

# virt-x *compliance*

## The cross-border exchange



Newsletter from  
virt-x Regulation & Compliance Department

June 2002  
Issue 4

We hope you will find this fourth issue of virt-x *compliance* a useful source of information and we welcome your comments and suggestions.

Emma Vick  
Director of Regulation and Compliance

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## MARKET NOTICES

Of the Market Notices issued since No 315 and up to No 344, please note that the following have not been included in the Rules, Directives or standing data:

Market Notice Number	Date	Content
320	28 March	Grace period for reporting Swiss securities within 30 minutes extended for a final time. At the end of the grace period, all off-order book trades to be reported within 3 minutes
329	3 May	Threshold for Exchange Traded Funds ("ETFs") for block trades and enlarged risk trades: EUR 4 million or US\$ 3.6 million
342	24 June	CREST is a settlement venue for FRESCO ETFs (w.e.f. 1 July 2002)

## UPDATES TO RULES AND DIRECTIVES

virt-x has updated the following Rules and Directives:

Rule/ Directive	Date	Market Notice(s)	Content
Rules 7.5 and 7.6	Effective from 6 May	317 and 323	Introduction of market making rules in respect of ETFs
Directive 4	Effective from 6 May	329	ETFs: thresholds for hidden size orders: EUR 1 million or US\$ 900,000
Directive 9	Effective from 6 May	329	Pan-European Equities Tariff renamed Pan-European Tariff and made applicable to ETFs
Directive 17	Effective from 6 May	323	ETFs: market making form and agreement

All Market Notices are available at [www.virt-x.com](http://www.virt-x.com) under the Member section at Notifications & Forms. All Rules and Directives are available on the web site under the Regulation section.

## **LOW VOLUME TRADES**

The virt-x Compliance and Surveillance department recently undertook a review of one-share transactions as a routine procedure following comments from some market participants concerning such transactions with a volume of only one share. The review was also aimed at establishing whether any such transactions were indicative of market abuse related to derivative products.

Our enquiry revealed many reasons for these types of transactions, including order routing and basket/portfolio trades.

However, the most common reason for low-volume transactions was to discover the identity of the counterparty behind a bid or an offer placed on the order book. Members largely find this behaviour objectionable and we concur with their assessment. In the interests of improved market practice, and the fact that these trades are clearly uneconomical, a number of Members ceased this practice with immediate effect.

Low volume transactions traded with the intention of affecting the price of a derivative instrument are clearly unacceptable. virt-x's Compliance and Surveillance department continuously monitors the market for transactions which could amount to such abuse.

It is not possible to give a general answer as to when a low volume transaction is justified. Each trade should be considered separately in relation to its circumstances. Members are recommended to seek guidance from virt-x Compliance if in doubt regarding the legitimacy of a particular trade.

## **TRADE REPORTING DEADLINES**

As members will be aware, virt-x's Rule 3.1 requires that virt-x members enter trade reports for off-order book transactions within 3 minutes of the transaction. In respect of Swiss securities only, the FSA granted a grace period during which reports for off-order book transactions in Swiss securities could be made within 30 minutes of the transaction.

Market Notice No 320 issued on 28 March 2002 informed members that the FSA will grant one further extension to this grace period. The FSA expects to reach a decision within the next few weeks on the expiry of the grace period. virt-x will inform members by issuing a further market notice confirming the duration of the extension once it has been notified by the FSA.

## **INTERNALISATION AND BEST EXECUTION**

The review of the Investment Services Directive ("ISD") and related regulation has prompted a thorough review of the entire landscape of financial regulation in Europe. One of the more contentious issues to arise from this review has been that of internalisation – the practice of a firm matching incoming client orders against other client orders or against its own book.

At virt-x, we are of course wholly in favour of free competition (that's a cornerstone of our existence!) and our view on internalisation is centred around protection of the rights and interests of investors – we think that internalisation cannot be viewed in isolation from the broader issues of market integration, investor protection and best execution. This raises two fundamental questions. First, whether internalisation is in the best interests of the retail customer. Secondly, does the creation of a separate pool of liquidity inhibit order interaction, and therefore market integration and the price formation process?

The latter question recognises that order interaction is both the engine of the price formation process and the heart of market integration – the ultimate end of market integration is the interaction of orders across national boundaries. Ideally, all orders would meet and interact in a consolidated montage of orders from across the range of trading venues. Having said this, a certain degree of internalisation will always occur and may not be a bad thing as long as it does not occur on such a systematic and widespread basis that liquidity is significantly damaged.

The question is how to ensure that a retail customer is not disadvantaged by having his order executed “in house”. After all, European investors should be entitled to have their orders executed at the best price in Europe, not the best price of those orders that happen to have gone through the same bank. In other words, internalisation must be subject to best execution requirements for retail investors.

This will only be effective if the standard of retail best execution is clearly defined. Broad standards such as “the customer’s best interests” will be too vague to apply and enforce. Lacking the sophistication and resources of institutional investors, retail customers must not be deprived of a better net price available outside their firm - unless the customer specifically waives execution at the better price. We believe waivers will be rare (at least among retail customers) but must be accommodated.

In sum, internalisation is a very complex issue. The sensible answer is neither to prohibit all internalisation nor to permit unfettered and unregulated internalisation. Rather, we must strike a balance which avoids dividing the European market into separate and isolated pools of liquidity in which the investor’s profitability is subject to the pool in which his order is taken. The best net price must always be the best net price in Europe.

## **TOPICS FOR FUTURE COMPLIANCE NEWSLETTERS**

We would welcome any topics for inclusion in future issues of the compliance newsletter. Please contact us with your suggestions.

Thank you!

<p>Please address any comments or questions to <a href="mailto:compliance@virt-x.com">compliance@virt-x.com</a> Tel: 44 (0) 20 7074 4545 - Fax: 44 (0) 20 7074 4532</p>
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