) FSA should avoid imposing new super-equivalent requirements

There is limited time in which firms will have to make substantial system changes in order to implement MIFID. FSA's approach to transaction reporting should be to continue existing arrangements as far as possible and avoid adding to the burden for firms either by introducing new super-equivalent requirements (e.g. for certain OTC derivatives), or by changing existing system arrangements extensively, where this is not mandated by MIFID. As FSA is aware, implementing even the MIFID minimum requirements will be a significant challenge for firms. Although we accept that FSA's objective in introducing new super-equivalent proposals is to improve its ability to monitor market abuse, we consider that FSA's proposals will not in many cases help to achieve that, while being costly for firms to implement.

It appears to us that the scale of changes FSA proposes in the August 2006 Approved Reporting Mechanism (ARM) informal Discussion Paper and in CP06/14 is partly directed at improving FSA's market abuse monitoring capacity and partly to rationalise the existing diverse methods of transaction reporting, as well as at the need to implement MIFID. However, FSA has not stated this openly in either document. FSA should distinguish clearly between those changes needed to implement MIFID and those which can be implemented over a longer timeframe. (For completeness, we also attach the joint response of BBA, ICMA, ISDA, and LIBA to FSA's August 2006 informal Discussion Paper on Approved Reporting Mechanisms ("ARMs") as an Annex to this response.)

We think that FSA, needing to rely also on transaction reports directed to other regulators, should concentrate its work on achieving a consistent pan-European approach to transaction reporting. We do not think that super-equivalent UK requirements are consistent with the fully harmonised nature of European transaction reporting.

(2) FSA's requirements should be as objective as possible

FSA's requirements on transaction reporting should be set out as objectively as possible, so that it is clear to firms exactly what they need to do to comply. See, for example, our comments below on the distinction between "house" and "client facilitation". In some cases, it may also be necessary for the industry to take a common view about how particular terms should be defined.

(3) All transactions executed through a UK branch should be reported to FSA

All EEA regulators need to be aware that it is likely to be impractical for a branch of a firm from another Member State to report some transactions to the branch country regulator and some to the competent authority in its home Member State: this would happen, for example, if a UK branch of a German bank had to report a trade with a UK counterparty to FSA under FSA rules but to report a trade with a French counterparty under BaFin rules. We believe that Article 32.7 and Recital 37 of MIFID

Level 1 do not contemplate this result and we would urge FSA and other CESR members to agree an interpretation of these provisions which avoids this outcome, so that (contrary to the current position) such a branch would report all transactions executed through the UK branch to FSA. (See our response to Chapter 5 above.)

(4) Enforcement by FSA should take account of long lead times in making systems changes

FSA should take into account the lead times for implementation of systems change in relation to transaction reporting when considering whether a firm is possibly in breach of rule book requirements. Even seemingly minor changes to reporting will take considerable time and cost to action. FSA should equally take account of the fact that firms' transaction reporting systems will be integrated into their upstream and downstream infrastructure. Therefore changes will also have consequential effects on their other systems.

(5) Changes should be planned on a consistent basis across the EEA

FSA focuses solely on transaction reporting requirements in the UK, without taking account of whether they will be consistent with the rest of the EEA. Where extensive changes on transaction reporting are necessary, they should be planned on a consistent basis across the EEA, to avoid multiplying costs for firms doing business in multiple entities or branches cross-border. If each Member State were to impose super-equivalence in areas of its own choice, firms operating across the EEA would have to implement super-equivalence in a very large number of different areas. There is also a need to minimise the degree to which firms would be required to make two separate extensive sets of changes: one to comply with individual regulators' MIFID implementation, and a second to make an alignment between national regulators across the EEA.

Article 25 of MIFID Level 1 should be implemented on a pan-EEA basis as it is a Europe-wide issue. FSA should not seek to introduce extensive changes to the mechanics of transaction reporting in the UK before any necessary work has been done at EEA level to coordinate the approach in different Member States. For example, FSA should not require firms to implement by November 2007 extensive changes to the specification of formats and standards for ARMs that are not coordinated with other EEA regulators, and are additional to the requirements to implement transaction reporting under MIFID.

FSA's requirements for transaction reporting need to be both clear and definitive by 31 January 2007. This will enable firms to spend the period to November 2007 putting new systems in place in order to comply with MIFID requirements. If changes to the transaction reporting requirements were made any later than 31 January 2007, this would be likely result in excessive cost to firms and, given IT lead times, the changes could not be implemented by November 2007.

(6) Essential work by CESR on transaction reporting is needed now, not at the end of 2007

CESR's original Q4 2007 timetable for Level 3 work on transaction reporting would not enable firms to build any harmonised standards that CESR might agree into their MIFID implementation plans. Any work by CESR on a Q4 2007 timescale, if it were to avoid successive major system changes for firms across the EEA, would need to take account of the bespoke mechanisms that would by then already have been developed by national regulators. In order to conform to the requirements of individual Member States, firms would already have completed extensive and costly system changes. In planning for that contingency, FSA and CESR should consider what scope there would be to use conversion engines so that harmonisation could take place in a way that would not necessitate substantial successive system changes.

It seems that there has so far been a lack of co-ordination between CESR's pan-European agenda and individual Member States' approaches to the same tasks, though we understand from FSA that CESR has now set up an expert group to address the issue, with a target around the end of the first quarter of 2007. However, CESR's revised Level 3 work programme, dated 20 October, includes for transaction reporting some workstreams that are planned for completion, not just in Q1 2007, but in Q2 2007. Workstreams planned for completion in Q2 2007 include: the list of financial instruments and the list of "markets"; and additional content of transaction reports (i.e. instrument specificities, trading methodology specificities and identification of the client). This is too late for firms, which need to have clear and definitive requirements by 31 January 2007 in order to be able to implement them by the due date.

