

ISD – A KEY TO MARKET INTEGRATION?

Summary: The revised Investment Services Directive (ISD) or Directive on markets in financial instruments (FIMD) as it is officially known, is without doubt one of the most hotly debated parts of the Financial Services Action Plan (FSAP). This is not surprising since it provides the architecture for the securities industry both wholesale and retail across Europe, and since it aims to provide harmonised regulation, at a relatively detailed level, for diverse European market structures which currently operate, and are regulated, in very different ways.

1. Background – A simple overview

It is worth starting with the European Commission's descriptive statement about what it perceives the objectives of the revised ISD to be, and what it will achieve. In October 2003, after the Council meeting, the Commission welcomed the Council's political agreement and noted that "the proposed new Directive will increase harmonisation of national rules and give investment firms an effective 'single passport', which would allow them to operate throughout the EU on the basis of authorisation in their home Member State. It would also make sure investors enjoyed a high level of protection when employing investment firms, wherever in Europe they were located. It seeks to establish, for the first time, a comprehensive regulatory framework governing the organised execution of investor transactions by exchanges, other trading systems and investment firms."

The revised ISD is one of the first Directives to follow the so-called 'fast-track Lamfalussy process' designed to cater for Directives being framed at a high level of principles allowing more detailed implementing measures and rules to be legislated in a faster procedure by the European Commission, based on advice by the Committee of European Securities Regulators ("CESR"), and subject to the assent of the European Securities Committee. For the time being, there is only a scrutiny right and a sunset provision for the European Parliament. Further implementation work should be undertaken by regulators among themselves (Lamfalussy level III). Despite the aims of the Lamfalussy process, it is interesting to note that the first ISD comprised 32 Articles, compared to 73 Articles in the revised ISD.

2. Did the first ISD achieve its objectives?

Looking back to the early 1990s and the first ISD, it is worth observing the following points:

- Investment (and economies) were largely country and not sector based. Fund-raising/IPOs were country-based and not cross-border.
- Trading floors existed in most Exchanges, but electronic order books were slowly becoming established
- Industry consolidation among investment firms and infrastructure providers was just starting; consolidation of Exchanges took place on a national level, but not across borders.
- Clearing and settlement (across-borders) was very expensive
- Stock Exchanges were governed and/or owned by their users and some had closed memberships

- Securities regulation was largely addressed on a national, not European, level. Many Member States have a much lighter regulatory framework on such issues as authorisation requirements (including for cross-border services) and regulation of wholesale financial services. Conduct of business rules varied enormously, and product regulation was also at an early stage. The emphasis was on self-regulation, and many exchanges were competent authorities.

The outcome from the first ISD was mixed. The regulators defined their frameworks - differently- but remote membership was allowed for the first time. Remote membership provided the essential regulatory underpinning for European exchanges and investment firms to take advantage of new trading possibilities created by technology and volume. The newly emerging regulatory regimes across Europe were generally prevented by the ISD from discriminating against cross-border competition. Firms were gradually able to rationalise their wholesale trading activities, and markets could use technology to offer membership to firms across the continent. Today the European wholesale trading activities in many firms are organized along sectoral lines rather than by national market. For the wholesale markets, therefore, European markets are, with the help of the first ISD, relatively integrated, though some costly barriers and duplicative regulation undoubtedly remain in some specific areas.

For retail markets the evidence of the first ISD having boosted market integration is less compelling. It is debatable whether the 'passport' for ISD firms works. The absence of a clear 'country of origin' regime and the ability of the host state to impose additional requirements ('invoking the general good') have not helped. The continued requirement to comply with 15 different sets of host country rules on conduct of business and other reasons beyond the scope of ISD - including settlement, tax, corporate actions, and legal structures - have combined to thwart the passport for retail financial services.

The great opportunity of a single financial market place was not created by the first ISD partly because of national barriers erected or maintained to protect national traditions, structures, and institutions, often of a monopolistic character.

