

THE REFORM OF THE ISD: KEY FOR EUROPEAN FINANCIAL SERVICES

Summary: The existing Investment Services Directive was finalised ten years ago in 1993. For a decade, the Directive served as the “constitution” of Europe’s securities markets. While seeking to respond to technological and structural changes properly, the new legislative project has to address two other acknowledged shortcomings of the existing Directive: its patchy implementation and loopholes in the mutual recognition of the passport which failed to eliminate cross-border barriers to the provision of investment services; and the lack of flexibility due to the absence of swift and flexible adaptation and implementation facilities.

In order to meet the Lisbon objective to make the European financial markets the most competitive in the world, it is essential that the new ISD finds the right balance in several aspects: between the need to facilitate competition and customer choice and the maintenance of appropriate levels of investor protection; between mutual recognition and measured levels of harmonisation of rules and, last but not least, between core principles at Level I (ISD level) and implementation legislation at levels II and III.

The Investment Services Directive (ISD) is the legal instrument for translating into practice the Treaty freedoms in respect of investment services and organised trading in financial instruments. The current Directive, which was drafted in the early 1990s, established the conditions by which authorised investment firms and banks located in one Member State could provide specified investment services in other Member States on the basis of their home state authorisation and prudential regulation. Conversely, Conduct of Business Rules, governing firms’ relationships with clients remained subject to host country competence. In addition, the Directive established remote cross-border access for investment firms to exchanges and permitted national authorities to mandate execution of transactions by local investors on the local exchange, seen at that time as useful for the price formation process. Approximately half the EU’s Member States availed themselves of this so-called “concentration rule”, though in most cases with important exemptions for wholesale business.

Uneven implementation of the Directive across the EU’s Member States and the continued application of both home and host country regulation signalled the need for an upgrading of the ISD passport. The concentration rule was viewed by most as preventing real competition between exchanges and between exchanges and alternative trading venues. The Commission’s proposal for revising the ISD is intended to meet that need for change.

Effective implementation of the Lamfalussy principles and changes that have taken place in the trading environment, for example the demutualising of most and listing of several exchanges, are felt to require a somewhat different approach to a revised ISD. In this approach, the desire to ensure that these changes do not impair high standards in appropriate investor protection must be matched by an equal determination to avoid any regulatory prejudice or favouritism. Any mismatch in this respect would jeopardise attainment of the equally important objectives of improving market efficiency and enabling commercial and financial organisations to fulfil the single market objective of making Europe the most competitive economic region in the world. If the new ISD is not grounded in the commercial realities of today and does not facilitate the opportunities of the future, this objective, at least in financial services, will not be achieved.

Key challenges in drafting an upgraded Investment Services Directive include:

- Creating a truly integrated single market for investment services by removing barriers to entry and fostering a competitive environment. The revised ISD intends to remove barriers “without fear or favour” and avoid any regulatory bias for or against any particular type of structure, participants, or process save only when they are justifiable on proven grounds of systemic risk or investor protection.
- Allowing innovation through competition, competitiveness through flexibility, and quality through appropriate oversight. European issuers and investors need highly efficient markets that keep the cost of capital low and investment returns high.
- Maintaining and enhancing the quality of liquidity of European securities markets so that they can serve as one of the EU’s greatest assets in global competition.
- Providing an adequate level of protection for those investors that need and want this protection while enabling investors to make informed decisions with regard to his or her choice of investment, execution venue, investment firm, clearing and settlement route, etc.
- Meeting the Lamfalussy principle of “proportionality”, including the test whether provisions differentiate adequately according to the nature and risk of a business and the type of parties to a business relationship. In this context, it is important that the right balance is found between Level I principles, on the one hand, and implementation measures, on the other hand, which should be passed on to Levels II and III for reasons of flexibility or their technical nature.
- Enabling retail investors to fully benefit from an integrated market. In fact, while technological advances have made the cross-border provision of investment services feasible, such activity, especially for retail investors, is often prohibitively expensive.