CESR's earlier work has focused solely on arrangements for the exchange of transaction reports between CESR members rather than minimising differences between national requirements. If Member States do not co-ordinate their transaction reporting requirements across the EEA, the potential complications and costs for regulators, and for firms that will be attempting to meet their transaction reporting obligations in up to 28 jurisdictions, are self-evident.

We would be grateful if FSA would discuss with the industry, as soon as possible, the practical implications of any information it has available on: what standards, formats, and types of super-equivalence other CESR members propose to apply for transaction reports; what standards and formats other CESR members propose to apply to ARMs; how similar these standards are to those that FSA plans; what scope there is, and on what timescale, to approximate or harmonise standards; and how significant the systems and other costs would be to effect those changes. We need to know this so as to gauge changes to standards and formats for transaction reporting that FSA foreshadowed in the ARMs paper; changes to standards, formats, and types of super-equivalence in CP06/14; and any plans that CESR may have for future harmonisation of standards. This is important not only for firms which operate internationally but also for all other firms needing to adapt transaction reporting systems to meet new FSA requirements.

In order for firms to avoid serial changes under the MIFID timetable, it is important for CESR to bring forward its programme of Level 3 work (in comparison with the current timetable) on:

- (a) Ensuring the same approach to approving reporting channels, so that a channel which is approved in one Member State can also be used in others.
- (b) Ensuring that firms do not have to report the same data to two separate authorities.
- (c) Gathering and making available comparative information on the mechanisms, formats, and standards that CESR members are using, or propose to use, for transaction reporting under MIFID, including information about transaction reporting requirements that go beyond the MIFID minima, as regards types of instrument or data fields. Comparative information will be an essential preliminary to any further work on harmonising standards and formats.
- (d) Establishing and maintaining a cross-EEA list of instruments admitted to trading, so that firms are aware whether a transaction reporting obligation exists for an instrument. However, in some markets the range of instruments admitted to trading is so wide that some firms may judge that it is easier to report all transactions than to establish a system to identify those which are not reportable.

When designing its systems for exchanging transaction reports between its members, we suggest that FSA proposes that CESR should take account of the connection between streamlined exchange of data between regulators under MIFID and the streamlining and coordination of firms' reporting requirements to the relevant competent authority in the first place. The greater the disparity in the content, format, and data standards of the original reports, the more costs international firms will incur in meeting different national requirements, and the more complex it will be for CESR's system to eliminate differences before transaction data can be exchanged.

FSA also needs to take account of the fact that regulators in many Member States do not have as sophisticated a transaction reporting system as exists in the UK. Therefore there should be some transitional arrangements created and agreed by CESR.

Detailed comments on Chapter 17

Definition of a reportable transaction (17.10-17.13)

17.10: We assume that the change from "entering into transactions" in the current Handbook to "executing transactions" in 17.10 and SUP17 derives from FSA's copying out the MIFID wording. We assume that the change does not imply any change in the scope of transaction reporting, and we ask FSA to discuss the matter with us if this is not the case.

Q45: Do you think that FSA's proposed approach provides firms with sufficient guidance to determine whether they should report transactions to FSA?

Q46: If not, what further information would you require?

Q47: Do you think it would be more appropriate for this guidance to be placed in FSA's proposed Transaction Reporting Users Pack?

Guidance in the Handbook carries much more weight than in an *ad hoc* transaction reporting users pack. However, the industry would not be opposed to guidance being given in a Transaction Reporting Users Pack that was not part of the FSA Handbook as long as there was a clear written declaration from FSA that firms could rely on the Pack in future and that it was subject to an equivalent consultation process to Handbook guidance.

Whatever form FSA's guidance takes, the industry should be given the opportunity to review it in draft as soon as possible; it should be co-ordinated with other Member States; and it should be definitive by January 2007 in order to allow firms time for implementation.

As regards the need for additional guidance from FSA, it would help firms if it could be made clear that, having reported a transaction to the relevant competent authority, a regulator in another Member State would not have the right to require further information from the firm about the same transaction. It would also be useful for FSA to give firms additional guidance and specific examples on when they are executing a transaction for reporting purposes. This has a particular impact for transactions executed cross border or between the branch or branches and "parent" company of a firm. In firms' view, transactions executed between branches of the same legal entity are out of scope of the transaction reporting obligations, as would be any other "internal" trades.

In addition, it would be useful to have guidance on the meaning of the term "execute" in the context of an executing broker (who may also have arrangements with EEA or third country members of local exchanges to execute transactions on its behalf) and a clearing broker providing services to a client under an International Give-up Agreement or other similar give-up/clearing arrangements. This would help eliminate the current confusion in this area and possible duplication of reporting. In particular, it would be helpful if such guidance could confirm the informal view given by FSA that a "clearer" does not execute a trade and is not responsible for the reporting (or failure to report) of the executing broker.

17.12-17.13: FSA should be aware that reporting volumes may increase in the light of the qualifying exchange exemption being terminated. It will be very onerous for firms to create/maintain a universal reference table to cross reference non-EEA securities to those with an EEA listing (i.e. admitted to trading on a regulated market) and therefore reportable. This is particularly pertinent for bonds, where there are dozens of takedowns from Medium Term Note (MTN) programmes every day, leaving aside new issuance. The cost of updating and maintaining such a list would be far out of proportion to any benefit. A typical large firm has estimated that the cost of establishing a system to distinguish EEA from non-EEA securities, assuming that static data is available, would be in the order of €250,000. Firms may therefore take the view that it would be less onerous for them to report all transactions regardless of whether they have an EU listing or not. We assume that over-reporting would be an

acceptable practice for FSA, and it would be helpful to have FSA's confirmation of this.

Means of making, and content of, a transaction report (17.14-17.28)

17.23: We believe that FSA's proposal to require transaction reporting in the format "HHMMSS" is too prescriptive and is super-equivalent. Firms use a multiplicity of systems across their various businesses and, whilst they all record "HH" and "MM", they do not all currently record "SS". FSA will appreciate that, for firms which do not currently record seconds, changing the basic format of a range of different systems to include seconds would be an enormous task, equivalent to the work done by firms over a much longer time period in preparation for Y2K compliance. In addition, clocks within different systems (and different firms) would never be sufficiently aligned to enable conformed transaction reporting of seconds.