3. What are the main changes in the revised ISD from the first ISD?

The changes resulted from an extensive consultation exercise, including two Commission Communications on which the European Parliament passed resolutions in 2001. They are in the main areas of the Directive: in its scope, in issues relating to investment firms, and in the provisions relating to markets. There are also important provisions surrounding the strengthening of regulatory co-operation and information sharing.

a. Scope

The scope is extended from the first ISD to include investment advice, commodity derivatives and tied agents. Also, in a significant change to the first ISD, the Council common position text would require ISD licensing not only of firms providing services to third parties, but also of other firms or investors dealing on own account, in a capacity that does not involve services to third parties.

b. Investment Firms

In theory there are stronger passport rights and country of origin conduct of business standards will apply in most cases, transaction reporting is strengthened and harmonised, new best execution standards are introduced (including mandatory disclosure of execution policies), order

handling standards are also introduced and there are detailed provisions to define eligible counterparties and professional clients, so that lighter regimes can be applied to them. For firms that internalise shares (i.e. deal with their customers on a principal rather than agency basis) a new mandatory quoting obligation is proposed as well as new restrictions on price improvement and new rules on open access.

c. Markets

The concept of regulated markets that had over the past decades been introduced in most EU legislation on financial markets, is strengthened and new standards for regulated markets and their operators are being introduced. For markets, the concentration rule, which permitted Member States to mandate that all execution of domestic retail orders take place on a regulated market, is removed. There are new standards for the operation of multilateral trading facilities (MTFs). The revised ISD aims at level-playing field regulation of a variety of execution venue types, including Regulated Markets (exchanges), multilateral trading venues (MTFs), and internalisation systems. There are new provisions on both pre-trade and post-trade equity transparency and on transaction reporting. Finally, there are two high level provisions regarding access to clearing and settlement.

d. Harmonisation

An important aspect is that through extensive use of the Lamfalussy process the revised ISD lays the groundwork for detailed harmonisation of many areas of Member State regulation, including conduct of business rules, trade reporting, and management of conflicts of interest. This can in principle have benefits for the integration of European markets. But Member States will remain free in all areas to impose additional national rules on top of those prescribed by Community law so that, depending on the approach Member States take, important divergences might remain.

4. The revised ISD – outstanding issues

As already noted, the revised ISD is one of the first directives to follow the Lamfalussy process. Unlike previous directives, the Commission's Proposal benefited from extensive prior consultation. This is reflected in the fact that as the second reading begins, only a small number of issues remain under discussion. There are, of course, important differences between the common position and the Parliament's first reading position, which appears to have been given little weight by the Council. Political agreement in the Council was reached on a split vote. Interestingly, there is probably more consensus on the right way forward within the industry (including both European Exchanges and investment firms), even if some important differences remain, reflecting different market structures and regulatory traditions. Perhaps the most significant outstanding issues are:

Internalisation (Article 4.1.7 and Article 27)

At first reading the Parliament focused on a definition of internalisation (Article 4.1.7) carried out continuously within a system in a 'standard market size'. The Council's definition is broader, and probably captures, in a broad sweep, most off-exchange liquidity provision below block size. Differences remain, closely linked to the definition of internalisation in Art. 4(1)7, over the quoting and dealing obligations of those that internalise systematically (Article 27). The common position defines a high threshold for the quote size (probably up to block size) which is unrealistic for public quotes. This risk would be further increased by the lack of efficient protection against multiple hits at the same (large) quote, especially by competitors.

Some fear that the practical effect might be that for larger trades up to the threshold size firms would not be willing to provide liquidity by taking on positions from investors, thus reducing the overall attractiveness and liquidity of European markets and causing more expensive and less flexible execution for investors.

A further discussion is focused on the ability of systematic internalisers to offer improved prices to customers. Proponents of price improvement, which is currently permitted, see the practice as a natural competitive instrument vital to the fulfilment of best execution requirements, that delivers eventual benefits for all investors. Others take the view that the practice could undermine the information content of the published quote and make it more difficult for investors and brokers in their search for the execution venue that delivers the best price. The Parliament's approach in First Reading was to allow price improvement without restrictions. This contrasts with the Council's approach not to allow price improvement for retail and restrict it for professionals. For Second reading, the rapporteur has explored a possible compromise, by establishing a general rule of no price improvement for retail clients (execution at the quoted price) unless justified by specific circumstances and eliminating the restrictions for professional investors, with additional oversight for regulators on pricing to reassure those that believe that quotes could be meaningless if price improvement was not controlled.