Market Structure

The regulatory approach in the ISD is based on the continued commercial differentiation between “regulated markets” and “investment firms”. The former are subject to trade monitoring and “proper market” standards, while the latter are subject to strict capital requirements and “business conduct” rules, such as client suitability and best execution. In framing the draft proposal, the Commission has sought to anticipate future developments in European market structures.

- Firstly, through the introduction of MTF (Multilateral Trading Facility) operators which, depending on their business profile, replicate a brokerage or exchange functionality. Here, the Commission relies heavily on the previous work undertaken by FESCO (now CESR) on obligations for Alternative Trading Systems.
- Secondly, by introducing new reporting and order-handling rules for banks and investment firms and limiting membership of MTFs and regulated markets to eligible counterparties – a fairly limited category of institutions that, for example, would not necessarily include most institutional investors.

Scope of the ISD

The scope of the ISD has been enlarged to include:

- the provision of investment advice (which, as a low risk activity, justifies a reduced regulatory burden);
- a revised approach to “reception and transmission of investor orders” which, although falling short of “arranging”, will catch new forms of distribution;
- commodity derivatives (with certain exemptions for specialist commodity derivatives dealers);
- “own account” counter parties dealing on a regular professional principal-to-principal basis;
- the business of operators of Multilateral Trading Facilities.

The proposed inclusion of the provision of investment advice, while requiring amendment, has not raised significant concerns. On the other hand, concern has been raised that if the relevant exemptions to the inclusion of commodity derivatives are not carefully drafted, certain types of specialist commodity dealers may become subject to disproportionate capital requirements. The inclusion of own account dealings has also raised questions over the extent to which there may be an (unintended) consequence of extending the requirements for financial services authorisation to organisations which should properly be regarded as “customers”.

Order-handling rules, pre- and post-trade transparency

The draft ISD imposes transparency requirements on “regulated markets” and “investment firms”. The two-year consultation focused on finding the specific rules for investment firms that would generate meaningful information for investors while not leading to excessive costs or reduced choices for the customers.

With respect to investment firms, the provisions additionally stipulate that:

- Investment firms will report on completed transactions in real-time (“post-trade reporting requirement” – Art. 26). Deferred reporting is permitted in the case of large/illiquid trades. Such reporting obligations currently exist in France, Italy and the UK though not in all other Member States.
- Investment firms engaged in off-exchange trading (whether on an agency or principal basis) will be required to display client limit orders (“limit order display rule – Article 20.4);
- Investment firms will be required to make public and update on a continuous basis “retail-size” two-way quotes and be obliged to deal with any counterparty for the securities in which they provide liquidity, whether on- or off-exchange (“mandatory quote rule” – Article 25);
- Investment firms will be required to obtain and annually renew the explicit consent of the customer to off-exchange execution (Article 20.3).

There is some division amongst regulatory authorities, exchanges and trade associations over what is the best means of ensuring efficient price formation and investor protection without damaging market liquidity or limiting the ability of commercial enterprises to compete either on price or by offering an alternative business model to that of a traditional exchange.

The proposed requirements obliging firms to deliver best execution, manage conflicts of interest and comply with client instructions, taken together with the proposed post-trade publication requirements, have all been designed to ensure price transparency and orderly functioning markets. Different views exist regarding the expected possible effect of pre-trade publication of retail client limit orders for the price formation process (Article 20.4). Some believe additional

mandatory quoting obligations (as proposed by Article 25), introduced in the last stages of the Commission's drafting process, would further contribute to the formation of prices. Others fundamentally question this assessment and express concern that such rules would introduce a disproportionate level of regulation, increase legal risk and restrict investors' choice.