Any requirement to change other field structures and formats would have a significant impact on firms' ability to meet FSA's requirements. We therefore urge FSA to keep any such changes to the absolute minimum necessary to comply with MIFID requirements.

17.24: We have three comments on FSA's proposal to use ISINs as the unique security code, and not any other security code (e.g. CUSIPs and SEDOLs). First, secondary market activity in new issues forms a significant portion of daily activity, and it is not uncommon after a new issue at present for the ISIN code not to be published for several days. This would clearly affect firms' ability to report transactions in time under MIFID.

Second, in 17.24 FSA suggests that, where a firm executes a transaction in a derivative admitted to trading on a regulated market which relates to an underlying instrument which has an ISIN, it should include (presumably in field 8 of SUP 17 Ann 1) the ISIN of the underlying instrument. SUP 17.4.4G suggests that, where a derivative has more than one underlying instrument, the firm should (for the purposes of field 6 - this presumably should refer to field 8) identify the most dominant underlying instrument or a representative underlying instrument.

Paragraph 17.21 states that MIFID imposes the requirement to include for a derivative transaction the security code of the underlying instrument. The requirement of the MIFID Regulation for transaction reports to identify underlying instruments is wholly new and could be extremely burdensome. But MIFID only requires transactions in financial instruments admitted to trading on a regulated market to be reported. By definition the only reportable derivatives will be those trading on a regulated market. The details of the underlying are inherent and part of the standard terms of the derivative contract. FSA should be able to obtain these directly from the relevant regulated market rather than require each firm to report separately. For example, it would be unnecessarily burdensome for firms to seek to identify the instruments underlying EuronextLIFFE or Eurex index futures or options, when this information is clearly available to FSA by other means. This could be achieved by making an exemption to completing field identifier 8 for "Underlying Instrument Identification" where the Instrument itself is an exchange traded derivative (see SUP Ann 1 table).

It seems to us that there is no need for firms to seek to identify the underlying security or instrument in the case of derivatives contracts listed on regulated markets. FSA should reduce the burden on firms by declaring that the information on underlying instruments is already in its possession or is available to it by other means in accordance with Article 13(1) of the MIFID Level 2 Regulation.

Similarly, we believe that, where a firm executes a transaction in securities such as warrants or exchangeable bonds which are admitted to trading on a regulated market, FSA should already have in its possession, or available by other means, the information on the underlying securities through access to the prospectuses or other public information about the characteristics of the instrument. There is no need to impose a requirement on firms to identify this information.

While we welcome the guidance in SUP17.4.4G as an attempt to reduce the burden on firms, it illustrates that for a large number of instruments this field will not generate useful data (for example, it will be difficult to identify a “dominant” or even a “representative” underlying instrument in relation to an index future or warrant). This suggests that FSA should seek to reduce the burden of these requirements on firms to the extent practicable.

A typical large firm has estimated the cost of developing systems to capture and report underlying reference ISIN codes on OTC derivatives and single name credit derivatives in the order of up to €1 million.

Third, some firms are concerned that there is a risk that some software vendors may not be ready, or have sufficient resources, to make the necessary systems changes by November 2007: e.g. the new requirement for ISIN codes re the underlying. We are aware that FSA has a software vendors’ panel relating to its IRR project, and urge FSA, if it has not done so already, to ensure that software vendors are fully engaged in understanding and implementing the changes to transaction reporting.

Finally, it would be helpful if FSA would keep commodity market participants informed about progress on its work with the LME on a possible market feed for transaction reporting, as this is a significant issue for them.

Which competent authority the firm should report to (17.29-17.31)

Firms that are EU branches will be among those most significantly affected by the changes involved in implementing transaction reporting under MIFID. These firms are expecting to have to build new systems infrastructure in their home Member State to cater for the new reporting requirements there. However, this work cannot progress far until there is reasonable certainty of what the new home state rules will be. This is likely to be significantly later than when FSA clarifies its position. Thus firms designing their group-wide reporting systems are almost certainly going to have to invest in some kind of (manual and expensive) interim solution for their London branches to cope with the probable earlier onset of FSA rules. In the medium term, firms would expect to extend the use of their new systems in the home state to cover London branch trading. Clearly, however, the greater the difference in the UK requirements, the more expensive it will be to adapt new systems to cover them.

Issues for EEA firms with UK branches: Firms also have a general concern over the lack of clarity about the requirements for UK branches of EEA firms, which is impeding progress on implementing the changes required under MIFID. As discussed in our comments on Chapter 5 above, we favour an interpretation which treats all services of the branch as provided “within” the State in which the branch is located: examples of the specific issues that face firms absent this interpretation are discussed below.

If a customer of the UK branch is located outside the UK, would a transaction with the customer be deemed to be executed in the course of “the services provided by the branch within the territory where the branch is established” and hence reportable to FSA? Would the position change depending on:

- (a) the location of the exchange on which the trade was executed (e.g. a contract on EuronextLIFFE London or Eurex Frankfurt);
- (b) the means by which the customer places the order (e.g. an order routing customer whose orders go directly to the exchange);
- (c) where the trade is booked or accounted for?

Other Member States may not require transaction reports from UK branches if their trades are reported to exchanges: as differences exist in respect of the recognised reporting systems, there is need for both clarity and common EU standards.

Issues for branches of UK firms established in other Member States: CP06/14 refers to the problems faced by UK branches of firms from other Member States carrying on investment business in the UK. Clearly, absent an interpretation that treats all services of the branch as provided “within” the State in which the branch is located (see above), UK firms that have exercised their rights to passport will also encounter difficulties if the UK has different reporting requirements to the Member States in which they have established branches and the branch is required to provide transaction reports to the host state for business conducted in that Member State and to FSA for all other business (e.g. cross border services carried on by the branch).