Advisory and Non-Advisory Services (Article 19.5 and 19.6)

On this issue, the approach of the Parliament and the Council is also very different. The Parliament opted in First Reading to simply distinguish between advisory and non-advisory/execution-only services, allowing regulators to fix the details but clearly establishing that suitability (and thus the need to monitor clients' activity) was not required for non-advisory services. However, the Council has established three types of services levels: (1) full advisory where suitability and continuous monitoring will be required; (2) for so-called "complex instruments" an assessment by the firm on whether a product is "appropriate" on a continuous basis – these requirements being legally speaking very similar to a full suitability test; (3) non-advisory/execution-only services restricted to very few products (shares traded only in European markets, plain-vanilla bonds and UCITS and other non-complex instruments) and only if provided "at the initiative of the client or potential client". The concept of "at the initiative" creates legal uncertainty for providers. The issues at stake for Second Reading, as outlined above, are major given the success of cheap execution-only services in Europe in providing access to major global exchanges such as the NYSE. The Council common position text could curtail the ability of investors to decide how to manage their own risks, and reduce the range of instruments they have access to for this purpose.

Regulated Markets (Article 5.3 and Recital 50)

It is not clear (article 5.3) whether Exchanges should be permitted to operate "secondary" market segments (i.e. market segments that do not aspire to be Regulated Markets) on the basis of their Exchange licence, or whether they should be subjected to a separate authorisation procedure. What is important for market participants is that Europe's Exchanges have the possibility to provide their clients with a flexible variety of market segments. Furthermore, bringing Regulated Markets under the scope of the revised Capital Adequacy Directive (CAD III) – as proposed in the common position (recital 50)– could render the discussion process about that directive even more complicated than it seems already to be.

Country of Origin and Home Country Control; branches regulation (Article 32)

The Directive's application of country of origin regulation is broadly welcome. However, there are concerns that home State regulation (rather than country of origin regulation) of cross-

border services provided by branches could discriminate against the freedom to provide services through branches (Article 32).

5. Next steps

EU institutions have two months to agree and adopt a final text, if an agreement is to be found before the Parliament elections. The need to achieve an appropriate compromise between Parliament and Council on the issues outlined above, and to ensure that uncontroversial but essential technical improvements are made in areas such as the treatment of commodity derivatives, poses a challenge to each of the institutions. It will be important to ensure that the democratic and technical input that the Parliament has provided is given due weight in contributing to the Final Directive.

A further area where Parliament and Council will have to reach agreement is on the appropriate degree of delegation of issues to Level 2. Related to this point, the Commission published in January its draft mandates requesting CESR's advice on implementing measures. While the revised ISD will likely be adopted by the summer, a great deal of work will remain to be carried out in agreeing as many as 20 implementing measures, especially as the Commission's mandates contain a very large amount of detail on issues that CESR must consider. Furthermore, CESR is asked to do this before the final outcome of some important issues such as best execution has been decided.

6. Conclusions: is the revised ISD a key to market integration?

The debate over the revised ISD has been hotly contested and is not over yet. There are some simple measures that will determine whether the revised ISD will provide the key to market integration and these include the following:

- Investors: will they have a real choice of execution services, brokers and custodians, access to all EU securities, and lower overall costs ie true 'best execution' but at no compromise to adequate protection of their interests? Might the revised ISD, instead of delivering a more integrated market in securities services, have the effect of reducing liquidity in certain classes of securities by introducing new restrictions?
- Investment firms: will they have free choice of and access to markets and market data as well as to information about issuers, access to EU clients, access to clearing and settlement infrastructure, lower costs, and ability to develop innovative services that investors, in Europe and worldwide, demand?
- Exchanges: will they have access to brokers and investors and vice versa, to clearing and settlement infrastructure, the freedom to admit securities in differentiated market segments, and an ability to disseminate data on a reasonable commercial basis?
- Corporates: will they have adequate access to admission on regulated markets and to inclusion into trading on other systems as well as to capital at the lowest feasible cost? What will be the effect of the revised ISD on their cost of capital, which is closely linked to their liquidity in the relevant securities markets?
- Regulators: will they have the possibility to exercise their regulatory and supervisory duties, will they consult openly, share information and co-operate effectively and regulate proportionately, in the best interests of investors and issuers, of intermediaries and markets?

In conclusion, it is not only the revised ISD that will provide the key to market integration since there are many other obstacles remaining. Barriers such as tax, legal (including contractual), clearing and settlement and cultural differences all play their part. But ultimately, while legislation and regulation can assist, they will not be the drivers of real integration and it will be markets and their participants (investors, issuers, and intermediaries) who will deliver the true benefits. That is why it is vital that the revised ISD should be a measure that opens up European markets and expands investment opportunities within a well-regulated, but not over-regulated, framework.

Briefing notes are prepared by the Financial Industry 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 Financial Industry Committee.

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