Conduct of business (COB) rules

Conduct of Business rules apply to investment firms (and MTFs) and have an important role to play in setting appropriate standards of investor protection. Under the current ISD, as generally implemented, service providers are subject to the COB rules of the Member State in which the client is located. However, home state authorities have tended to apply their own rules in addition, creating a patchwork of rules for regulated firms to adhere to, and allowing scope for discriminatory application of rules to incoming services. In its opinion of March 2001 (Kauppi Report, reinforced by the Katiforis Report), the European Parliament called for full application of the country of origin principle to COB rules.

There is some provision in the draft proposal for a "lighter touch" regime in the case of professional customers (subject to their consent). However, a number of market participants have identified areas where the proposals could be made less onerous. Specifically:

- because of inadequate coverage, dealings with professional counterparties will still, in some cases, be overlaid by retail rules;
- the definition of eligible counterparties is generally considered rather narrowly framed e.g. it does not include national governments, central banks, specialist commodity dealers;
- the principle of reliance on home state regulation, although rightly extended to cover business conduct rules, does not cover the important issue of counterparty classification;
- while the retail-professional classification – urged by the European Parliament in its early work on the ISD in 2001 – is to be strongly welcomed, the COB rules still need to be better differentiated by customer type. In some cases dis-application of a rule (for example, the best execution rule) for professional investors should be explicitly allowed;
- the suitability assessment obligation (the obligation to check the suitability of a transaction order with the risk profile and background of the customer) is presently proposed to apply not only to investment advice but also to execution-only or direct offer business. In the case of such services the firm executes orders on behalf of the client without any form of advice making the suitability assessment unnecessary. It would moreover prevent the development of simplified investment products based on execution-only and leaflet sales.

Regulation of Regulated Markets

Regulated Markets encompass a broad set of functions which vary from country to country and represent a distinct organisational form which may embody several sets of particular trading features. They are often assigned a role in vetting the quality of instruments admitted to trading and participants in the trading systems and, like other market participants, in ensuring orderly market activity.

Rules governing Regulated Markets need to be defined in a manner that is flexible and wide enough to cater for the variety of market models available today and foreseeable in the future.

For example, extending the ISD to commodity derivatives markets without recognising the particular structures of these highly specialised wholesale markets could create consistency problems within the Directive.

The earlier FESCO Standards for Regulated Markets, which form the basis for today's ISD proposals, had the advantage of being principles to which national regulators could adhere flexibly and which could be changed relatively quickly by FESCO/CESR Members. As with other sections of the directive, the European legislator is thus presented with the challenge of finding the right balance between true "high-level principles" at Directive level, implementation measures on level II and the right degree of well-supervised implementation flexibility on level III.

The ISD takes account of the structural changes in the landscape of Regulated Markets in Europe, both in terms of governance and business-orientation of market operators and of cross-border co-operations and mergers. The questions of access to regulated Markets, and of interference by regulators into strategic and business decisions of markets and their operators are among the areas that warrant additional attention in the current legislative process. The ISD standards must in no case stifle competition or innovation.

Briefing notes are prepared by the Industry Advisory Committee to the European Parliamentary Financial Services Forum. For further information on the subjects raised in the briefs please contact the Chairman, Members or Secretariat of the Advisory Committee.

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Robert Goebbels, MEP
Chris Huhne, MEP
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Alexander Radwan, MEP
Peter Skinner, MEP
Theresa Villiers, MEP

Chairman Advisory Committee

Paul Arlman
Federation of European Securities Exchanges
Rue du Lombard 41
B – 1000 Brussels
Tel: 0032 2 551 01 80
Fax: 0032 2 512 49 05
E-mail: arlman@fese.be

Secretary

John Houston
Houston Consulting Europe
Avenue de la Joyeuse Entrée 1-5
B – 1040 Brussels
Tel: 0032 2 504 80 40
Fax: 0032 2 504 80 50
E-mail: info@houston-consulting.com

Founding Members

Richard Balfe MEP	C.A. Gasoliba I Bohm MEP
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