Also, if a branch of a UK firm located in another Member State trades on a UK exchange, will FSA, to whom the exchange reports the transactions be able to pass relevant information to other EU regulators or would the branches have to report directly?

Remote members of UK exchanges located in other Member States: Linked to the above issue is the question of branch members of exchanges (or MTFs) using the regulated market (or MTF) to report their trades to the regulator in the country where the exchange is located, which would then report them on to the branch’s host state regulator – they, unlike their parent, might otherwise require separate reporting systems to transaction report to the host state competent authority those trades that they do in or from the host state.

Q48: Do you agree that EEA-passported branches established in the UK when providing services within the UK should have to comply with the FSA's transaction reporting rules?

We note that the treatment of branches is still under discussion. However, FSA should be aware that it is likely to be impractical for a UK branch of a firm from another Member State to report some transactions to FSA and some to the competent authority in its home Member State: this would happen, for example, if a UK branch of a German bank had to report a trade with a UK counterparty to FSA (on the basis that this related to a service within its territory) but to report a trade with a French counterparty to BaFin (on the basis that it related to a service not provided within the UK). We believe that Article 32.7 and Recital 37 of MIFID Level 1 do not contemplate this result and we would urge FSA to agree an interpretation of these provisions which avoids this outcome, even if it results (contrary to the current position) in such a branch reporting all transactions executed through the UK branch to FSA.

In particular, we note that the second paragraph of that Article indicates that the competent authority of the Member State in which a branch is located has the right to enforce the obligations in specified articles, including Article 25, with respect to “the services and activities provided by the branch within its territory”. This provision seems more appropriate to the application of Article 25 than the first paragraph of Article 32.7, as that paragraph only requires the branch State to ensure that “the services provided by the branch within its territory” comply with the requirements of the specified articles. However, it is by no means clear, on the face of it, that this would extend to transaction reporting requirements as these do not directly relate to the service provided. It does seem natural to regard the “execution” of a transaction by a branch to be an “activity” provided within the territory of the Member State where the branch is located. This suggests that a branch should report all transactions executed in the branch to the Member State in which the branch is located. We would encourage an outcome where regulators work co-operatively to exchange information between themselves as required, and provide as much clarity to firms as possible.

Reporting obligations not required under MIFID

Definition of a reportable transaction (17.33-17.36)

We disagree with the proposal to require reporting of transactions in OTC derivatives whose underlying is a debt or equity instrument admitted to trading on prescribed/regulated markets. As a matter of general principle, we do not think that FSA should be seeking to impose super-equivalent requirements in this way, in the absence of a compelling cost-benefit analysis. In particular, while firms currently report transactions in OTC derivatives related to debt or equity securities, this proposal would now require firms to categorise all their OTC derivatives by reference to whether they do or do not relate to debt or equity securities admitted to trading on a prescribed/regulated market (and only report those that do).

It may not always be that easy to determine whether or not transactions have an underlying which includes securities admitted to trading on prescribed/regulated markets, in particular in relation to basket or index transactions in equity securities

and credit default swaps where there might be large numbers of underlying securities (e.g. indices or baskets of non-European stocks may include just one issuer that happens to have shares admitted to trading on a prescribed/regulated market). In relation to credit default swaps, typically the buyer of protection will be able to deliver any outstanding bond of (or guaranteed by) the underlying issuer on the happening of a credit event. Some issuers have large numbers of outstanding debt securities. In some cases, it may be difficult to determine whether the underlying issuer has (or has guaranteed) bonds admitted to trading on a prescribed/regulated market at the time the contract is entered into (of course, even if it does not have any bonds so admitted to trading at the time of the transaction this may occur at a later stage). This would be even more difficult in relation to credit default swaps on baskets or indices or more complex composite transactions.

We believe that it would be expensive for firms to build and maintain the systems to enable them to identify which transactions to report, and FSA's proposals could lead to over-reporting. Moreover, it is illogical to single out OTC derivatives in this way. There may be bonds, warrants or other securities which are not admitted to trading on regulated or prescribed markets but which reference underlying instruments which are so admitted.

In any event, if these super-equivalent requirements are to apply:

- (a) The proposed wording which specifies that the obligation extends to OTC derivatives "the value of which is derived from, or which is otherwise dependent upon" an equity or debt-related financial instrument admitted to trading on a prescribed/regulated market is too broad in so far as it suggests that it is enough that there be a mere correlation between the price or value of OTC derivative and an instrument admitted to trading on a prescribed market. If there is to be an obligation to report, FSA should make clear that the obligation only arises in relation to OTC derivatives whose contractual terms specifically reference a relevant underlying instrument.
- (b) There is no need to require the firm to identify the underlying instruments in field 8 for these types of transactions. No cost-benefit analysis is put forward for this entirely new requirement and, as indicated (above in relation to 17.24), in many cases it would provide no useful information.

Admission to trading: The requirements on transaction (and trade) reporting depend on being able to identify which instruments are "admitted to trading" on a regulated or prescribed market. FSA should, as soon as possible, confirm that instruments are not treated as "admitted to trading" on a regulated or prescribed market merely because they are capable of being traded on such a market.

For example, under the rules of the London Stock Exchange (LSE), a transaction by a member firm in an "international equity market security" may be treated as "on exchange": i.e. executed on the international equity market operated by the LSE (which is a prescribed market but not a regulated market). However, the definition of an international equity market security encompasses, among other things, an equity security of any company which is incorporated in or has its principal office in a country outside the UK, the Isle of Man and the Channel Islands and which is

officially listed, or listed or traded under the rules of a registered organisation, other than a domestic market security or one admitted to trading on AIM: i.e. broadly speaking, any equity listed or traded under the rules of any of the major world exchanges.

Similar issues arise in relation to bonds. A transaction by an LSE member in a “fixed interest security” may be treated as “on exchange”: i.e. executed on the gilt edged and fixed interest market operated by the LSE (which is a prescribed market and a regulated market). However, the definition of a fixed interest security encompasses any security, other than a gilt-edged security, which carries a right to a stated rate of interest or dividend on an annual or other periodic basis and which is officially listed, or listed or traded under the rules of a registered organisation: i.e. broadly speaking, any bond listed or traded under the rules of any of the major world exchanges.

We doubt that FSA envisages that transactions in OTC derivatives on such a broad class of equities/bonds should be regarded as transactions which should be the subject of a transaction report. This will also be important in relation to the question of whether or not it is necessary to transaction or trade report transactions in the underlying instrument.

Content of a transaction report (17.37-17.38)

Q49: What do you think the impact of this change would be?

We would like further clarity on what is meant by “a unique and consistent internal reference code”. In many cases, the client does not have a BIC or equivalent; as it is on a variety of different bank systems, it is not possible to give it a single identifier per client across all asset classes because there will be a number of differing trading and operational platforms in use that do not necessarily share client static data. The implementation of a single source of static data with the interfaces to existing reporting mechanisms would require significant investment on behalf of firms. A typical large firm has estimated the cost, for the UK alone, of mapping existing client data into a single client identifier and building a technical infrastructure in the order of €4 million, and the cost of linking the system to the transaction reporting infrastructure in the order of €300,000.

17.38: FSA proposes a super-equivalent transaction type identifier: “CDS”. In principle, we are opposed to such super-equivalent requirements. Even if the cost of implementing this particular requirement were relatively small, the costs and increased complexity could become significant if other Member States followed FSA by imposing their own requirements. Chapter 17 does not identify any significant benefits to FSA in having this additional information.

Q50: Are the relatively modest costs outlined in our CBA for FSA’s addition of a new requirement to identify credit derivatives consistent with what firms will have to do in order to comply?

Q51: In your view, do the benefits of identifying this type of instrument justify the costs?

Firms are opposed to super-equivalent requirements to report OTC, and especially credit, derivative transactions (see above). It is hard to see what benefits FSA would derive from this information, if it was provided. But it would also be complex and costly to provide it. It is not clear how credit derivatives would be defined. The costs of changing systems to provide the information requested by FSA would be much higher than FSA's CBA suggests. A typical large firm has estimated the cost of systems development to be able to identify and report this information in the order of €100,000. Every super-equivalent provision added by FSA will increase London branches' costs and give impetus to transferring more trading activity from London to their home Member States or to branches elsewhere. It is only relatively recently that firms have been migrated to TRS and seemingly firms will be required to react to a further iteration of transaction reporting requirements.

Indeed, we question whether the MIFID Regulation allows FSA to impose super-equivalent requirements of this kind. The Regulation aims to achieve harmonization and specifically states those areas where Member States are permitted to go beyond its requirements in relation to transaction reports (e.g. Article 12(4) and Table 2, Annex 1). Those provisions would be redundant if Member States were free to add super-equivalent requirements.

Firm capacity (17.39-17.40)

Q52: What do you think the additional cost of requiring firms to identify the capacity in which they trade as principal (i.e. client facilitation or house account), will be?

This requirement would represent a very substantial additional cost for firms. Estimates from typical large firms for the cost of system changes alone needed to be able to distinguish in transaction reports between house account and client facilitation are in the range of €1 million to €2 million per firm. Even developing a system to identify trades on house account only would still cost in the order of €300,000.

It is not clear exactly where FSA would delineate between principal and client trades: for example, whether client facilitation is intended to capture transactions undertaken purely on receipt of a firm order or whether it also includes transactions undertaken in a trading book in anticipation of a client order. Drawing a distinction between principal and client trades would require a person rather than a machine to determine. It would go against the idea of straight through processing (STP) and its associated benefits. These definitional issues are particularly relevant in the area of client facing traders who may purchase securities in anticipation of client demand but without a confirmed client order. Given the volume of transactions this would be not only very expensive but also impracticable. If FSA were to go ahead with this proposal, it would need to determine clearly what trades it would see as principal trades and in a fashion that can be coded into firms' existing systems.

Even the more limited proposal to require firms to report a separate principal category might impose unnecessary and complex changes on firms' trading arrangements, and undermine systems and controls designed to reduce the risk of market abuse. For example, one firm has concluded that implementation of even the more limited superequivalent reporting requirement would force it to change its actual trading and

booking arrangements in ways that would impair the firm's existing system and controls, including those designed to reduce the risk of market abuse. Its small proprietary desk only deals directly with external counterparties when it inputs orders for on-exchange derivative contracts into the trading system of its clearing broker.

All its other trades are done through other product teams with the subsequent position backed out into its books via matching internal book entries. From a compliance point of view, this arrangement has the benefit of avoiding any potential conflict or misunderstanding arising between different desks trading the same products. It also means that desks handling client transactions or orders can always handle them appropriately vis-à-vis the firm's own proprietary trades. If FSA were to require that proprietary trades should be reported separately, the only practicable way for this particular firm to achieve that would be by ending the existing arrangement and requiring its proprietary traders to conduct all their own trading directly. Thus a proposal intended to improve FSA's access to data for anti market abuse intelligence purposes could have the perverse effect of increasing the risk of market abuse actually occurring in the first place.

Q53: Do you think that this cost is outweighed by the benefit of FSA's being able to monitor more accurately trading by firms?

There would be a substantial additional cost without any benefit. The monitoring of market abuse needs to focus on price anomalies and outlier transactions or unusual patterns. However, the house/client split would provide virtually no useful information about this, and yet would be very complex and expensive to introduce because the decision about the house/client split would be more subjective than objective. Different firms would interpret it in different ways: the suggestion that "risk allocation" determines the distinction would mean that some firms would probably never report anything under the "principal for client facilitation". In the data sharing model between competent authorities, FSA would not receive this designation on activity that was initially reported to another regulator.

Any house/client split would need to be objective, and public policy would need to be very clearly justified, given that it would be a very difficult split to engineer. Introducing such a split would involve a major piece of IT work (including possible changes to business flows) and would need to be set out in detail at an early stage, given the long lead times needed to implement it. In particular, it would be very expensive to undertake the IT work necessary for a firm to be able to identify and accurately report any proprietary business resulting from the firm's sales trading desk "by default", where client orders cannot be completed and executions are held on the book until completion.

Since FSA's proposal is super-equivalent to MIFID, its introduction could, and should, be delayed unless and until it is agreed as part of an EU-wide standard for transaction reporting. There is no justification for introducing it now, given the tight deadline to which the industry is already working. In addition, information will be available after the event in the firm's records that would enable FSA to examine the motivation of any suspicious transactions that it did identify. Furthermore, as introduction of the new capacity identifier would not consistently be made available to FSA, additional analysis is required to find a solution that is reasonable for firms to implement and would consistently provide FSA with the information required. The

analysis and discussion on this point should be separated from the implementation of MIFID.

If FSA were to change its requirement from reporting transactions on the house account and client facilitation to reporting only transactions on the house account, this would not overcome the problem for firms, as the definition of the house account would still not be an objective one. The same difficulties of splitting out the house account would arise. And the resulting transactions reported would not provide useful information to FSA in monitoring market abuse.

We also question whether the MIFID Level 2 Regulation allows FSA to impose super-equivalent requirements of this kind (see above).

Means of making a transaction report (17.41-17.46)

Q54: Do you think the potential costs imposed by requiring firms to notify FSA of their proposed reporting system will be minimal?

Yes.

Material removed from the Handbook (17.47-17.48)

Q55: Do you have any views on this proposed additional obligation?

Yes, it would be complex and expensive to change from baskets to the underlying constituents. It is also not clear exactly what FSA means by “basket”, and it would be useful to have examples as to how the proposed obligation would apply to both “index” and “bespoke” baskets. Basket trades are not broken down internally, and therefore this proposed obligation would require new systems both upstream and downstream for firms and intermediaries. A typical firm has estimated the cost of developing systems to capture and report this information in the order of €600,000.

Reporting the constituent elements of a basket trade separately could also be misleading in several respects. The basket is priced as a whole, so prices for constituents will be estimates. If the purpose of the basket trade is to replicate an index, it could be misleading to report individual dummy trades underlying it separately. It might be necessary to use a basket trade to hedge a position on an index which included a share which was under takeover rules or subject to Takeover Panel restrictions which prohibit trading in that share without clearance. Since omitting the share from the index basket would mean that the firm would take a position in the stock concerned, the Panel has allowed such shares to be included, provided that the trade is part of a basket trade and the basket is representative of the index. However, if the transaction were required to be reported as if it were a separate trade, it might give the impression that the firm was trading in prohibited securities.

In addition, greater clarity is required on which constituents of a bespoke basket transaction would be reportable. Reporting the dominant underlying is not simple to derive, especially on portfolio swaps, and would be costly for firms to implement while providing minimal benefit to FSA.

FSA should also be prepared to face increased volume of transactions from the MIFID as a result of the proposed change. Baskets can have a significant number of underliers, and reporting these individually will place an increased cost for firms to report this activity on an on-going basis. The constituents may not all be admitted to trading in Europe; FSA will not have a view to what was traded in its entirety. We oppose this for the reasons given in our answer to Q52-Q53.

Comments on Annex 2.13: Cost-Benefit Analysis

Q58: Do you agree with FSA's estimates?

No. We have asked a range of larger firms to cost a selection of the proposed requirements. We believe FSA's estimates to be substantially underestimating the cost of these changes. See in particular the cost estimates in our comments above on paragraphs:

17.12-13 (removing non-EEA-listed securities from the transaction reporting population) - €250,000 per firm;
17.14-28 (underlying ISIN codes) - €1,000,000 per firm;
17.37-38 (unique client identifier) – up to €4,000,000 for some firms;
17.37-38 (credit derivatives) - €100,000 per firm;
17.39 (firm capacity) - €1,000,000 to €2,000,000 per firm, or €300,000 to identify house trades alone; and
17.47 (basket trades) - €600,000 per firm.

One firm has commented that the bulk of its estimated total costs (over €5 million) for implementing MIFID transaction reporting requirements according to FSA's Chapter 17 proposals would be attributable to the superequivalences that FSA proposes, with a heavy IT component and a large number of different systems affected.

Against these costs, firms do not consider that there will be any significant benefits in the form of information that would be useful for detecting market abuse. We would be willing to discuss with FSA how best it can improve its monitoring of market abuse, but we suggest that this should be done as a separate workstream which does not divert scarce resources away from urgent MIFID implementation tasks.

Q59: Do you have any views on the implications of FSA's proposals? What are the drivers of the potential cost to your firm of FSA's proposals relating to the identification of transactions as being undertaken for a house account or for a client?

See the text of our response above.

Q60: The majority of this analysis was undertaken on the basis of the 6 February text of the Level 2 Implementing Regulation. Some changes have been made with the publication of the agreed ESC text in June. What, in your view, are the material implications, if any, of the Level 2 text changes for our CBA on transaction reporting?

We do not think that there are any changes of any major significance in this area.

New Recital 11 provided that ISO 10962 is an example of a uniform internationally accepted for instrument classification. BBA, ICMA, ISDA, and LIBA expressed concern in their response to FSA's ARMs discussion paper about the proposal to require reports to make use of this standard.

The amendment to Article 9(1) clarified that most relevant market in terms of liquidity applies only to instruments admitted to trading on a regulated market.

The amendment to Article 9(6)(b) extended transaction reporting to cover contracts whose underlying is a money market instrument.

The amendment to Article 10(2) extended the most relevant market in terms of liquidity to cover instruments in respect of which an instrument in Article 9(6)(a) or (b) is the underlying.

The additions to Article 11 required competent authorities to make lists of instruments available from beginning of June 2007, and RMs to provide identifying reference data. This seems helpful.

The amendment to Article 12(1) required non-electronic reporting in a medium which allows storing in a way accessible for future reference by competent authorities.

The amendment to Article 14(1)(b) affirmed the right of competent authorities not to receive transaction reports under Level 1 Article 25(6).

The amendment to Article 14(5) required competent authorities to report to the Commission in February 2007 rather than November 2007 on the design of arrangements for exchange of information. This seems helpful.

Comments on Annex 5, part 2: draft Handbook text

See also our comments on Chapter 17 above.

Annex 5, Part 2, Annex D SUP17.1.5R: States that SUP 17 applies to ‘transactions executed in the United Kingdom’. See our comments under Chapter 5 above about the treatment of transactions transmitted by a branch to the head office for execution.

Annex 5, Part 2, Annex D SUP17.2.4G : We query whether it is appropriate to impose additional expectations in the form of guidance on firms to verify aspects of the reliability of information reported by an RM, MTF, or Approved Reporting Mechanism.

Annex 5, part 2, Annex D SUP17.4.1EU: FSA should state how it will make the declaration that information is or is not already in its possession or available by other means.

Annex 5, part 2, Annex D SUP17.4.4G: See our comments on paragraphs 17.14-28 above.

Annex 5, part 2, Annex D SUP17 Ann1 EU, Table 1, No 5: We welcome FSA’s helpful clarification of the MIFID trading capacity terminology as corresponding to ‘principal’ or ‘agent’.

ANNEX:

BBA, ICMA, ISDA, and LIBA response to FSA's August 2006 Discussion Paper on Approved Reporting Mechanisms ("ARMs")

Key underlying issues and dependencies as regards FSA's proposals on ARMs, CP06/14, and CESR Level 3 work:

1. There is little time to implement substantial system change on a broad range of MIFID implementation issues. There may be enough time to put in place MIFID minimum requirements, but not to combine these with other complex changes that are not absolutely necessary for MIFID implementation.
2. FSA's approach in transaction reporting, as in all MIFID implementation areas, should therefore aim to continue existing arrangements to the extent possible, and avoid adding to the burden either by adding superequivalent requirements, or changing existing system arrangements extensively where change is not mandated by MIFID.
3. We understand that the scale of changes FSA proposes in the ARM discussion paper and CP06/14 is partly directed at improving its market abuse monitoring capacity, partly to rationalise the existing diverse methods of transaction reporting, and not just by the need to implement MIFID. FSA should explain whether there is a regulatory failure that justifies proceeding with such an extensive set of changes in addition to those which are necessary for MIFID implementation.
4. Where extensive changes are necessary, they should be planned on a consistent approach across the EEA, to avoid multiplying costs for firms doing business in multiple entities or branches. FSA should not seek to introduce extensive changes to the mechanics of transaction reporting before any necessary work has been done at EEA level to coordinate the approach of different countries. There is a need to minimise the degree to which firms would be required to make two separate extensive sets of changes: one to comply with individual regulators' MIFID implementation, and a second to accomplish any alignment between EEA regulators.
5. FSA should therefore not try to squeeze into the period before 31st October 2007 both what is needed for MIFID implementation of transaction reporting and extensive additional changes to the specification of formats and standards for ARMs that are not coordinated with other EEA regulators.
6. It should be clear at 31st January 2007 what firms are required to do, so that they are able to spend the February to October 2007 period putting new systems in place to comply with MIFID requirements.
7. FSA's (and other EEA regulators') work on ARMs and transaction reporting requirements, and any CESR Level 3 work on harmonising standards, needs to take account of the constraints of the timetable and the need to avoid subjecting firms to two different sets of extensive system changes in close succession. CESR's Q4 2007 timetable would not enable firms to build any harmonised standards that CESR might agree into their MIFID implementation plans. Any work by CESR on a Q4 2007 timescale, if it were to avoid mandating successive major system changes for firms across the EEA, would need to take account of the fact that by then EEA regulators would already have developed their own bespoke mechanisms, to conform with which firms would already have completed extensive and costly system builds or system changes. FSA and CESR should consider what scope there is to use conversion engines to resolve the harmonisation question in a way that will not necessitate substantial successive system changes.
8. We have the impression that FSA has developed its ARM proposals and its arrangements for implementing MIFID's transaction reporting requirements to meet its domestic policy objectives, and to date with little interaction with the pan-EEA agenda of CESR or how other Member States are approaching the same task, and that CESR's current work has focused solely on arrangements for the exchange of transaction reports between CESR members. If

each member of CESR operates in this fashion, the potential complications and cost for regulators, and for firms that will be attempting to meet their transaction reporting obligations in up to 28 jurisdictions, are self-evident. In order to gauge the interaction between FSA's proposals for

(1) changes to standards and formats for transaction reporting in the ARMs paper;

(2) changes to standards, formats, and superequivalences in CP06/14; and

(3) any plans that CESR may have for future harmonisation of standards,

we would be grateful if FSA could discuss with us the practical implications (not only for firms which operate internationally and need to design systems to report transactions to multiple jurisdictions, but also for all firms which would need to adapt transaction reporting systems to meet new FSA requirements) of any information it has or is able to obtain on:

- a) what standards, formats, and superequivalences other CESR members propose to apply for transaction reports;
- b) what standards and formats other CESR members propose to apply to ARMs;
- c) how similar those standards are to those that FSA plans;
- d) what scope there is, and on what timescale, to approximate or harmonise standards, and how significant the systems and other costs would be to effect those changes.

9. If serial changes are to be avoided under the MIFID timetable, CESR should start work now (rather than on the timescale set out in its consultation on MIFID Level 3 work) on:
 - (a) Ensuring the same approach to approving reporting channels, and ensuring that a channel which is approved in one Member State can also be used in others;
 - (b) Avoiding duplication of reporting rules;
 - (c) Gathering and making available comparative information on the mechanisms, formats, and standards that CESR members are using or propose to use for transaction reporting under MIFID, including information about transaction reporting requirements that go beyond the MIFID minima, as regards types of instrument or data fields. Comparative information will be an essential preliminary to any further work on harmonising standards and formats.
 - (d) Establishing and maintaining a cross-EEA list of instruments admitted to trading, so that firms know whether a transaction reporting obligation exists for an instrument or not (though in some markets the range of instruments admitted to trading is so wide that some firms may judge that it is easier to report all transactions than to establish a system to identify those which are not reportable).
10. When designing its systems for exchanging transaction reports between its members, CESR will need to take account of the connection between streamlined exchange of data between regulators under MIFID, and the streamlining and coordination of how firms are required to make those reports to the relevant competent authority in the first place. The more disparity there is in the content, format, and data standards of the original reports, the more cost international firms will incur in meeting different national requirements, and the more complex it will be for CESR's system to eliminate discrepancies and superequivalences before they can be exchanged.

Comments on the ARMs DP

11. The primary transaction reporting obligation falls on investment firms. Firms' obligation to report transactions continues regardless of whether ARMs provide them with a conduit to do so or not. Firms must be able to configure their systems to be able to report through ARMs.
12. As FSA acknowledges in paragraph 2.10 and 3.3 of the DP, at least in the short term firms will place extensive reliance on ARMs to fulfil their transaction reporting obligations, as they do on "Permitted Reporting Systems" (PRSS) at present.
13. The timeline in Annex 1 of the DP allows only very limited time for any changes to systems that may be needed as a result of MIFID requirements. FSA should phase its programme to approve ARMs early enough that PRSS have the information that they need to decide how to proceed, and early enough for firms themselves to react to PRSS' decision whether or not to become an ARM, and the systems consequences of doing so. There needs to be enough time for ARMs to develop and test any changes to systems interfaces with reporting firms and

FSA, and for firms to develop and test any changes to systems interfaces if they need to move to a different ARM or a third party. FSA should consider carefully whether a 31st December 2006 deadline for PRSs to indicate whether they plan to apply for ARM status, and a 1st July deadline for ARM approval, leaves firms enough time to plan alternative arrangements if any PRSs decide not to apply to be ARMs.

14. The proposed timeline in Annex 1 of the DP assumes that all ARMs will be approved, but paragraph 5.4 contemplates that FSA may refuse to approve an applicant until conditions have been met, and paragraph 5.14 explicitly contemplates the possibility of suspending an ARM which did not comply with MIFID requirements, which FSA says “would imply that firms that report their transactions through this ARM would have to find other means to submit their reports”. Given the short timescale available to implement MIFID provisions, the long lead times associated with firms’ IT development, and the need to avoid duplicate transaction reporting, FSA should proceed on the general presumption that existing PRSs will become ARMs unless major failings emerge, and that it will work through any problems that arise, rather than proceeding directly to deny ARM status.
15. We understand, having discussed with FSA that statement in Paragraph 2.10: “We are aware that some firms currently rely on a combination of reporting systems to fulfil their transaction reporting obligations and that those arrangements are unlikely to be tenable in the post-MIFID regime”, that FSA means that it expects that in future firms are likely to need to make any single transaction report through a single system, rather than reporting some of the information about the transaction through one system, and some of it through another. We understand that it is not FSA’s intention to prevent firms from continuing to rely on different reporting systems for different instruments. Given that we understand FSA is thinking of imposing similar standards on regulated markets and MTFs, there is a need to consider whether this approach is achievable as regards exchange-traded commodity derivatives.
16. FSA should ensure that its decisions about ARMs’ status do not leave firms without efficient mechanisms through which they are able to fulfil transaction reporting obligations. FSA should ensure that firms are not expected to devote substantial resources on a short timescale to develop alternative reporting mechanisms as a result of being deprived of the mechanisms which they currently use. The requirements from MIFID Level 2 Regulation Article 12 set out in paragraph 3.4 (security and confidentiality of data, error correction, source authentication, recovery from system failure, format and time limits) are all such as we would expect existing PRSs to be able to satisfy. FSA should also interpret the monitoring requirement in such a way that it does not impede the ability of PRSs/ARMs to continue to provide current services efficiently.
17. Annex 3b of the discussion paper on ARMs appears to signal an extensive range of changes to many of the field formats and data standards that Permitted Reporting Systems currently use. The List of ARM fields for reporting purposes in Annex 3b of FSA’s informal discussion paper envisages a number of changes to the formatting of data fields (some of which are referred to in CP06/14, though others are not). For example:
 - (a) In a number of fields (14: strike price; 15: price multiplier; 16: unit price; 18: quantity) FSA proposes numeric fields of up to 19 characters, which may be more than firms’ systems are set up to provide at present.
 - (b) Field 10 (instrument type) requires that the type must be ‘at least as granular as the ISO 10962 CFI scheme: the full ISO scheme is more extensive than MIFID requires (only the top level categories), and would require more characters
 - (c) Field 6 (instrument identification) uses the same field for either an ISIN number, another local code, or description of the instrument
18. As explained in the section on key underlying issues and dependencies above, FSA should minimise the extent of change to existing reporting fields and formats, in order to reduce the amount of work that needs to be done to effect change in the limited time available. This applies to TRS as well as other ARMs. To the extent that FSA wishes to make changes to the format and content of data fields in the short term, FSA should examine the scope for doing so

by applying conversion engines to data provided by ARMs or firms, rather than by imposing change elsewhere.

19. FSA should explain how it will ensure that TRS will be independently audited, subject to the same objective assessment as other ARMs, and subject to truly independent oversight when operating as an ARM.

25th August 2006